

OPTIONAL FEDERAL CHARTER: A REMEDY FOR AMERICA'S ANTIQUATED INSURANCE REGULATORY SYSTEM

by

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Our Dysfunctional Regulatory System. The current state-based insurance regulatory system is a mismatched patchwork, each jurisdiction having its own set of rules — for very minor things, as well as for important operational issues. There are different rate and form regulatory requirements for various lines of insurance. Informal regulatory practices, known as “desk drawer rules,” impose additional, often needlessly onerous, procedural requirements. As a result, companies wishing to launch a national product cannot do so until both price and product have been separately approved in every state in which that product will be offered.

While this antiquated regulatory system remains in place — substantially hindering insurers’ ability to adapt and better serve consumers — the legal and economic financial services environment in which insurers operate is changing at breakneck speed. If the insurance industry cannot keep pace, the economy suffers. Insurance underpins and provides essential security for businesses and individuals to innovate, invest, and accept risk. Consumers ultimately pay more for less adequate risk protection than they would under a more uniform, efficient, market-driven, and dynamic regulatory system.

The current state regulatory system imposes significant direct and indirect costs, including:

- higher compliance costs associated with non-uniform regulations and multiple enforcement requirements;
- complex corporate structures needed to accommodate unique regulatory regimes;
- delayed implementation of new products and pricing changes, due to multi-state regulatory delays; and,
- less competition due to entry, exit, price, and product approval barriers that have been erected in numerous states.

A Regulatory System Based on Price and Product Controls. An insurer’s operational costs associated with doing business in multiple state markets are burdensome enough. From a socioeconomic perspective, price controls that are part of the current system are at the root of the problem. Use of government price controls in

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the 21st Century is archaic and fails to maximize consumer welfare. Indeed, it is a well-established economic reality that price controls do not work except in very narrow, specialized cases. They should be considered the regulatory tool of last resort after all market-based efforts have failed.

Government price controls are dangerous precisely because they sever the connection between actuarial risk and price, distorting the marketplace and the role of risk signals. Once established, price controls become a permanent fixture because of surface political appeal — and insurance pricing becomes a political tool, rather than the product of a market-based economy. This key factor has accelerated the construction of the most dysfunctional regulatory system of any major industry in the United States. Insurers alone — not airlines, railroads, trucking firms, banks, farms, securities dealers or any other enterprise in a competitive environment — must operate within a regulatory system seen as a relic of disproved, discarded economic theory.

The Failure of Reform Efforts. Nearly every stakeholder in the current system is keenly aware of the dysfunctional state of the current insurance regulatory system. The National Association of Insurance Commissioners (NAIC) has acknowledged the need for more efficient, market-based regulation.

AIA has been working closely with the NAIC and individual state legislators and regulators to promote market-based initiatives across the regulatory system as a whole, as well as in each state. Unfortunately, the pace of change at the state level continues to lag, falling ever farther behind the marketplace. Changes that *have* been made are not uniform. As a result, property-casualty insurers still face a patchwork system of regulatory obstacles that impose significant costs and delays without concomitant consumer benefits.

In 1999, in response to the changing reality of the financial services marketplace, Congress passed the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (GLBA). GLBA tore down Depression-era barriers among financial services sectors. GLBA was both a practical reaction to realities of the vastly changed marketplace and a symbolic reassertion of federal involvement in insurance.

To many longtime observers of insurance regulation, state implementation of GLBA privacy provisions has been viewed as a litmus test of state ability to harmonize regulation with a federal law. Unfortunately, the lack of state uniformity in implementing these provisions underscores the inherent problems with trying to achieve operational standardization at the state level. Some states wanted to go beyond the parameters of GLBA; others applied their own unique regulatory twists. Indeed, although the NAIC unanimously adopted a model privacy regulation, many states have departed from the provisions of that model in small and large ways.

Origins of the Current Regulatory System. The debate over the best way to regulate the business of insurance is not new: it has been going on for well over a century. Traditionally, the question has been whether insurance should be controlled by individual states or at the federal level. During this time, several key decisions set and reset the stage.

In *Paul v. Virginia*, 75 U.S. 168 (1869), the Supreme Court held that insurance policies were local contracts and, therefore, not “interstate commerce” within the meaning of the U.S. Constitution. This ruling, and the historically perceived need for local oversight, paved the way for the state regulation of insurance. This is how things remained for the next 75 years.

In *U.S. v. Southeastern Underwriters Association*, 322 U.S. 533 (1944), however, the Court reversed course, holding that insurance was indeed “interstate commerce” within the meaning of the Constitution. The decision made insurance subject to all federal laws that govern business generally, like the federal antitrust laws, and it gave Congress the ultimate authority for deciding how insurance would be regulated.

Less than 18 months later, Congress, under considerable pressure by states — which were facing both loss of regulatory authority and significant tax revenues — passed the McCarran-Ferguson Act. McCarran-Ferguson reaffirmed the states’ power to continue regulating and taxing insurance companies, and effectively exempted insurers from federal antitrust laws.

Despite the presence of McCarran-Ferguson, many in the insurance community began seriously discussing the need for re-involving the federal government in the early 1990s. Then-chairman of the powerful House Commerce Committee John Dingell (D-MI) developed legislation outlining a federal insurance regulatory role, with a particular focus on solvency issues. The NAIC responded to Dingell's effort with a solvency policing initiative of its own that helped take the prospect of federal regulation off the table.

Today, the changed nature of the financial services marketplace, the dysfunctional state regulatory system, and the demands of the new operating environment have resurrected, and, at the same time, reframed the traditional debate of "state versus federal" regulation.

Regulatory History's Next Step: The Need for an Optional Federal Charter. Given the intrinsic features of the current system and the abject failure of reform from within, there are several compelling reasons for Congress to consider an optional federal charter:

Rapid change has altered all aspects of the insurance mechanism, except its regulatory structure. Over the past five years, changes stemming from GLBA, globalization, and technology have changed the insurance system more dramatically than during the first fifty years of regulatory life under McCarran-Ferguson.

A level playing field is critical to the long-term viability of the insurance industry. GLBA changed the rules for insurers, banks, and securities firms. A level regulatory playing field is essential for insurers to compete in this environment. The dual charter (similar in concept to optional federal chartering) model has served the needs of banks and their customers for over a century.

New technologies do not countenance state-specific regulatory barriers. The Internet and e-commerce offer tremendous potential for improving efficiency of the insurance mechanism and increasing customer awareness and access. State-specific regulatory requirements threaten to undermine the ability of insurers, agents, and policyholders to fully access these technologies.

While some aspects of insurance are local in nature, the business is increasingly national, and international in its customer focus and regulatory needs. The property-casualty insurance industry is extremely diverse. While a state-based regulatory approach may be appropriate for companies operating on a single-state or regional basis, for national and international companies — and their customers — the current state regulatory system is costly and inflexible. Optional federal chartering would allow companies and customers to choose the regulatory approach most suitable for their size and operational scope.

Like the industry itself, the challenges facing the property-casualty insurance industry are increasingly national and international in scope. Because it is decentralized, the current regulatory system lacks tools to address these complex issues in a comprehensive manner.

Recent events, such as the omnipresent threat of terrorism, have required the federal government to accept a larger role in insurance regulation. The Terrorism Risk Insurance Act of 2002 (TRIA) was a response to the need for a reinsurance backstop mechanism where none was available in the private sector. The TRIA provides some short-term stability to the insurance marketplace. Insurers, of course, must still navigate the logistical, capacity, and pricing challenges involved with a difficult-to-assess risk such as terrorism. U.S. Department of Treasury officials now have the task of implementation and administrative oversight in an area traditionally regulated by the states. These officials have had to face new responsibilities while battling a steep learning curve, limited staff resources, and relatively short deadlines. Despite these challenges, Treasury has undertaken its regulatory duties with great enthusiasm, a refreshing regulatory outlook, and an ability to learn quickly.

Principles for Optional Federal Chartering. The breakdown of the current system in addressing the needs of the insurance marketplace provides a unique opportunity to think creatively about fixing the system. If current regulatory system weaknesses were not so fundamental, moderate changes would be appropriate.

However, because the current system's flaws are so intrinsic and systemic, reform measures should be fundamental.

AIA has worked with other sectors of the financial services industry to develop a principled proposal for an optional federal charter. Under this proposal, an insurer could choose to obtain a national charter to write either life or property-casualty insurance, but not both. The national charter would be in lieu of the current state-by-state system of licensing and regulation. An insurer that obtains a national charter would have the opportunity, but not the obligation, to write life or property-casualty insurance in any or all states.

Nationally chartered insurers would be subject to direct federal regulation of solvency, specified market conduct activities and other chartering standards. State regulation in these areas would be prevented. The current state-by-state guaranty fund system would remain in place for both nationally chartered and state licensed insurers, but would be subject to standards. A nationally chartered insurer would generally be subject to the federal antitrust laws, but would not have its rates subject to regulation.

Insurers choosing to remain state-licensed and regulated would not have to obtain a federal charter. The McCarran-Ferguson Act, including its antitrust provisions, would remain unchanged for such insurers.

An Office of National Insurers, established within the Treasury Department, would be authorized to issue national charters to life and property-casualty insurers. It would oversee both market conduct and financial regulation, and would be authorized to take appropriate action against federally chartered insurers, including rehabilitation and liquidation proceedings for an insurer in hazardous financial condition. Unfair claims and marketing practices would be addressed by the Office, which would have the authority to conduct market conduct examinations and levy fines.

Taken together, these principle-based features would assure that the new regulatory system is responsive to the needs of customers and claimants, taxpayers, and the public at large. Moreover, they would avoid "competition in laxity," taxpayer subsidies of the insurance industry, politicization of the regulatory process, dual regulation, and other concerns raised by some optional federal chartering opponents.

Consumer and Public Benefits. Optional federal chartering would bring numerous benefits to consumers and the public. Consumers would realize savings as the market becomes more efficient and competitive, and as the costs of unnecessary regulation are squeezed out of the system. There would also be more product options, particularly with respect to innovative personal and commercial lines coverages. Insurance markets would be able to keep up with fast-paced changes in the national and international economies in which their customers operate; at the same time, they would be in a position to satisfy the financial needs of locally based businesses, as well as individuals and families.

Optional federal chartering also would enhance America's position as a trading partner and address criticisms from abroad that the current system is protectionist. Finally, under optional federal chartering, Congress and the regulators would be well-equipped to deal with unexpected national or international crises (such as terrorism), as well as other problems (such as long-tail liabilities) that take time to develop, but nonetheless have huge financial consequences for the insurance industry and the economy at large.

Finding a Future That Works. The debate over insurance industry regulatory improvement and modernization is no longer just a theoretical, conceptual exercise. One advantage of optional federal chartering is that it is conservative; it allows the state-based system to remain in place while providing an alternative structure that is strong in the areas where the former is weak. It maximizes the benefits of regulatory competition, spurring needed changes in complacent regulatory structures.

There may be legitimate disagreements among stakeholders about how best to reform the insurance regulatory environment. In the view of many longtime observers of the business of insurance, however, the current system is "the future that doesn't work." What we owe to ourselves and those who depend on insurance is the willingness to consider a future that does.