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Alternative Frameworks for Insurance Regulation in the United States

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Executive Summary

After 150 years of state-run regulation within the U.S. insurance industry, many insurers are now supporting a system that involves greater oversight by the federal government. In a move strongly opposed by the states, insurers are specifically backing the creation of an optional federal charter (OFC), which would allow insurance companies and agents to choose federal regulation, therefore exempting them from state regulation. In addition to an OFC, Grace and Klein consider proposals such as the State Modernization and Regulatory Transparency Act, a single-state regulatory system, and the delegation of solvency regulation to the federal government and market regulation to the states, evaluating each alternative on its implications for regulatory and market efficiency. Citing the industry's legacy, the authors suggest that initial changes will be small but may become more substantive as political conditions evolve.

Insurance regulation is divided into two primary areas: (1) financial or solvency regulation, designed to protect shareholders and the public against excessive insurance insolvency risk, and (2) market regulation, which includes regulation of prices or rates, policy forms, products, and insurance agents. In answer to industry pressures and the threat of federal intervention, the states have sought to reduce, in particular, their inefficiencies within the latter. Despite these improvements, the concept of an OFC continues to gather attention. First introduced to the Senate as the National Insurance Act (2007), the proposed legislation would establish the Office of National Insurance, to which life and property-casualty insurers could apply for a charter and license to sell particular products in all states. The ONI would also regulate the solvency and market conduct of these insurers. Guaranty associations and residential market mechanisms would remain under the control of the states.

Proponents argue that an OFC would result in policy reforms and the elimination of rate regulation for participating insurers. Federal regulation could also offer greater structural efficiencies than the state system and produce a uniform set of laws and regulations for the industry nationwide. However, inadequate regulation of national insurers could expose state insurers to large guaranty association assessments and vice versa. The federal government cannot guarantee the creation of a more reasonable and official set of policies than the states, nor are they immune to excessive regulation or the pressures of interest groups.

A second option is to create federal standards for state regulation, as put forward in the State Modernization and Regulatory Transparency (SMART) Act, a draft legislative proposal released in 2004. Under SMART, states would be required to meet minimum standards in areas like market conduct, rates and policy forms, and insurer and producer licensing. While SMART would bypass the need for a federal regulator and related bureaucracy, monitoring and enforcing the standards could prove highly difficult. With regulatory administration left to fifty-six regulators, gains in efficiency would be limited. Due to the popularity of an OFC, a version of the SMART Act is unlikely to be seriously considered, though some of its policies and concepts may be carried over to a future OFC bill.

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Introduction

Insurance regulation in the United States is at a crossroads. The states have regulated the industry for 150 years. During this long history the states have successfully repelled several federal challenges to their authority with strong industry support. However, as the insurance industry has evolved, its support for state regulation has eroded, and many insurers now support the creation of an optional federal charter (OFC) that would preempt state regulation for insurers and agents regulated by the federal government and also modify antitrust law for insurers. The U.S. Department of the Treasury's blueprint for financial regulatory reform, issued under the Bush administration, also envisioned a much greater federal role in the industry's oversight (U.S. Department of the Treasury 2008). Subsequent federal actions associated with the recent crisis in financial markets have spurred further discussion of federal oversight of the industry.

The Treasury under the Obama administration has released its plan for financial regulatory reform that contemplates a much more limited role for federal insurance regulation (such as tighter regulation of holding companies that own insurers), but that could change (Treasury 2009). The states as well as certain industry groups (for example, independent agents) with a vested interest in preserving the existing system strongly oppose an OFC, and a fierce debate continues over the restructuring of the insurance regulatory framework and its policies.

Despite this strong opposition, the push for some form of federal regulation is unlikely to diminish and may intensify. Change is clearly in the wind, but how things will evolve is uncertain given the interplay of many forces. While large segments of the industry continue to prefer an OFC, other institutional arrangements may surface as the debate continues. Some of these alternatives may be viewed as incremental steps to a more comprehensive federal framework while others may be proposed as ultimate "solutions." Further, a number of issues arise with the specific design and implementation of any particular arrangement, including the regulatory policies that would be adopted within a given framework. In this context, it is important to develop an understanding of the key features of the most viable alternative frameworks and their potential advantages and disadvantages.

This paper examines the merits of alternative frameworks for insurance regulation in the U.S. and their implications for regulatory and market efficiency. This examination is founded on a review of the historical foundations of the current system as well as its present structure. It is helpful to understand how insurance regulation

has evolved and its present configuration in considering how it might be improved. This naturally leads to a discussion of the limitations of the current U.S. regulatory system and the potential benefits and pitfalls of alternative arrangements. We also address issues concerning how insurance should be regulated (that is, regulatory policies) that are inevitably intertwined with the locus of regulatory authority.

The paper begins with a brief historical overview of insurance regulation in the U.S., and then it outlines the current framework for insurance regulation and state efforts to improve its efficiency. We then examine alternative frameworks for insurance regulation, their relative advantages and disadvantages, and their implications for rationalizing regulatory policies and enhancing the efficiency of the insurance industry. Finally we summarize and conclude our analysis.

A Brief History of Insurance Regulation

Insurance regulation in the U.S. has a long history that is relevant to the current debate about how it should be reformed. There have been several attempts to establish a greater federal role in insurance regulation that have been thwarted by the states, often with strong industry support. Further, the state regulatory framework has evolved in response to developments in the industry as well as issues that led to threats of greater federal intrusion. However, significant segments of the industry have become disenchanted with state regulation within the last two decades, believing that it is an antiquated system that is incapable of achieving the efficiency that would be provided by a single federal regulator. Hence, it is important to weigh the progress of and initiatives implemented by the states against the arguments made by the proponents of federal regulation.

Early Origins

State insurance regulation dates back to the early 1800s, when insurance markets were generally confined to a particular community.[1] At that time, property insurers were formed as stock companies or mutual protection associations to provide fire insurance for a particular town or city. The high concentration of exposures and the occurrence of large conflagrations led to considerable market instability. Pricing was highly cyclical, and there were periodic shakeouts when a number of insurers would fail after a major fire (Hanson, Dineen, and Johnson 1974). During this same period, life insurance companies also were formed, but some became notorious for high expenses, shaky finances, and abusive sales practices (Meier 1988). The fact that insurance markets were local in nature led municipal and state governments to establish the initial regulatory mechanisms for insurance companies and agents.

Local governments made the first attempts to assert some industry oversight, but their efforts proved to be inadequate as the industry grew and market problems persisted (Meier 1988). Various states (beginning with New Hampshire in 1851) then formed insurance commissions to license companies and agents, regulate policy forms, set reserve requirements, police insurers' investments, and administer financial reporting. Price regulation was essentially confined to limited oversight of property-casualty industry-rate cartels. At that time, uniform pricing was viewed as the solution to "destructive competition," and

regulators' expected role was to ensure that this system was not abused to extract excessive profits from consumers.[2]

The states soon realized the need to coordinate their regulatory activities as insurers began to cross state boundaries and common issues arose. This led to the formation of the predecessor organization to the National Association of Insurance Commissioners (NAIC) in 1871. Initially, it focused on developing common financial reporting requirements for insurers. State regulators also began using the NAIC as a vehicle for discussing common problems and developing model laws and regulations that each state could modify and adopt (or not) according to its preferences.

Through the years, insurance department responsibilities and resources grew in scope and complexity as the industry evolved. Two major trends appear to have heavily influenced the evolution of regulatory functions and institutions (Klein 1995). One trend has been the significant growth of the industry and the increasing diversity of insurance products and the types of risks that insurers have assumed. The other trend is the geographic extension of insurance markets with a number of carriers operating on a national and international basis. Other important trends include significant consolidation within the industry, new types of firms offering insurance coverage and/or services, changes in distribution channels, convergence of financial services markets, alternative risk transfer and financing vehicles, and systemic financial and economic risks. Tables 1 and 2 summarize basic trends in the property-casualty and life-health insurance sectors that document some aspects of the industry's transformation.

Arguably, such developments have increasingly challenged the state regulatory framework. Every state has had to increase its resources and expertise to oversee a more complex and geographically extended industry. The states' reliance on the NAIC also has necessarily increased as it has become a

Table 1

Property-Casualty Insurance Trends: 1960-2006

	1960	1970	1980	1990	2000	2006
No. of Companies	NA	2,800.00	2,953.00	3,899.00	3,215.00	2,648.00
Assets ($M)	30,132.00	55,315.00	197,678.00	556,314.00	1,034,090.00	1,483,013.00
Revenues ($M)	15,741.00	36,524.00	108,745.00	252,991.00	341,590.00	501,106.00
New Premiums Written (%)	95.1	94.3	89.6	86.9	87.7	89.3
Investment Income (%)	4.9	5.7	10.4	13.1	12.3	10.7
Market Share of 10 Largest Insurer Groups (%)	34.4	36.8	38.2	40.3	43.7	48.5
Premiums/Surplus (%)	125.5	210.2	183.4	157.6	75.6	89.7
Return on Net Worth (%)	NA	11.6	13.1	8.5	6.5	13.4

Sources: Insurance Information Institute, A.M. Best

Table 2

Life-Health Insurance Market Trends: 1950–2006

	1950	1960	1970	1980	1990	2000	2006
No. of Companies	649	1,441	1,780	1,958	2,195	1,268	1,072
Assets ($M)	64,020	119,576	207,254	479,210	1, 408,208	3,185,945	4,882,884
% 10 Largest Insurer Groups	NA	62.4	57.7	52.5	36.7	41.7	NA
Income ($M)	11,337	23,007	49,054	130,888	402,200	826,660	883,597
% Life Insurance Premiums	55.1	52.1	44.2	31.2	19.1	15.8	16.9
% Annuity Considerations	8.3	5.8	7.6	17.1	32.1	36.7	34.3
% Health Insurance Premiums	8.8	17.5	23.2	22.4	14.5	12.8	16.0
% Investment Income	18.3	18.7	20.7	25.9	27.8	25.2	27.1
% Other	9.5	5.8	4.4	3.3	6.5	9.5	5.9
Policy Reserves ($M)	54,946	98,473	167,779	390,339	1,196,967	2,711,420	3,607,743
% Life	NA	71.9	68.8	50.7	29.1	27.4	30.8
% Annuities	NA	27.2	29.1	46.5	68.1	69.1	65.0
% Health	NA	0.9	2.1	2.8	2.8	3.5	4.2
Net Rate of Investment Income (%)[1]	3.1	4.1	5.3	8.1	9.3	7.1	5.4
Capital Ratio (%)[2]	NA	NA	9.7	9.2	8.5	11.1	10.0
Return on Equity (%)	NA	NA	NA	13.9	10.7	10.0	12.0

[1] Net investment income divided by mean invested assets (including cash) less half of net investment income.

[2] Capital plus surplus plus Asset Valuation Reserve divided by general account assets.

Source: American Council of Life Insurance, Insurance Information Institute, A.M. Best

vehicle to pool resources and augment their regulatory activities. Consequently, the NAIC has been transformed into a major service provider as well as a mechanism for coordinating state actions and centralizing certain regulatory processes. These measures have been developed, at least in part, to address growing externalities among states as well as to achieve greater economies of scale in performing certain regulatory functions (Klein 1995 and 2005). Although the states have substantially increased their resources and the sophistication of their regulatory mechanisms, their critics raise concerns about the inherent inefficiency of a state-based framework and its ability to keep pace with the industry and the broader economic environment in which it operates.

The State versus Federal Regulation Debate

The states and the federal government have been engaged in battles over insurance regulation since the mid-1800s. An inherent tension exists between state and federal authorities, which is fostered by the interstate operation of many insurers and their significant presence in the econ-

omy. In several instances, the federal government has sought to exert greater control over the industry, and the states, backed by the insurance industry, have successfully defended their authority. The economic and political stakes are high for both sides.

The primacy of the states' authority over insurance was essentially affirmed in various court decisions until the U.S. Supreme Court decision in *U.S. v. South-Eastern Underwriters* in 1944.[3] In that case, the Court ruled that the commerce clause of the Constitution did apply to insurance and that the industry was subject to federal antitrust law. This decision prompted the states and the industry to join forces behind the passage of the McCarran-Ferguson Act (MFA) in 1945, which delegated regulation of insurance to the states except in instances where federal law specifically supersedes state law.[4] The MFA also granted a limited antitrust exemption to insurers tied to compensating regulatory oversight by the states.

Despite the passage of the MFA, federal interest in insurance regulation has continued to grow over time for several reasons. First, the insurance industry plays an increasingly important financial role in the nation's economy. Second, the performance of insurance markets affects interstate commerce and a number of areas of public policy of interest to the federal government, such as health care, the availability of liability insurance, natural disasters, and terrorism risk, among others. Third, periodic crises, such as the spike in insurer insolvencies in the 1980s and the current crisis in financial markets (including the federal bailout of the American Insurance Group), have raised concerns about the ability of state regulators to adequately oversee the industry.[5] These crises and concerns have prompted debates about whether federal intervention was warranted to remedy market failures. Fourth, the lines between financial services markets have become blurred as insurers compete with other financial institutions in the sale of products with similar characteristics, a development that has been aided by the passage of the Gramm-Leach-Bliley Act (GLBA) in 1999. Finally, considering the vast resources commanded by the industry, one might expect that some members of Congress would favor a stronger federal role in insurance in order to increase their authority and influence.

Historically, the industry strongly supported state over federal regulation. However, in recent years this has changed as the industry has continued to evolve. Increasingly, many insurers—especially those that operate on a national basis—have come to favor some form of federal regulation, such as an OFC.[6] These insurers have become increasingly frustrated with the additional costs and burdens that they associate with the state system. They perceive that it would be less costly and more efficient for them to deal with one central regulator than with fifty-six jurisdictions (Pottier 2007; Grace and Klein 2000; Grace and Klein 2007; Regan 2007).

The reality is that most of the insurance purchased in a typical state is sold by insurers that are not domiciled in that state, as indicated by Tables 3 and 4.[7] Insurers advocating federal regulation have not been satisfied with the states' efforts to harmonize and streamline their regulation, which can only go so far before they undermine the basis for preserving a state-based system. We should note, however, that the industry is not unanimous in its support of federal regulation. Many state and regional insurers, along with local agents, continue to support a state framework, albeit with policy reforms.[8]

Table 3

Direct Premiums by Non-Domestic Property-Liability Insurers
By State in 2006

State	Domestic Companies	Premiums Written by Non-Domestic Companies	Non-Domestic Market Share (%)
Alabama	960,140,814	5,633,368,769	85.4
Alaska	199,073,287	1,326,309,523	86.9
Arizona	784,507,535	7,684,470,329	90.7
Arkansas	225,406,700	3,687,605,735	94.2
California	18,476,141,444	41,325,400,747	69.1
Colorado	318,006,417	7,414,151,021	95.9
Connecticut	1,159,681,584	5,892,575,976	83.6
Delaware	293,658,907	2,069,795,401	87.6
Dist. f Columbia	34,573,764	1,499,298,480	97.7
Florida	10,703,312,702	28,341,801,727	72.6
Georgia	1,525,419,120	12,380,639,913	89.0
Hawaii	727,497,055	1,597,694,859	68.7
Idaho	286,125,255	1,567,678,247	84.6
Illinois	9,279,732,130	11,874,180,974	56.1
Indiana	1,363,404,594	7,150,200,213	84.0
Iowa	1,146,817,315	3,425,251,422	74.9
Kansas	488,023,038	4,052,269,830	89.3
Kentucky	984,111,055	4,821,562,698	83.0
Louisiana	1,661,060,873	7,090,655,905	81.0
Maine	457,457,203	1,515,481,541	76.8
Maryland	1,236,942,435	7,719,661,243	86.2
Massachusetts	5,243,218,893	6,639,899,899	55.9
Michigan	7,205,703,810	8,114,813,197	53.0
Minnesota	924,741,008	7,745,520,222	89.3
Mississippi	502,048,337	3,670,694,377	88.0
Missouri	1,097,599,585	7,956,990,523	87.9
Montana	27,744,210	1,530,069,650	98.2
Nebraska	382,761,886	2,789,080,106	87.9
Nevada	243,628,746	4,351,300,716	94.7
New Hampshire	278,220,809	1,877,017,495	87.1
New Jersey	5,017,772,536	12,339,873,743	71.1
New Mexico	154,322,435	2,410,956,362	94.0
New York	8,613,369,469	26,104,575,059	75.2
North Carolina	1,836,157,736	9,977,224,870	84.5
North Dakota	163,328,226	1,142,870,091	87.5
Ohio	5,049,116,034	8,265,064,920	62.1
Oklahoma	751,286,657	4,499,132,418	85.7
Oregon	1,380,962,536	4,052,242,598	74.6
Pennsylvania	4,953,341,519	15,013,047,840	75.2
Rhode Island	361,172,066	1,581,234,985	81.4
South Carolina	370,493,137	6,218,784,461	94.4
South Dakota	75,346,971	1,381,121,923	94.8
Tennessee	1,174,449,321	7,216,198,614	86.0
Texas	14,760,141,813	19,960,335,380	57.5
Utah	430,183,750	2,846,911,603	86.9

Table 3

Direct Premiums by Non-Domestic Property-Liability Insurers
By State in 2006

State	Domestic Companies	Premiums Written by Non-Domestic Companies	Non-Domestic Market Share (%)
Vermont	122,420,815	988,759,500	89.0
Virginia	333,919,068	10,287,049,724	96.9
Washington	1,629,453,680	7,198,468,407	81.5
West Virginia	892,213,671	2,189,954,125	71.1
Wisconsin	3,673,436,736	4,343,889,876	54.2
Wyoming	60,703,862	775,488,036	92.7
Guam	100,803,619	17,461,504	14.8
Puerto Rico	1,793,660,730	245,922,413	12.1
U.S. Virgin Islands	37,680,482	52,579,647	58.3
Total	120,020,352,549	361,538,625,273	75.1

Source: NAIC data, authors' calculations

Table 4

Direct Premiums by Non-Domestic Life-Health Insurers
By State in 2006

State	Domestic Companies	Premiums Written by Non-Domestic Companies	Non-Domestic Market Share (%)
Alabama	298,066,325	5,233,207,341	94.6
Alaska	–	834,760,555	100.0
Arizona	117,100,491	7,818,979,186	98.5
Arkansas	88,049,707	2,779,417,289	96.9
California	76,601,008	51,420,393,745	99.9
Colorado	328,631,440	8,353,159,748	96.2
Connecticut	8,968,009,457	6,870,054,939	43.4
Delaware	2,041,820,825	19,148,123,831	90.4
Dist. of Columbia	2,917,207	1,824,003,522	99.8
Florida	117,188,109	29,349,453,410	99.6
Georgia	94,096,665	10,892,022,010	99.1
Hawaii	32,534,630	2,329,902,873	98.6
Idaho	11,343,082	1,804,368,678	99.4
Illinois	1,503,515,928	19,126,798,445	92.7
Indiana	1,463,279,671	8,315,296,615	85.0
Iowa	3,588,079,498	3,709,342,923	50.8
Kansas	271,151,674	6,762,640,085	96.1
Kentucky	40,642,575	4,095,718,603	99.0
Louisiana	189,099,358	6,346,594,741	97.1
Maine	20,841,111	1,819,432,785	98.9
Maryland	82,953,614	13,559,717,706	99.4
Massachusetts	1,256,082,604	11,917,921,901	90.5
Michigan	2,227,779,994	13,784,728,642	86.1
Minnesota	1,855,673,642	8,873,038,300	82.7
Mississippi	274,013,875	8,715,275,174	97.0
Missouri	86,937,283	2,521,007,968	96.7

Table 4

Direct Premiums by Non-Domestic Life-Health Insurers By State in 2006

State	Domestic Companies	Premiums Written by Non-Domestic Companies	Non-Domestic Market Share (%)
Montana	4,653	941,542,572	100.0
Nebraska	482,479,999	3,146,838,231	86.7
Nevada	–	2,711,936,563	100.0
New Hampshire	3,895,969	2,138,005,891	99.8
New Jersey	3,997,113,346	23,774,433,526	85.6
New Mexico	149,672	1,822,502,902	100.0
New York	28,191,295,409	18,763,361,604	40.0
North Carolina	230,361,030	13,120,640,035	98.3
North Dakota	10,876,876	917,750,343	98.8
Ohio	2,078,124,424	16,121,765,181	88.6
Oklahoma	67,781,186	3,803,658,441	98.2
Oregon	319,696,672	4,195,542,367	92.9
Pennsylvania	451,254,503	21,565,944,160	98.0
Rhode Island	28,844,603	1,707,491,388	98.3
South Carolina	110,067,752	4,969,509,836	97.8
South Dakota	1,130,649	1,105,132,252	99.9
Tennessee	319,837,470	8,215,414,510	96.3
Texas	3,685,963,076	25,560,975,825	87.4
Utah	228,460,797	3,048,828,855	93.0
Vermont	19,631,888	953,128,301	98.0
Virginia	2,451,603,347	10,743,862,258	81.4
Washington	198,817,990	7,992,753,296	97.6
West Virginia	635,249	1,875,780,064	100.0
Wisconsin	789,986,198	8,523,553,424	91.5
Wyoming	–	695,590,887	100.0
Guam	808,328	59,418,880	98.7
Puerto Rico	243,252,558	577,431,857	70.4
U.S. Virgin Islands	–	43,791,513	100.0
Total	68,948,483,417	447,301,945,977	86.6

Source: NAIC data, authors' calculations

Although the primary regulatory authority for insurance still resides with the states, the federal government has affected state insurance regulatory policy and institutions in several ways. In a number of instances, Congress has instituted federal control over certain insurance markets or aspects of insurers' operations that were previously delegated to the states. In other cases, the federal government has established insurance programs that are essentially exempt from state regulatory oversight. Even the threat of such interventions has spurred the states to take actions to forestall an erosion of their regulatory authority.

The federal government also has set regulatory standards for certain insurance products (for example, Medicare supplement insurance) which the states are expected to enforce. Additionally, Congress also has significantly constrained state regulatory control over certain types of insurance entities, such as risk-retention groups and em-

ployer-funded health plans, in order to increase coverage options in markets where the cost of traditional insurance is high. Finally, federal policies in a number of other areas such as antitrust, international trade, law enforcement, taxation, and the regulation of banks and securities have significant implications for the insurance industry and state regulation.

The most recent manifestations of the push for federal regulation are proposals for federal regulatory standards and an optional federal charter (OFC) for insurers that choose to be federally regulated. The states oppose both proposals, with their strongest opposition aimed at an OFC, which is receiving the most attention. They likely perceive that many insurers, especially larger companies, would choose an OFC, which would effectively remove a large part of the industry from state oversight.[9] State-oriented insurers and agent groups also strongly oppose an OFC, recognizing that it would reduce state entry barriers and enhance the competitive position of national insurers and producers. The OFC proposal is now the central focus of the state versus federal regulation debate.

While the OFC proposal remains controversial, the Congress and the administration have continued on the path of more incremental changes. For example, legislation has been introduced in the Congress that would establish an Office of Insurance Information (OII) within the Treasury. The OII's purpose would be to provide the Treasury with expertise on insurance markets and to assist in developing international standards. The NAIC is supporting the OII legislation and has pledged its cooperation in working with the federal government to establish and maintain such an office. Other proposed federal bills would ease state regulatory constraints on reinsurance and surplus-lines insurers, facilitate reciprocal licensing of nonresident agents and brokers, and expand risk-retention groups to property insurance. There is considerably less political opposition to this legislation than to an OFC.

Views differ on what these measures would portend if enacted. Some state regulators might believe that these steps would ease the pressure for and imminence of broader federal insurance regulation. Others may see these measures as laying a pathway for a true federal insurance regulator.[10] Indeed, while OFC supporters have stated that this kind of legislation helps to address specific problems, it does not obviate the need for broader insurance regulatory reform (Keating 2008).

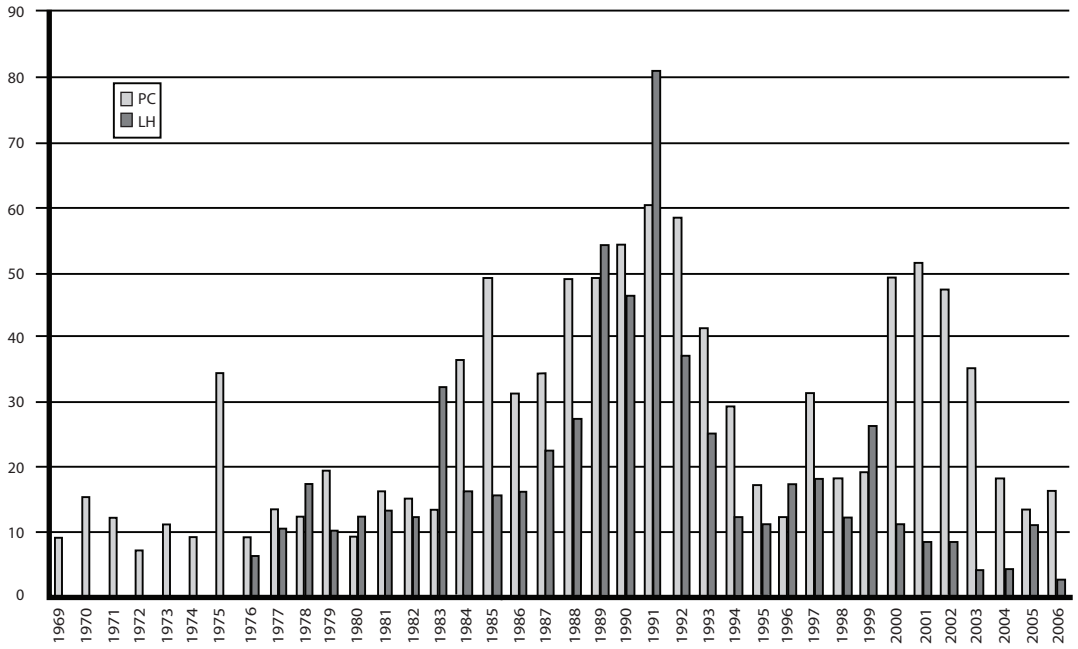
The Evolution of State Insurance Regulation

As noted above, insurance regulation has been greatly affected by and compelled to evolve in response to changes in the industry and its economic and financial environment. One wave of reforms, which began in the late 1980s, were primarily aimed at strengthening solvency regulation. A large spike in the number and cost of insurer insolvencies (see Figure 1) in the mid-1980s led to an intensive congressional investigation and a number of state regulatory initiatives. These initiatives included strengthening insurer financial standards, establishing risk-based capital requirements, improving financial monitoring systems, and developing a program for certifying the adequacy of each state's solvency regulation (Klein 1995). As insurer insolvencies fell, congressional scrutiny diminished and the immediate threat to the state system seemed to subside.

However, growing industry complaints about

Figure 1

Insurance Company Impairments
Property-Casualty and Life-Health Insurers



the inefficiency and high cost of outmoded state regulatory policies warranted attention. This led to a second wave of state and NAIC initiatives that continue through the present (Klein 2005). The objective of these initiatives has been to streamline and harmonize state regulatory policies and practices to lessen regulatory cost burdens on insurers (and coincidentally ease the pressure for federal regulation). Other measures have been aimed at enhancing the effectiveness of state regulation in several key areas.

During this period, several initiatives ensued or gained increased momentum, including:[11]

- Commercial insurance deregulation
- Enhanced consumer protection, reflected in the Consumer Information Source (CIS) website
- More efficient market regulation, articulated in the *Market Analysis Handbook*
- "Speed to Market for Insurance Products," encompassing the Interstate Insurance Product Regulation Commission (IIPRC) and the System for Electronic Rate and Form Filing (SERFF)
- Uniform forms and processes for producer licensing, reflected in the National Insurance Producer Registry (NIPR)
- Standardized insurance company licensing, represented in the Uniform Certificate of Authority Application (UCAA)
- Improved solvency regulation, encompassing the NAIC Financial Data Repository (FDR) and other enhanced solvency monitoring measures

- Streamlined changes of insurance company control, reflected in the Form A Database.[12]

While these initiatives are impressive and some may be enhancing regulatory and market efficiency, they have failed to satisfy many insurers' demand for a true national regulatory system. It is difficult to see how insurers' desire for one regulatory system can be reconciled with the states' desire to retain their individual authorities to regulate insurers and insurance markets. Indeed, the states face a dilemma as they move toward more uniform regulation. If the states took the concept of uniform regulation to its ultimate limit, it would beg the question of why regulatory authority and enforcement should continue to reside at the state level. A more realistic scenario is reflected in the current state and NAIC initiatives that appear to take uniformity only to a certain point. This would retain state discretion on certain rules and regulatory enforcement, which would seem fundamental to arguments for maintaining a state-based framework. However, such a scenario would be unacceptable to large segments of the industry that seek a truly singular regulatory system. In essence, even if the natural limit of harmonizing regulation is reached, it still does not solve many insurers' problems associated with duplicative and conflicting regulation.

The Current Framework for Insurance Regulation

To inform our discussion of alternative frameworks, we review the current system of insurance regulation in terms of its structure, functions, and policies. Many (although not necessarily all) current regulatory functions might be assumed by a new regulator or divided among different authorities depending on the proposed framework. How these functions would be performed raise significant issues and considerations. The orientation and specific design of regulatory policies could change dramatically under different institutional arrangements and also raise a number of questions. Hence, it is helpful to have some understanding of the current system of insurance regulation in considering how it might be reformed.

Structure

The current regulatory framework is not confined to insurance departments per se but extends to all levels and branches of government. The major authorities in this system are: (1) state insurance departments, (2) the courts, (3) state legislatures and the Congress, and (4) the executive branch at the state and federal level. Involving both federal and state government authorities in insurance regulation adds complexity and also leads to potential conflicts.[13]

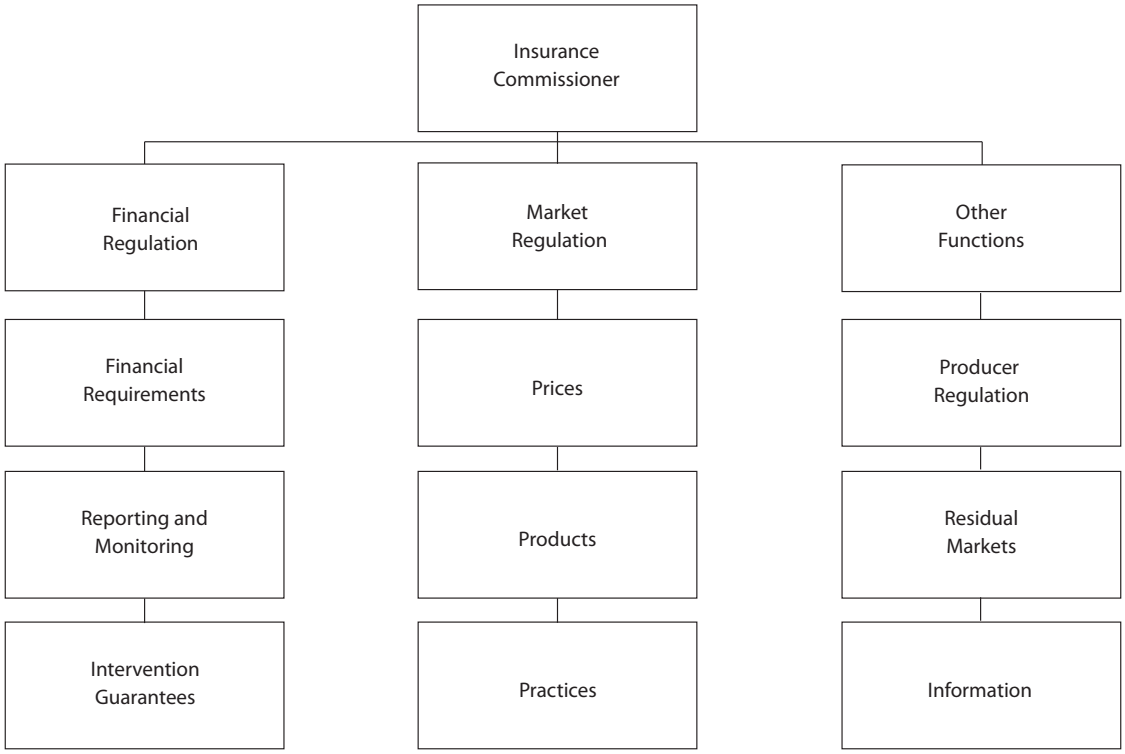
The legislature establishes the insurance department in each state, enacts insurance laws, and approves the regulatory budget. Each insurance department is part of the state executive branch, either as a stand-alone agency or as a division within a larger department. Commissioners often must utilize the courts to help enforce regulatory actions, and the courts in turn may restrict regulatory action. The insurance department in a given state must coordinate with other state insurance departments in regulating multistate insurers and must also rely on the NAIC for advice as well as some support services. The federal government overlies this entire structure, currently delegating most regulatory responsibilities to the states, while retaining an oversight role and intervening in specific areas.[14]

In most states, the governor (or a regulatory commission) appoints commissioners for a set term or "at will," subject to legislative confirmation. Typically, the governor and other higher administration officials do not interfere with daily regulatory decisions but may influence general regulatory policies and become involved in particularly salient issues. Twelve jurisdictions elect their insurance commissioners, who are more autonomous in the sense that they are not appointed by their governors, but they must still cooperate with the administrations and legislatures in their states in order to achieve their objectives. The insurance commissioner and the administrative branch, the legislature, and the courts collectively determine regulatory policy.

Regulatory Functions

Insurance regulatory functions can be divided into two basic areas: (1) financial or solvency regulation and (2) market regulation. Beyond these two basic areas, state insurance departments engage in certain other activities, such as providing consumer information, to facilitate competition and better market outcomes. Such activities can be important in promoting regulatory objectives and potentially lessening the need for more intrusive regulatory constraints and mandates. However, the states do not view these activities as substitutes for active regulatory oversight and enforcement actions. The most important aspects of the different regulatory functions are summarized below and diagrammed in Figure 2.

Figure 2
Insurance Regulatory Functions



Financial Regulation

Arguably, the primary goal of insurance regulation is to protect policyholders and the general public against excessive insurer insolvency risk (Munch and Smallwood 1981). This goal is accomplished by requiring insurers to meet certain financial standards and to act prudently in managing their affairs. To perform this task, insurance regulators are given authority over insurers' ability to incorporate and/or conduct business in the various states. State statutes set forth the requirements for incorporation and licensure to sell insurance. These statutes require insurers to comply with minimum capital standards and financial reporting requirements and authorize regulators to examine insurers and take other actions to protect policyholders' interests. Solvency regulation involves a number of areas of insurers' operations, including: (1) capitalization, (2) pricing and products, (3) investments, (4) reinsurance transactions, (5) reserves, (6) asset–liability matching, (7) transactions with affiliates, and (8) management. It also encompasses regulatory intervention with insurers in financial distress, management of insurer receiverships (bankruptcies), and insolvency guaranty mechanisms that cover a portion of the claims of insolvent insurers. These functions are similar in many respects to the financial regulation of banks with some differences that are specific to insurance companies.

The primary responsibility for the financial regulation of an insurance company is delegated to the state in which it is domiciled. Other states in which an insurer is licensed provide a second level of oversight, but, typically, non-domiciliary states do not take action against an insurer unless they perceive the domiciliary state is failing to fulfill its responsibility. The states use the NAIC to support and coordinate their solvency oversight and compel domiciliary regulators to move more quickly in dealing with distressed insurers if this proves necessary. This helps to remedy (but may not fully correct) the negative externalities associated with solvency regulation. An insurer's domiciliary state tends to reap the lion's share of the direct economic benefits of its operations (such as employment and payrolls), but the costs of its insolvency are distributed among all the states in which it operates. Economic and political considerations could cause a domiciliary regulator to exercise more forbearance in dealing with a distressed insurer than what regulators in other states might believe is warranted.

The states rely heavily on a number of reports that insurers are required to file, including annual and quarterly financial statements. Insurer financial reports are subject to Statutory Accounting Principles (SAP), which differ somewhat from the U.S. Generally Accepted Accounting Principles (GAAP). Regulators review these reports in in-house bench audits, and insurers' financial data are analyzed using various automated tools and monitoring systems. Financial monitoring occurs at the state level for all insurers, and the NAIC also performs financial monitoring of larger companies that write business in a significant number of states. This analysis can trigger further investigation of an insurer if there are concerns about its financial condition. Insurers are subject to both periodic on-site examinations (conducted every three to five years) and targeted exams to address particular questions or issues.

Insurers are subject to both fixed minimum and risk-based capital (RBC) requirements. Each state sets fixed-minimum standards, which average in the area of $2 million. Each company's RBC requirement is determined through formulas developed by the NAIC, which apply various fac-

tors to accounting values. It is essentially a static system; U.S. regulators do not require insurers to perform any kind of dynamic risk modeling.[15] An insurer's total adjusted capital (TAC)—its actual capital with minor adjustments—is compared to its RBC to determine whether any company or regulatory actions are required. The RBC model law, adopted by the states, specifies certain authorized or mandatory regulatory actions that are tied to specific TAC-RBC ratios that start at 200 percent and become progressively more severe as lower ratio triggers are reached.

Insurers that fail to comply with regulatory financial standards and/or are deemed to be in hazardous financial condition are subject to regulatory intervention that can be formal or informal. Formal interventions typically involve regulators seizing control of a company and can constitute conservation, rehabilitation, or liquidation depending on the condition of the insurer and its prospects. It is not uncommon for an insurer's financial statement to be revised when regulators step in, and, hence, regulatory measures can progress rapidly from simply controlling an insurer's transactions to its liquidation if restructuring or rehabilitation is infeasible.

The domiciliary regulator is primarily responsible for administering remedial actions or sanctions taken against an insurer, including managing its receivership, and can exercise a fair degree of discretion with court approval. However, other states in which the insurer is licensed can bring pressure to bear on the domiciliary regulator to act more quickly and decisively if warranted. While this dual layer of financial monitoring has likely improved the states' regulation of insurer solvency, there is still empirical evidence that domiciliary regulators have been allowed to exercise too much forbearance in some instances (Grace, Klein, and Phillips 2002).[16]

Every state has separate state guaranty associations for property-casualty insurers and life-health insurers. These associations cover a portion of the unpaid claims obligations of insolvent insurers in their respective states. These associations cover only certain lines of insurance, and there are maximum dollar limits on the amount of coverage for each claim with the exception of workers' compensation insurance. Generally, insurance products purchased by individuals and small businesses receive greater coverage than those purchased by larger commercial insurance buyers. Guaranty association costs are assessed back against licensed insurers. The ultimate burden of these assessments falls on insurance buyers, taxpayers, and the owners of insurance companies (Barrese and Nelson 1994).[17]

Market Regulation

The regulation of an insurer's market practices is principally delegated to each state in which it operates. Hence, each state effectively regulates its own insurance markets. The scope of market regulation is broad (potentially encompassing all aspects of an insurer's interactions with consumers), and the states' policies can vary significantly.[18] State regulation of insurers' prices or rates is a particularly visible and controversial topic. The rates for personal auto insurance, homeowners insurance, and workers' compensation insurance are subject to some level of regulation in all the states.[19] The extent of price regulation for other commercial property-casualty lines tends to vary inversely with the size of the buyer. The rates for certain types of health insurance may be regulated, but the prices of life insurance, annuities, and related products are only indirectly regulated through the product approval process.

Insurers' policy forms and products also tend to be closely regulated with the exception of products purchased by large firms. Other aspects of insurers' market activities—for example, marketing, underwriting, and claims adjustment—generally fall within the area of "market conduct" regulation. A state may impose some specific rules regarding certain practices, such as constraining an insurer's use of certain factors in underwriting or mandating that they offer coverage to all applicants. Beyond this, regulation tends to be aimed at enforcing "fair practices" based on regulators' interpretation of what this means. Monitoring and enforcement activities are typically implemented through investigating consumer complaints and market conduct examinations.

The states also regulate producers or insurance agents. Producers must be licensed in each state in which they sell insurance and are required to pass tests to demonstrate their competence. They must also comply with continuing education requirements and are subject to sanctions if they violate regulations governing their conduct. The close relationship between insurers and agents can sometimes blur the line between who is responsible for certain market conduct problems and the targets for regulatory sanctions.

Not surprisingly, market regulatory policies and practices are complex and also subject to the greatest criticism by insurers and economists. Further, this is an area where the states most strongly defend their individual authorities and prerogatives. A number of factors influence a given state's policies, including the cost of risk and its political climate, among many others. Economists tend to have greater confidence than regulators and legislators in competitive insurance markets' ability to produce efficient outcomes. Perhaps more important, political interests and social preferences are often at odds with the outcomes that a competitive insurance market would produce, such as risk-based prices. This difference in perspectives contributes to the fierce debate about insurance regulatory policies and the prospects for their reform.

It should be noted that while financial regulation and market regulation are often discussed separately, they are necessarily intertwined. Regulating an insurer's financial condition and risk has implications for its market practices and vice versa. This is an important consideration in discussing alternative regulatory frameworks and policy reforms. Proposed frameworks and other structural options vary in terms of the extent to which financial and market regulatory authority is vested in one entity or divided between federal and state governments. The potential for contradictory financial and market regulatory policies must be evaluated for different regulatory schemes. This observation also applies to the relationship between the stringency of financial regulation and insolvency guarantees.

Alternative Frameworks for Insurance Regulation

Debate continues over expanding the federal government's role in insurance regulation. Various proposals for some form of federal regulation (or greater federal involvement in state regulation) have been vetted over the years. The concept that is currently receiving the greatest attention and industry support is the establishment of an optional federal charter, which would allow an insurance company or agent to choose to be federally regulated and exempt from state regulation. Another concept that has been proposed but has received less attention is the enactment of federal standards for state regulation that would impose greater uniformity on the current system.

Other institutional arrangements have been discussed but have not garnered significant legislative attention.

Each alternative raises a number of issues that warrant discussion. In theory, consideration of the institutional features of any particular framework might be separated from the regulatory policies that it would adopt and enforce. In reality, institutions and policies become intertwined in the proposals that have been offered and how they might be implemented. Some policies may be more feasible and/or more likely under one framework than another. Hence, our evaluation considers both the institutional features of alternative systems as well as the policies that one might associate or anticipate with these systems.

Status Quo

We begin with the current system of state regulation for several reasons. The first reason is that some form of the current system may remain dominant for a considerable period of time, understanding that it will continue to evolve. To many observers, some form of federal insurance regulation may be inevitable, but strong political opposition to this concept could delay its implementation. Secondly, discussion of any alternative framework must consider the functions it would inherit from the current system as well as how its policies may be similar or different. Thirdly, the current system may coexist with an alternative framework, and this could have implications that warrant consideration. For these reasons, it is useful to contemplate how the current system may evolve with or without the creation of a new institutional arrangement.

As discussed earlier, both industry pressures and the threat of federal intervention have compelled the states to embark on a set of ambitious policy and institutional reforms. The stated intent of these reforms is to streamline, harmonize, and rationalize the current system of state regulation while preserving certain state prerogatives. In essence, the states are seeking to reduce as much of the inefficiency that has been associated with the state-based framework as politically and logistically possible.

This is an important qualification. Fundamentally, if the states wish to retain a significant amount of discretion in how they regulate insurers, especially in the area of market practices, then there is a limit as to how far harmonization can go. For example, if a state insists on retaining rate regulation, mandated coverages, and prohibitions on certain underwriting factors, there is no force other than the federal government or market pressures to compel it to do otherwise. Further, the NAIC's centralized systems for filing rates and policy forms, agent licensing, and other processes must accommodate differing state requirements, and each state determines regulatory approvals and compliance, not the NAIC. The interstate commission for life insurance products (to which thirty-six states belong) is an exception to this observation in that all members agree to a common set of standards. Beyond this exception, there is still considerable variation in state market regulations. Finally, the policy reforms supported by the majority of states fall far short of what the industry and many experts advocate. It is difficult to envision that this difference in perspectives will ever be resolved to the satisfaction of both sides.

There are some positive aspects of this picture. One is that the states have made substantial strides even if they fall short of what could be achieved under an alternative framework. A second observation is that the threat of federal inter-

vention has tended to push the states in the right direction. It is likely that the states' "efficiency initiatives" will continue to move forward. The operative questions are how far forward and how quickly this further evolution will occur. Arguably, the states will never be able to fully replicate the efficiency of a single regulatory authority.

That said, state regulation advocates have several arguments in their quiver that may resonate with some stakeholders and legislators. For example, while state inertia may thwart or delay beneficial policy reforms, it also can discourage nationwide shifts in the opposite direction. In other words, it may be easier to fight excessive price regulation in a few states than to try to counter a federal regulator bent on implementing price regulation in all states. Another consideration is that state regulators are geographically closer to the consumers they are sworn to protect, and this may offer some benefits to the industry as well as to consumers. The states further argue that this proximity allows them to craft and enforce regulations that are more tailored to the circumstances in their specific jurisdictions. This may be the most challenging argument that advocates of federal regulation or single-regulator systems will need to address.

There are also issues involved with the financial regulation of insurance companies under the current system. Generally speaking, the states have adopted fairly uniform financial standards, so uniformity per se is not the predominant concern. The more significant issues lie with the underlying approach and standards that the states have adopted and their ability to enforce these standards. As discussed by Grace and Klein (2008a) and Klein and Wang (2007), the states are still wedded to a prescriptive approach to insurance financial regulation that is falling behind the more progressive principles-based systems being developed by the European Union (EU) and other countries.

The states would not be precluded from moving to a true principles-based system that employs the most modern methods, such as dynamic modeling to determine insurers' capital requirements. However, beyond a few general statements and limited initiatives (for example, principles-based reserving for life insurers' reserves), there are no indications that the states are seriously contemplating a major paradigm shift. Further, even if the states desired to move to an EU type of system or something comparable, there would be serious questions as to their ability to implement it given the division of resources among fifty-six regulatory agencies. Arguably, a federal regulator would be better positioned to adopt and implement a modern financial regulatory system for insurance companies (consistent with the regulation of other financial institutions) with the concentration of resources and expertise within one agency.

Hence, the current system, while inherently inefficient and still driven by local political winds, is still evolving and improving. Ironically, the strong push for federal regulation plays a significant role in driving this evolution. Like it or not, this is the system that insurers may have to live with for some time to come. In such a scenario, regulatory reform is likely to incur incrementally both at the state and federal level. Such incremental changes are reflected in proposed legislation to establish a federal Office of Insurance Information (OII) and other small steps that seek to remedy specific problems, such as regulating agents, surplus lines insurers, and reinsurance transactions. Some might view these measures as paving the way to a broader federal role while others may be concerned that they will undermine the impetus for

a single regulatory system. Time will tell which scenario becomes the reality.

Federal Standards

One approach to increasing the federal role in insurance would involve creating federal standards for state regulation. This concept was embodied in a draft legislative proposal released in 2004—the State Modernization and Regulatory Transparency (SMART) Act—by representatives Michael Oxley (R-OH) and Richard Baker (R-LA).[20] The proposed legislation would establish minimum standards that would govern various aspects of state insurance regulation. Federal rules would preempt state regulations that fail to comply with the minimum standards after specified time periods. At the time it was released, the SMART proposal attracted some attention, but it appears that interest in this approach has diminished as the OFC concept has garnered significant support among certain industry segments. Still, the SMART concept warrants some discussion. There is the possibility that it could resurface in some form as an alternative to an OFC or some of its elements may be included in other proposals.

The areas of insurance regulation encompassed by the SMART Act include, but are not limited to:

- Market conduct
- Rates and policy forms
- Insurer and product licensing
- Surplus lines
- Reinsurance
- Financial surveillance
- Receiverships

Essentially, the Act would cover all lines of insurance and industry sectors. A state–national insurance coordination partnership would be charged with determining state compliance with the federal standards and resolving disputes among government agencies.

This proposal has two principal objectives. One, it would compel the states to achieve a level of regulatory uniformity that they might not otherwise achieve. Two, it would dictate insurance regulatory policies in a number of areas. The dual nature of the proposal—framework reform and policy reform—is also characteristic of other proposals for federalizing insurance regulation. The notion of establishing federal standards for state regulation has some precedent. It is currently reflected in federal standards for state regulation of Medicare supplement insurance. The concept of federal standards also was broached as a potential remedy to the significant increase in insurer insolvencies in the late 1980s and early 1990s when the Congress raised concerns about the adequacy of the states' financial regulation of insurance companies (U.S. House of Representatives 1990).

Some might view the SMART concept as less intrusive and ambitious than other proposals that would establish a federal regulator, although states and consumer groups still oppose it.[21] Under SMART, the states would still be responsible for insurance and regulatory oversight and enforcement, and would still retain some discretion in regulatory policy within the limits of the federal standards. As Harrington (2006) observes, SMART would avoid the establishment of a federal regulator and its associated bureaucracy. Further, it could avoid significant policy swings that would undermine market efficiency and harm consumers. The term "could" is an important qualifier, as the enactment of the SMART Act would not preclude subsequent congressional changes to its minimum standards.

At the same time, Harrington identifies a number of potential disadvantages to SMART.

From a framework perspective, one of the principal concerns is that SMART could prove to be an administrative, monitoring, and enforcement nightmare. Some states might seek to circumvent the standards, and there would be the prospect of protracted and costly disputes regarding states' compliance with the standards. SMART could be simplified and its scope narrowed, but this would also undermine its objectives of greater uniformity and policy reform. This reflects the fundamental tension between uniformity and the states' prerogative to regulate insurance as they see fit.

The policy changes contemplated under SMART are broad in scope and, arguably, its principal objective. The thrust of these reforms is to substantially deregulate many areas of insurance and lessen regulatory constraints in others. The states and consumer groups oppose a number of these changes, arguing that they gut essential consumer protections. The proposed reforms are outlined at a relatively high level in the draft document. Any legislative version that would be seriously considered by the Congress would likely be much more detailed and specific and subject to intensive discussion and modification.

It seems that SMART's principal advantages would be greater uniformity in state regulations than what would likely be achieved by the states acting on their own. The Congress would determine what policies the states would be required to implement. Further, the policy reforms embodied in SMART, particularly deregulation in several key areas, would likely go farther than what the states would choose to adopt. On the other hand, regulatory enforcement would still be left to fifty-six regulators, and SMART would not offer the efficiencies that could be achieved by concentrating regulatory activities within one central agency. Further, SMART would not offer the optional characteristics of an OFC that would allow insurers and agents to choose their regulator. Finally, as noted above, enforcing the SMART standards could prove to be very difficult.

At this time, it appears unlikely that any version of the SMART Act will receive significant legislative consideration as the industry is placing its support behind OFC legislation. Still, some of the concepts and policies embodied in SMART could emerge in an OFC bill as it proceeds through its legislative gauntlet.

Optional Federal Charter

The concept of an optional federal charter (OFC) has received the greatest support among significant segments of the industry and attracted the greatest interest. It continues to be the focus of attention in the current state versus federal regulation debate. The original vehicle for the optional federal charter approach was the National Insurance Act (NIA)—S. 40—introduced on May 24, 2007, by Senators John Sununu (R-NH) and Tim Johnson (D-SD).[22] A companion bill was introduced in the House at the same time—H.R. 3200—cosponsored by Representatives Melissa Bean (IL) and Edward Royce (CA). The two bills were referred to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, and there was no further action on either bill, although a number of hearings were held on the proposed legislation. In the new Congress, Representative Bean has introduced a similar bill, the National Insurance Consumer Protection Act —H.B. 1880—which is also supported by Representative Paul Kanjorski (D-PA). While many details may or may not be in a final bill enacted by Congress, a number of important provisions

in the proposed legislation are likely to be present in any law that is enacted.[23]

The NICPA would set up the Office of National Insurance (ONI) within the Department of the Treasury. This agency would be similar to the Office of the Comptroller of the Currency (OCC), the agency that regulates national banks operating in the U.S. Indeed, the entire proposed federal insurance regulatory system is modeled on the OCC. Like the OCC, the ONI's functions would be funded by an assessment on the insurers it regulates.

The NIA allows both life and property-casualty insurance companies to apply to the ONI for a charter and license to sell particular products in all states. It further permits the ONI to regulate the solvency and market conduct of insurers within its jurisdiction. Additionally, it authorizes a commissioner of national insurance to establish a comprehensive insolvency resolution scheme, which includes the state guaranty associations (funds) that meet minimum qualifications. Thus, the ONI would oversee solvency, policy forms, other aspects of market conduct, and insurer insolvencies. It would not regulate prices (except that prices and reserves would have to be based upon sound actuarial principles) or underwriting standards.[24] States would not be able to discriminate against national insurers (those companies receiving a national charter) or national insurance agencies (those agencies with a national license).

Certain state prerogatives would be preserved under the OFC legislation. States would still be permitted to tax insurers under current tax law—again with the qualification that no national insurer or national agency would be taxed differently than insurers domiciled in a state. This would preserve both state premium taxes and the special aspects of their retaliatory taxes. Federal insurers also would be subject to state compulsory auto and workers' compensation laws and also could be required to participate in state residual market mechanisms. Further, national insurers would participate in a state's insolvency guaranty association if a state's guaranty system were deemed to be adequate.[25] If a state plan does not qualify, a federal plan would cover insolvent OFC insurers' obligations in the state.

National insurers or agencies would also be allowed, under the NIA, to choose their state of domicile, which could be different from the state where the company has its headquarters if the company so desires. In addition, the NIA would permit insurers to choose the law under which their insurance contracts are to be interpreted. Finally, the NIA would subject the industry to the antitrust provisions specifically exempted under the MFA. The major exception to the antitrust exemption repeal would be that insurers would still be able to share information about losses or claim payments.[26] Finally, the NIA allows lawsuits in a federal court if a state attempts to interfere with the operation of a national insurer or agency.

Theoretically, federal regulation would offer greater structural efficiencies than the current state regulatory system. Economies of scale could be achieved by consolidating insurance regulatory functions in one central agency. Presumably, the coordination and communication problems faced by state insurance departments would also disappear, but such problems can arise even within a single federal agency, albeit to a lesser extent. Insurers and producers would be subject to one uniform set of laws and regulations nationwide, reducing barriers to interstate operations and fa-

cilitating greater competition. This should significantly reduce the regulatory costs borne by insurers (and ultimately their policyholders) in dealing with fifty-six regulatory jurisdictions. Overall, a fairly strong case can be made that a federal system, properly designed and administered, would offer the most efficient and effective framework for regulating insurance.

Proponents of an OFC also are hoping that it would result in significant policy reforms. Most important, rate regulation would be eliminated (under the proposed legislation) for OFC-regulated insurers—a major concern of property-casualty insurers. OFC policies in other areas are more difficult to predict, but additional reforms are possible. For example, the standards for and regulation of insurance products could be rationalized, and unnecessary and inefficient constraints could be avoided. A federal regulator could also establish and enforce more reasonable and efficient oversight of other aspects of insurers' market practices. Finally, a more progressive principles-based approach could be employed in the financial regulation insurers. This would be consistent with the Treasury's blueprint for financial regulatory reform, which envisions a more coordinated and advanced system for the oversight of financial institutions.

The carve-outs for state residual market mechanisms and guaranty associations are understandable from a political perspective but potentially problematic if an OFC were established. Excessive state regulatory constraints can cause residual market mechanisms to balloon and incur large deficits, a problem that mismanagement of these mechanisms can exacerbate. This could pose a significant burden on national insurers, which might be viewed as a lucrative target for extracting cross subsidies. It is difficult to predict whether this would prove to be a significant problem or an unusual occurrence.

The participation of national insurers in state guaranty associations could present a more significant dilemma. Excluding national insurers would likely significantly reduce the capacity of state guaranty associations, and we presume this is why the existing state guaranty association system is preserved in the current OFC proposal. However, under this arrangement poor regulation of state insurers could expose national insurers to large assessments. Conversely, inadequate regulation of national insurers could expose state insurers to large assessments. The bifurcation of solvency oversight and insolvency guarantees between different government authorities invites moral hazard on the part of financial regulators.[27] This issue may generate further discussion if OFC legislation moves forward.

Questions have also been raised about modifying the industry's antitrust exemption as contemplated in OFC legislation. Grace and Klein (2008b) concluded that such modifications would likely have a minor impact on the industry, if any. Arguably, the industry's current practices already comply with antitrust rules that apply to firms generally. Sharing loss data and analysis could be justified as pro-competitive and economically beneficial and hence would pass broader antitrust scrutiny. The carve-out for this activity in the current OFC proposal would further reaffirm the legality of this practice. The only concern might be that changing insurers' antitrust exemptions could create some legal uncertainty, at least in the short term, but this concern could dissipate over time and any problems could be remedied through further tweaking of insurance antitrust provisions.

Beyond these issues, there is no assurance that the federal government would establish and sus-

tain a more reasonable and efficient set of policies than the states (Detlefsen 2008).[28] There are a number of instances where the Congress has intervened and required the states to impose additional regulatory constraints on insurers in certain areas such as health insurance. For example, during the Clinton administration, the Department of Housing and Urban Development sought to extend Community Reinvestment Act (CRA) requirements to homeowners' insurers. Some members of Congress are currently calling for tighter regulation of property insurance in hurricane-prone areas. Consumer advocates and economists can debate whether such policies would be welfare enhancing, but the federal government is not immune from interest group pressures and excessive and unsound regulatory actions. National insurers might hope to opt out of federal regulation in such a worst-case scenario, but "regulation hopping" would probably not be a viable strategy.[29]

Despite a strong push from many segments of the insurance industry for an OFC, the states and certain industry groups—independent insurance agents and state and regional insurance companies—present a formidable opposing force, and there has been no significant action to date. Indeed, new issues have emerged about the need for strengthening federal regulation of banks and financial markets. It is unclear how OFC legislation (or something akin to it) will fare in the current environment. Hence, insurance is being drawn into a broader reconsideration of financial regulation that could aid or hamper OFC efforts. Regardless of the political climate, OFC advocates will continue to push the issue.[30]

There is a possibility that OFC proposals will surface for specific industry sectors. For example, some believe that the issues associated with establishing an OFC for life insurers are less significant than they are for property-casualty insurers. Hence, there is a distinct possibility that a life-insurance-only OFC proposal will surface with better political prospects than an OFC for all insurers. Another possibility is an OFC for insurers that sell commercial insurance. While these options might be viewed as "half a loaf" to OFC advocates, they might gain traction in an incremental journey to a broader OFC.

A Single-State Regulatory System

An alternative framework that has been discussed (although no legislative version has been introduced) would allow an insurer to choose one state as its regulator (Harrington 2006; Butler and Ribstein 2008). There are several potential advantages to such an approach. One is that an insurer would be subject to a single regulator and one set of rules. A second advantage is that it would make use of the existing state insurance regulatory agencies and avoid the need for creating a new federal bureaucracy. A third advantage envisioned by those favoring such an approach is that it would promote healthy regulatory competition among the states. The states would have an incentive to establish good regulatory systems to attract or retain insurers within their jurisdictions.

This kind of approach shares some similarities with the current rules governing risk retention groups.[31] Some might raise the concern that it would induce a "race to the bottom," in the sense that states would be induced to go too far in creating "lax" regulatory systems to attract insurers. Grace and Klein (2007) offer counter arguments to this concern. In essence, they argue that insurers would be most attracted to "good" regulators, as this would enhance their reputation and

ultimately contribute to firm value. Consumers could learn who the good regulators were and be willing to pay a premium for products from companies who had good regulators. Grace and Klein point to the banking industry, where regulatory competition has tended to lead to better regulation as well as to benefits for consumers. Still, one might want to insert some safeguards so that "low quality" insurers would not abuse such a system. Rating agencies could take regulatory quality into account in their assessments of insurers. Unfortunately, not all insurers are rated, and consumers (and their agents) do not always pay attention to insurers' ratings when they buy insurance. A single-state regulator would also need to be able to address market conduct issues wherever its insurers operated.

This proposal to allow a single-state regulator to oversee insurers in other states has an existing analogue. Corporate regulation is undertaken by the state that incorporates a company. Any disputes involving shareholders and management are interpreted under the law of the incorporating state. State legislation affects only those corporations that have chosen to incorporate under those rules. Insurance regulation is different from corporate law, due in part to the fact that injured third parties are bound by the terms of a contract in which they played no role in terms of its negotiation. With the adoption of a single-state regulatory system, these third parties possibly would be subject to remedy limitations that they could not influence. This is already true under the current system when an out-of-state person is injured by a state resident. Thus, some minimum level of state protections might be in order under the single-state-regulator model.

The major benefit of this style of regulation is that there would be the possibility of true regulatory competition among the states. If we look at the banking model with state and federal regulators, one might suggest that there is competition between the federal and state regulators. However, in practice most states emulate federal regulators so as not to provide national banks with advantages over state banks. In addition, the switching costs between a state and federal regulator are high and make such threats to leave less credible. However, with a single-state regulator, the cost of compliance is much lower, as an insurer need only comply with one set of standards. So if a state were thinking of imposing a costly type of regulation on the industry, it would be able to move to a competitor state.

Other Options

A number of other potential regulatory frameworks have been discussed or might be considered. One such system would delegate solvency regulation to the federal government and market regulation to the states. The appeal of this kind of system is that a single federal regulator might be best positioned to oversee the financial condition and risk of multistate insurers, and some might believe that the states are best positioned to deal with other consumer protection issues within their respective jurisdictions. Further, there is some precedent for this kind of federal–state system in the financial services industry as well as in certain other countries, such as Canada and Australia.

However, there are some potential concerns with this kind of system. One is that state regulatory constraints and actions could have implications for an insurer's financial condition. For example, the states may have an interest in keeping prices of insurance low. This can increase the likelihood for insurer insolvency, thus setting up

a conflict between state and federal regulatory authority. Further, such a proposal would not address most of the complaints about the current system that have more to deal with market regulation than financial regulation. Hence, while this model has some attributes, it is unlikely to satisfy proponents of federal regulation nor induce the states to drop their opposition to a greater federal role in insurance regulation.

Our discussion has omitted other proposals that have been offered. These include the Insurance Consumer Protection Act, a mandatory federal charter for insurance companies, and an insurance information office. There may be others we have failed to mention. While these other proposals are not in the forefront of current discussions with the exception of an OII, some of their elements could appear in future initiatives to reform the framework for insurance regulation.

Summary and Conclusions

In sum, the economic and political context surrounding proposals for insurance regulatory reforms is complex. Proponents of federal regulation believe they have a strong case, and a number of arguments can be made in support of a federal framework. However, the real world is messy and advocates of federal regulation face formidable political opposition that has so far stymied optional federal charter (OFC) legislation. Further, even academic experts are not uniformly in favor of the kind of federal system that the largest insurers advocate, although most support significant reforms. Fortunately, from our point of view, the changes contemplated for the industry's antitrust exemption should not be problematic and may prove to be the least controversial.

Unfortunately, the same cannot be said for other institutional and policy reforms. Both practical considerations and politics will encumber efforts to rationalize insurance regulation. Hence, a major revamping of the current system is unlikely to occur in the near future. What we are likely to see are smaller incremental changes at both the state and federal level that have been the industry's historical legacy. These changes will not achieve the objectives of reformists, but they may help set the stage for more substantive reforms under more favorable political conditions. The topic of insurance regulation and its transformation will continue to provide rich ground for research and discussion by scholars and practitioners.

Notes

1. See Day (1970), Hanson, Dineen, and Johnson (1974), Lilly (1976), and Meier (1988) for more detailed reviews of the history of state insurance regulation.

2. This "destructive competition" was likely due to several factors. These factors could include the lack of good actuarial methods, poor financial management practices, and the general immaturity of the industry and its management. Over time, the industry has matured in terms of its methods and management. In the industry's infancy, regulators allowed the cartels to set prices so as to keep the companies healthy while at the same time limiting insurers' ability to overprice customers. Today there is no need for this type of system, but regulatory oversight of insurers' financial condition is still warranted.

3. *U.S. v. South-Eastern Underwriters*. 322 U.S. 533 (1944).

4. McCarran-Ferguson Act. 15 U.S. Code §§ 1011–1015.

5. It should be noted that advocates of federal regulation have argued that recent events further demonstrate the need for federal oversight of insurance. On the other side, advocates of state regulation make the opposite case. Insurance companies, with a few exceptions, did not en-

gage in the types of transactions that have stressed other financial institutions, and the performance of federal financial regulators has been questioned.

6. Trade associations representing large insurers, reinsurers, and brokers strongly support an OFC. These organizations include the American Insurance Association, the American Council of Life Insurance, the Reinsurance Association of America, and the Council of Insurance Agents and Brokers. They are joined by other organizations with a stake in federal insurance regulation, such as the American Bankers Association.

7. For property-casualty insurance, among the states, the mean percentage of premiums written by nondomestic insurers was 78.9 percent in 2006. For life-health insurance, the mean percentage of premiums written by nondomestic insurers was 92.3 percent.

8. Industry organizations that oppose an OFC include the Property Casualty Insurance Association of America, the National Association of Mutual Insurance Companies, the Independent Insurance Agents and Brokers of America, and the National Association of Professional Insurance Agents.

9. It should be noted that large companies account for most of the insurance sold in the U.S. Many small and regional companies might choose to remain state regulated, but they account for less than 25 percent of the total amount of insurance written (Grace and Klein 2008b).

10. This view was reflected in the 2008 Treasury blueprint, which envisions a phased approach to increasing the federal role in insurance regulation.

11. Klein (2005) discusses the initiatives in greater detail.

12. "Form A" refers to the statement that must be filed with regulators when an insurance company is acquired or there is a change in its control and ownership.

13. See Klein (1995 and 2005) for more detailed reviews of state insurance regulation.

14. In practice, the federal government has left the principal regulatory functions for insurance to the states. Congress, from time to time, has threatened greater federal involvement, and that causes the states to change behavior consistent with congressional objectives. The most recent case of this occurred in the late 1980s and early 1990s when Congressman Dingell held hearings on the failure of state solvency regulation. The states made significant changes to their approach as a direct result of congressional threats to intervene.

15. Life insurers are required to perform some stress testing of their policy reserves. The NAIC is also advancing a principles-based approach to determining the reserve requirements of life insurance companies.

16. Willenborg (2000) and Hall (2000) also provide empirical evidence of this problem.

17. There are some similarities as well as differences between the protections provided by insurance guaranty associations and those provided by the Federal Deposit Insurance Corporation (FDIC) for bank depositors. Klein (2005) provides a more detailed discussion of insolvency guaranty associations.

18. Regulating insurance markets and insurers' market conduct, is, arguably, much more extensive than that for banks. This may be partly due to the nature of insurance transactions but also may be influenced by political factors given the high salience of certain insurance issues (for example, the cost and availability of auto and home insurance).

19. Some states tend to allow market forces to determine rates in these markets while other states seek to assert some control over pricing. Regulatory pricing constraints can become particularly severe in some jurisdictions (such as homeowners insurance in Florida).

20. In June 2006, Rep. Ginny Brown-Waite introduced part of the SMART Act as H.R. 5637, 109th Cong. 2d Sess., June 19, 2006 (NIA, § 2).

21. See Harrington (2006) for a comparative review of different options and proposals for federalizing insurance regulation.

22. National Insurance Act of 2007. SB 40. 109th Congress.

23. A number of papers have examined the pros and cons of an OFC, including Scott (2008), Brown (2008), Grace and Scott (2008), and Detlefsen (2008).

24. Note that states also do not regulate life insurance prices per se. The states only regulate prices indirectly in their review and approval of life policy forms, which includes consideration of the relationship between the premiums that would be charged and the benefits that would be paid.

25. We presume that, under this arrangement, the state guaranty associations would function essentially as they do under the current state system. An insolvent insurer's claims obligations in a given state would be covered by

that state's guaranty association. Assessments to cover the guaranty association's claim payments would be allocated to insurers in the state according to the amount of insurance premiums they write in the state.

26. This is more pertinent to non-life insurance than life insurers. Life insurers do not use statistical agents to compile industry data on the amount of benefits they pay, although this information is reported in the public financial statements they file with regulators and others. Life insurers use mortality tables, which the NAIC publishes as a reference to assist them in pricing life insurance policies and annuities.

27. Arguably, this problem exists even if the two responsibilities are housed in different agencies within the same government. The Federal Deposit Insurance Corporation (FDIC) has sought to counter this problem by setting its own minimum standards for federally insured banks that are regulated at the federal or state level.

28. Brown (2008) also identifies flaws in the OFC proposal.

29. In reality, companies would find regulation hopping to be quite expensive. For example, a company undertakes conversion from a state-licensed company to a federal company. A great deal of information concerning marketing practices, contract terms, and other compliance activities must now be set up to comply with federal regulations. Returning to state regulation would require setting up to comply with every state regulatory requirement for each state where the company writes. For a national company this would be costly.

30. A number of commentators have suggested that AIG's failure was the result of state regulation (Sununu et al. 2008). Some have argued that it was, in fact, caused by the lack of appropriate federal supervision (Rusboldt 2008). Either way, the recent financial market problems will be part of the discussion.

31. Under current federal law, a risk retention group (RRG) can form in one state and operate in any other state without being subject to extra-state regulation. Initially, the states resisted this system and problems were encountered with RRG insolvencies. However, some of these problems appear to have been resolved, and the relationships between RRG domiciliary states and other states have improved.

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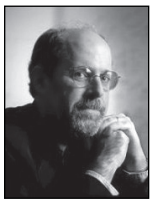

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