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The Future of Insurance Regulation: An Introduction

Martin F. Grace and Robert W. Klein

The question of who should regulate the insurance industry has been debated in the United States since the time of the Civil War. Insurance continues to be regulated by the states despite several challenges to their authority over the years. The states' authority over insurance was supported in various court decisions until the *Southeastern Underwriters* case in 1944.[1] In that case, the Supreme Court determined that the commerce clause of the Constitution applied to insurance and that insurance companies (and agents) were subject to federal antitrust law. The Court's ruling caused the states and the industry to push for the McCarran-Ferguson Act (MFA) in 1945, which delegated the regulation of insurance to the states.[2]

At that time, the majority of insurance companies favored state over federal insurance regulation. However, since the passage of the MFA the bulk of insurance is now written by national (and international companies) operating across state borders. Many of these insurers have come to view state regulation as an increasing drag on their efficiency and competitiveness and now support a federal

1. 322 U.S. 533 (1944).
2. 15 U.S.C. secs. 1011–15.

regulatory system. This is reflected in recent proposals that would establish an optional federal charter (OFC) for insurance companies and agents that would allow them to choose to be federally regulated and exempt from state regulation. However, there is fierce opposition to an OFC among the states and state-oriented segments of the industry.

Since the Gramm-Leach-Bliley Act (GLBA) was enacted in 1999, there has been increasing interest in Congress and significant sectors of the insurance industry to establish some form of federal insurance regulation. The GLBA provided the opportunity for banks, insurance companies, and other types of financial intermediaries to be owned by the same holding company. In addition, each type of firm was still subject to regulation by the particular intermediary's regulator. Although the GLBA was a significant step forward, a number of experts have criticized the division of regulation among various agencies and levels of government. In this sense, insurance is marked as the area most out of line with a modern, integrated system of financial regulation.

The demand for federal regulation arises from not only the high cost of state regulation but also other problems associated with it. The high cost of state regulation derives from the fact that insurers must comply with the specific regulations in each state in which they do business. Insurers are burdened by duplicative yet often inconsistent regulation of many aspects of their operations, including solvency, products, prices, and market conduct.[3] While solvency regulation is relatively uniform (albeit enforced by each state), the regulation of insurers' other activities (that is, market regulation) varies greatly among the states. Many insurers are concerned about the hurdles they must overcome in getting prices and products approved and the constraints and mandates imposed on various aspects of their market activities, which they view as excessive and unnecessary.[4] These concerns have grown as the industry has becoming increasingly national and international in its scope of operations and as financial convergence has spurred competition between insurance companies and other institutions in the sale of certain financial products with similar attributes. The U.S. system of state insurance regulation is viewed as substantially undermining insurers' efficiency and ability to compete in national and international markets.

At the same time, any move to federal insurance regulation is strongly opposed by certain stakeholder groups, including state officials, state and regional insur-

3. Grace and Klein (2000).

4. For a series of case studies on the effects of automobile insurance price regulation, see Cummins (2002).

ance companies, and many insurance agents. Opponents of federal regulation raise concerns about the possibility of weakened regulation, reduced consumer protection, and lack of proper attention to local issues. State regulators, understandably, also may fear significant erosion of their authority if large segments of the industry become subject to federal regulation. Additionally, state-oriented insurance companies and agents may be concerned about the competitive advantages that would be gained by national insurers and agents that opt for federal regulation. Hence proposals to establish some form of federal insurance regulation, principally an OFC, have been mired in a fierce debate that has thwarted decisive legislative action.

Still the push for federal insurance regulation shows no signs of abating and may very well intensify in the context of the current problems in financial markets and efforts to restructure the regulatory framework for all financial institutions. The U.S. Department of the Treasury issued its blueprint for financial services regulation reform in March 2008, before conditions in financial markets reached crisis proportions and contributed to cascading problems in the overall economy.[5] The Treasury blueprint acknowledged an important federal role for insurance regulation and advocates an insurance OFC similar to that conceived in pending federal legislation. The 2008 Treasury plan will likely be revisited by the new administration and Congress that took office in January 2009, but many of its components, including an insurance OFC, may be incorporated into the reform measures advocated by this administration.[6]

With the financial crisis of September 2008, the significant financial failure of a noninsurance subsidiary of the American International Group (one of the largest insurers in the world), and the resulting federal bailout of the financial services industry, the interconnections among various financial institutions and markets became apparent, increasing the pressure for overhauling the regulatory structure. Insurance will likely be a subject of considerable discussion as reform efforts move forward, but how and when it might be incorporated into a federal regulatory framework remains uncertain. Views differ as to how recent events will affect the prospects for federal insurance regulation. However, the issues underlying the

5. U.S. Department of the Treasury (2008).

6. In testimony before the Senate Banking Committee, the new Treasury secretary, Timothy Geithner, stated that OFC proposals had merit and that his personal view is that a federal charter is likely to be an important part of the administration's regulatory reform plan. See "Geithner: Federal Insurance Charter 'Important Part' of Financial Plan," BestWire, February 10, 2008.

need for examining the structure of insurance regulation have remained largely unchanged even as market conditions have changed.

This brings us to the purpose of this book. In July 2008 Georgia State University, the American Enterprise Institute, and the Brookings Institution sponsored a conference on the future of insurance regulation in Washington, underwritten by the Risk Foundation. The following chapters are based on papers presented at the conference and address a number of issues surrounding the structure of insurance regulation and its policies. Although the papers were presented in July 2008, in the chapters that follow the authors reflect on subsequent events and their significance for the future of insurance regulation.

The conference addressed a number of important issues surrounding the future of insurance regulation and the different paths it might take, primarily the question of state versus federal regulation, specifically the merits of an OFC and how it might be designed. Beyond the questions involved with the institutional framework for insurance regulation, the conference also considered how insurance should be regulated from a policy perspective and the implications of financial convergence and the internationalization of insurance markets for an optimal regulatory structure. Arguably, current OFC proposals leave a number of unanswered questions, and other reform scenarios are possible. Hence, the purpose of the conference was to look beyond the merits of an OFC and to ask broader questions, such as

—What is the right administrative apparatus for insurance regulation?
—What areas should be regulated and how?
—How does deregulation affect markets and consumers?
—How does financial convergence interact with changes in regulation?
—How does regulation affect insurance markets internationally?

This is an appropriate time to examine these questions. Recent events have exposed further vulnerabilities in financial markets and cracks in the regulatory structure for financial institutions. Policymakers must tackle a host of issues in charting a future course for financial regulation generally and insurance regulation specifically. The following chapters put the OFC proposal in context and examine various aspects of its design and implementation as well as a broader set of questions associated with insurance regulation. This book provides policymakers and academics with insights into the implications of a number of the policy choices that are likely to be considered.

An Overview of the Insurance Industry and Its Regulation

In chapter 2 Robert Klein provides an overview of the insurance industry and its current regulatory structure that establishes a context for the following chapters. He reviews the considerable growth and evolution of the U.S. insurance industry and its principal sectors: life insurance and annuities, accident and health insurance, and property-casualty insurance. Since the enactment of the MFA, the industry has grown substantially in size, scope, and complexity. Most of the insurance in a given state is sold by insurers that are domiciled in other states. Insurers also now underwrite a wide variety of exposures, and their financial structure and risks have become much more complex. The states have been challenged in keeping pace with the industry and its growing scope and complexity.

State insurance regulators have responded to these challenges by substantially increasing their resources and improving their methods in overseeing the industry. They have made substantial changes in many areas and have embarked on various initiatives to harmonize their regulatory requirements, eliminate unnecessary constraints, and ease the compliance burdens of insurers. Still these efforts have fallen far short of what national insurers would consider satisfactory, and it is questionable whether a state-based system could ever achieve the efficiencies of a federal regulator. Nonetheless, the vision of federal regulation may not be realized any time soon, which makes reforms at the state level all the more relevant.

Klein also outlines alternative frameworks for insurance regulation. An OFC has received the greatest attention and support, but other structures have been proposed. Other proposals include federal standards for state regulation and the creation of a single-state regulatory system in which an insurer would be subject solely to the oversight of its domiciliary jurisdiction regardless of where it did business. While these other proposals have not attracted strong constituencies, their relative merits may surface as the debate over insurance regulation progresses. Indeed, if history is any guide, the pattern of incremental changes in federal and state roles may continue for some time before a more fundamental restructuring of insurance regulation occurs.

The Pros and Cons of Federal Insurance Regulation

In chapter 3 Martin Grace and Hal Scott examine the legal structure of regulation proposed in OFC legislation and compare it to current state practice and current federal regulatory practice. The chapter starts with an overview of the economic argument for an optional federal charter approach to insurance regulation. In the

last few years a number of researchers have attempted to document the costs of the state system of regulation. Evidence exists that the insurance industry is an interstate business. Thus duplicative regulation is costly, and the states themselves are not necessarily efficient regulators. The average property liability company has sixteen state licenses, and the average life company has twenty-five licenses. Grace and Scott pose several questions. Is there any social value in having sixteen or twenty-five different regulators looking at each company? Is there any value in duplicative regulation or inconsistent regulation? Does each state have the proper incentives to regulate when it knows there are other states looking at the firm? Evidence suggests that small states might free ride on bigger states' regulatory apparatus. A federal regulator might be able to reduce these types of costs to the benefit of the insurance consumer.

Grace and Scott also look at the response of the National Association of Insurance Commissioners (NAIC) to the issue of duplicative regulation by examining the commonality of regulatory approaches for a number of model acts promulgated by the NAIC. Few of the model laws in their (admittedly nonrandom) sample were uniformly adopted by the states: there not only seems to be a natural limit to the number of states that might adopt a model act but, in addition, some large states have adopted their own version of the model.

Grace and Scott also find that there are significant questions left unaddressed by the current proposal. For example, it is still feasible for firms in a group to expose the market to significant systemic risk and be outside the scope of systemic risk review. In addition, because of the competitive nature of various markets and the various sophistication levels of consumers of these products, what gets regulated needs to be examined. Further, how state solvency funds interact with an OFC warrants more thought. Finally, in a point that is often overlooked, the authors stress that a national and international industry needs the regulation that will allow it to thrive in its chosen markets.

In chapter 4 Robert Detlefsen takes a critical look at an optional federal charter style of regulation. He summarizes several criticisms of an OFC, including the likelihood that a dual system would create inequities among firms competing within the same markets; the potential that an OFC would confuse consumers as to who is responsible for regulating their insurer; and the possibility that an OFC would require the establishment of a new federal bureaucracy on top of the bureaucracies that exist in each state. Detlefsen also takes on the question of whether federal regulators would be more competent than their state counterparts, given the recent performance of federal regulators responsible for overseeing financial institutions and markets.

Detlefsen also points out that the demand for an OFC style of regulation is different for each sector of the industry. While both are concerned about uniformity of licensing and the speed to market for new products, property-casualty companies are interested in reducing distortions caused by rate regulation and underwriting restrictions. In contrast, life companies are more interested in avoiding the costs of duplicative and inconsistent regulations, which hamper their ability to get new and innovative products introduced in the market.

Detlefsen examines the dual-charter option in the banking industry in a practical light. He asserts that an OFC is not really optional, as competition between state and federal regulators is illusory. First, companies may choose a federal regulator, but the costs of reversing such a decision would likely be high. Second, there will not really be regulatory competition between the states and the federal government due in part to the high costs of switching as well as the possibility of significant federal preemption of state regulatory authority. Restricting state authority to what the federal government decides is proper takes away the states' ability to compete. This is important in Detlefsen's view because Congress could take an interventionist approach to insurance with the goal of fairness in mind. However, fairness is likely to socialize private risk sharing by prohibiting the use of risk-related underwriting criteria. While this could happen in the states, the comparison between markets can provide evidence to other states regarding the desirability of such policies.

Regulatory Policy Reform

In chapter 5 Martin Grace and Robert Klein tackle the issue of policy reform. They believe that proponents of a federal charter approach envision that federal regulators will diverge significantly from the restrictive policies enforced in a number of areas by the states. Thus even if an OFC could achieve significant structural efficiencies, its ultimate effect on insurers and insurance markets will greatly depend on the policies adopted by federal regulators. Also, to the extent that the states continue to be the predominant regulators, their policies will have significant implications for how insurance markets function. Hence Grace and Klein outline a set of principles and discuss needed reforms in key areas of insurance regulation that are relevant in either a state or a federal framework.

Grace and Klein argue that insurer solvency regulation is mired in an antiquated paradigm that relies too heavily on accounting valuations of insurers' financial condition and their compliance with extensive prescriptive rules and too little on insurers' management of their financial risk. The U.S. approach is being

eclipsed by the development of principles-based regulation of insurance companies in other large markets throughout the world. Principles-based regulation is also being implemented for other financial institutions in the United States and internationally. The current system also performs poorly in terms of prompt intervention when insurers encounter financial distress and managing the receiverships of failed companies. The costs of managing the receiverships of insolvent insurers are high relative to other financial institutions, in part due to the current structure of state insolvency management. Grace and Klein contend that there is a strong need for U.S. regulators to move to a principles-based approach to solvency regulation that employs the best methods to assess an insurer's financial risk and the management of that risk.

Grace and Klein also call for substantial reforms with respect to the regulation of insurers' prices, products, and market practices. They recommend that prices be fully deregulated, given the competitive structure of insurance markets and the problems created in states and in lines of business in which prices are still subject to significant constraints. They also argue that the regulation of insurers' products should be rationalized and streamlined to foster innovation and to speed the introduction of new products to meet consumer needs. Other areas marked for reform include excessive constraints and mandates in the underwriting of insurance policies, the mismanagement of residual market mechanisms, and the inefficient methods used to police insurers' market conduct.

Focusing on one of the proposed benefits of an OFC, Robert Litan and Phil O'Connor look at state insurance price regulation and deregulation in chapter 6. This is an important issue to the property-casualty insurance industry. Price regulation is specifically precluded in current OFC proposals, which would allow federally regulated insurers to charge rates based on the cost of risk as well as other competitive considerations. The competitive market would discipline insurers and, as in other sectors, would keep premiums in line with claims, other expenses, and a reasonable profit, given the risk of the line of business.

Historically, automobile, homeowners, and workers' compensation insurance have been subject to considerable price regulation by the states. Presumably this has been motivated, in part, by concerns that insurers charge excessive prices, but other factors also may play a role, such as keeping insurance "affordable" and limiting the premiums paid by high-risk insureds. Litan and O'Connor assess the empirical evidence on automobile insurance specifically to determine how consumers have fared under different regulatory policies. This question is particularly relevant to the proposed OFC legislation, which explicitly eliminates price regulation.

Litan and O'Connor examine prior research on rate regulation in auto insurance as well as conduct their own tests of the effects of changes in states' regulatory polices. A large body of evidence suggests that rate regulation has been ineffective in what it set out to do. The regulated lines are generally quite competitive, which raises questions as to the need for or the benefits of price regulation. Overall, the effect of regulation on average premiums appears to be negligible. However, the prior research also suggests that price regulation distorts the market, subsidizing high-risk drivers at the expense of low-risk drivers.

Litan and O'Connor further assess the effects of deregulation in two states (New Jersey and South Carolina) and the impact of increased regulation in a third (California). They look at prices before deregulation and after deregulation to assess the effect of an OFC prohibition on price regulation on auto insurance markets. They find that average auto insurance consumers paid no more after deregulation than before deregulation. Indeed, they suggest that regulation may cause consumers to pay higher prices than necessary in the long term, as insurers may be more reluctant to lower rates in a highly regulated environment. In addition, they find that residual markets (populated by the highest-risk drivers) shrink after deregulation, thus providing additional evidence that deregulation reduces subsidies to high-risk drivers. They conclude that current OFC proposals that would deregulate insurance pricing would offer significant benefits to consumers.

Financial Convergence and Global Insurance Markets

In chapter 7 Peter Wallison examines the effect of convergence (cross-industry competition) on the insurance industry. Convergence comes in two forms, each of which affects the structure of regulation. One convergence is the agglomeration of banks, insurers, and other intermediaries within a holding company structure. Another convergence is the group of individual financial intermediaries that provide financial products that overlap with financial products provided by other sectors of the financial services industry. Both types of convergence are, potentially and unnecessarily, constrained by an antiquated regulatory system. The Treasury's blueprint for reform also noted that outside forces put pressure on the U.S. regulatory structure. Convergence has occurred in other parts of the U.S. financial system to some extent as part of the GLBA, but it is more common in other markets internationally. The GLBA is just a partial response to the market pressure for increasing convergence. In fact, Wallison observes there are more than a hundred state and federal regulators for banks, insurers, and securities

firms. So while there is some convergence in the financial services industry, there is little interest in changing the overall regulatory approach despite the long-term market trends.

The important long-term trends are the growing productivity benefits from information technology and the growth of interindustry competition. Banks and securities firms are competing, as are banks and insurance companies. The latter competition is especially important given the recent financial crisis. This is, in part, due to the varied types of industry competition. Banks and insurers are developing products that compete as substitutes for capital market contracts. Banks and capital markets are able to produce substitutes for traditional insurance products. Corporate consumers are also looking to many types of providers for their risk management products, and sophisticated savers are looking to both banks and insurers for annuity-like products. Finally, securities firms are competing with insurance producers in markets for mutual funds and other products with similar characteristics.

One of the reactions to the convergence phenomena is regulatory resistance; the turf battle between the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC) over derivatives markets is a classic example of how things might evolve in other markets if a given agency attempts to provide benefits to firms within its jurisdiction at the expense of others. Wallison argues that an optimal regulatory structure should provide a level playing field in terms of how different financial institutions and their activities are regulated. Firms would not receive arbitrary benefits from chartering with a given agency, so which regulator oversees a firm would become immaterial in terms of its ability to compete in various markets. Wallison concludes that a reasonable way to accomplish this objective is to treat banks, securities firms, and insurance companies as a single industry and regulate them according to the objectives of regulation rather than the particular way that their products and services were structured or delivered in the past.

In the final chapter, John Cooke and Harold Skipper examine the international dimension of the structure of regulation in the United States. On the surface, to enter the U.S. market in its entirety, a firm would need fifty-six licensees from fifty-six regulatory bodies. Cooke and Skipper argue that the costs of entering the U.S. market as a result of its state-based structure constitute a significant entry barrier. Further, other countries may use this structural barrier as a means of justifying barriers for U.S. insurers. International banks can obtain a national charter, which raises questions as to why insurance companies are treated differently.

Like Peter Wallison, Cooke and Skipper point to the forces of convergence and the fact that other countries have responded to this convergence differently. Some countries have adopted a single-regulator system for all financial services, while others use functional regulatory schemes with mechanisms to promote coherence among the various regulators. For example, Australia uses two regulators, one for consumer protection and one for market conduct.

Cooke and Skipper also point to the EU's approach to federalism as a possible example for the United States. Each EU country has, by treaty, agreed to harmonize regulations and use similar standards in regulation. In addition, a company licensed in any country is allowed to sell in any other member country. The EU approach theoretically promotes a high degree of coherence for solvency regulation and at the same time leaves market conduct to the member states. This approach has a close U.S. analog in the Interstate Insurance Product Regulation Commission (IIPRC), which was set up to provide a centralized clearinghouse for product approvals. However, while important to the life industry, the IIPRC covers only a narrow aspect of insurance regulation, and only thirty-three states have become members to date.

Insurance is becoming more important internationally: insurers sell their products through cross-border sales, through the establishment of country-specific subsidiaries or branches, and through the reinsurance market. A well-functioning competitive insurance market needs international insurers. To the extent that regulatory structure limits competition, social welfare is reduced. Cooke and Skipper point to a number of aspects of U.S. insurance regulation that have been identified as trade barriers for both interstate and foreign entry. Important barriers include multiple state licensing requirements, government entities that are either monopolists or direct competitors in the market, compulsory reinsurance requirements, extraterritorial application of state laws, and significant state-imposed exit costs. Government-owned foreign insurance companies seeking to enter the U.S. market also face problems if the states have certain restrictions, requirements, and trade laws (such as restrictions on a foreign-owned firm obtaining a license, citizenship requirements, seasoning requirements, trade laws that allow states to retaliate against insurers for their home country's laws or regulators, and requirements that foreign insurers maintain surplus funds with a state trustee).

Cooke and Skipper believe that an OFC would be similar to the regulation of other large markets by not only providing the benefits of additional competition in the United States but also allowing U.S. companies to enter international markets at lower costs. In addition, it is presumed that a national regulator would be

able to remove the barriers to entry that hinder legitimate insurance competition. The states and the NAIC have been aware of these international trade issues for many years, but little has been accomplished: the federal government cannot speak on behalf of the states for insurance regulation, and the states have no incentive to agree on international trade provisions. However, an OFC approach would offer competitive advantages to U.S. insurers, provide a single regulatory voice for international trade issues, and promote competition.

Conclusion

Insurance regulation has historically been focused on state markets. However, state markets are no longer dominated by local firms. This has been true for some time; the industry is becoming more of an interstate and international business with each passing year. In addition, insurance companies are competing with other types of financial services firms, such as consumer and corporate product firms. The U.S. regulatory system for insurance was designed for a world that no longer exists, and the United States is at a crossroad in terms of resolving this dilemma. The following chapters provide valuable insights on various questions associated with the future of insurance regulation in the United States and how it might evolve.

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