

Optional Federal Chartering of Insurance: Rationale and Design of a Regulatory Structure

by

Martin F. Grace
James S. Kemper Professor of Risk Management
Robinson College of Business
Georgia State University

and

Hal S. Scott
Nomura Professor of International Financial Systems
Harvard Law School

I. Introduction

Since the early nineteenth century, states have preempted federal authority (reverse preemption) in the regulation of the U.S. insurance industry. In contrast to other financial services (i.e., securities and banking), Congress has not sought to exercise either concurrent or preemptive authority over insurers. Indeed, the McCarran-Ferguson Act of 1945 explicitly found state regulation of insurance to be in the public interest, and provided that no federal law should be found to “invalidate, impair, or supersede” any state insurance regulation or tax.¹ Recently, however, and particularly in the wake of the Gramm-Leach-Bliley Act of 1999,² many insurers have proposed a system of optional federal chartering and regulation of insurance (OFC).

In May 2007, Senators John Sununu and Tim Johnson introduced S. 40, the National Insurance Act of 2007,³ which sets forth a scheme for the optional federal chartering (OFC) for life and property/casualty insurers largely modeled on the National Bank Act of 1864.⁴ In July

¹ Pub. L. 15, March 9, 1945. (Codified at 15 U.S.C. §§1101-1115.)

² Pub. L. 106-102, Nov. 12, 1999.

³ S. 40, 110th Cong. 1st. Sess., May 24, 2007 (“NIA”).

⁴ Act of June 3, 1864, c. 106, 13 Stat. 99, as amended. (Codified at 12 U.S.C. §§ 1-548; 19 U.S.C. § 197; 31 U.S.C. § 543.38.)

2007, Representatives Bean and Royce introduced a companion bill, H.R. 3200.⁵ In contrast to the state coordination approach taken by the State Modernization and Regulatory Transparency (SMART) Act introduced by Representatives Michael Oxley and Richard Baker in March 2004,⁶ NIA would establish a “comprehensive system for the Federal regulation and supervision of national insurers and national agencies. . . .”⁷ State regulation would be preempted except in a few areas, such as taxation and participation of national insurers in state residual risk mechanisms and qualified guaranty funds.⁸ In March 2008, the U.S. Treasury endorsed an optional federal charter, as part of its Blueprint (“Blueprint”) to modernize the federal regulatory structure, much along the lines of the pending bills in Congress.⁹

We first present the arguments for abandoning the status quo and moving towards an alternative approach to regulation based on an optional federal charter. Further, we add to the discussion by describing what additional issues need to be addressed if we adopt an optional federal charter approach to regulation. While the merits of OFC have been much debated, comparatively little consideration has been given to the matter of how such a system should function if enacted.¹⁰ This paper considers the proposal by Senators Sununu and Johnson, and the issues raised by the need to design an appropriate regulatory structure for OFC. Ultimately, the design of a regulatory structure must turn on the objectives of federal insurance regulation and the lines of insurance to be regulated.

⁵ H.R. 3200, 110th Cong. 1st Sess., July 26, 2007.

⁶ In June 2006, Rep. Ginny Brown-Waite introduced part of the SMART Act as H.R. 5637, 109th Cong. 2d Sess., June 19, 2006.

⁷ NIA, § 2.

⁸ *Id.*, at §§ 1125, 1601, 1703.

⁹ The U.S. Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (March 2008)(Blueprint)..

¹⁰ Scott Harrington provides an overview of options for federal intervention in insurance regulation, and suggests two alternatives to OFC: (1) federal minimum standards that would preempt inadequate state regulation, or (2) the creation of a system of “primary state” chartering akin to the current system of corporate chartering. *See Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation*, Networks Financial Institute Policy Brief, No. 2006-PB-02 (March 2006) 25-30.

II. Current Proposal: National Insurance Act of 2007

The NIA would establish an Office of National Insurance within the Department of the Treasury to provide federal chartering for life and property/casualty insurers. The Office would be headed by the Commissioner of National Insurance, the insurance counterpart to the Comptroller of the Currency, who would be authorized to issue federal charters and licenses to insurers, and to regulate exclusively their operations and solvency.¹¹ The Commissioner would have the power to implement the NIA by regulation, and would “have exclusive authority to determine whether a person subject to this Act has complied with the Act or the application of any State law to matters regulated under this Act, including the determination of any complaint raised by any person.”¹² Thus, the NIA apparently would provide national insurers with visitorial protection analogous to that granted to national banks. Like the Office of the Comptroller of the Currency, the Office of National Insurance would be self-funding. The NIA provides that the Office would be funded by the examination fees paid by national insurers and agents, as well as “such additional fees as the Commissioner determines to be necessary and appropriate to fund the expenses of the Office.”¹³

The NIA would eliminate prior approval of policy form and rate regulation for nationally licensed lines of life and property/casualty insurance. It would establish a “file and use” system for life insurance forms, and allow national life insurers to classify policyholders and set rates freely.¹⁴ National property/casualty insurers would be subject to a “use and file” system, and free from any requirement by the Commissioner that they use “any particular rate, rating element, price, or form.”¹⁵

¹¹ NIA, § 2(3).

¹² NIA, § 1102(b)(1)(A)(iv) & (b)(2)(A).

¹³ NIA, § 1122.

¹⁴ *Id.*, § 1213.

¹⁵ *Id.*, § 1214

National insurers still would be required to comply with state law prescribing compulsory coverage requirements for workers' compensation and individual auto insurance,¹⁶ and to participate in state mandatory residual risk mechanisms and guaranty funds.¹⁷ However, the NIA would afford national insurers some protection from state law in these areas. Under the Act, no state would be empowered to regulate the rates at which a national insurer might offer workers' compensation or auto insurance, or to require a national insurer to participate in any residual risk mechanism that would "fail to cover the expected value of all future costs" associated with it.¹⁸ Also, the Commissioner would have to certify that each state guaranty fund fairly represents insurers by size and product line, and does not discriminate against national insurers.¹⁹ If the state guaranty fund did not qualify for certification, a national insurer operating in that state would join the National Insurance Guaranty Corporation established by the NIA instead.²⁰

Internally, the Office of National Insurance would contain a Division of Insurance Fraud, a Division of Consumer Affairs, and an Office of the Ombudsman. The Division of Insurance Fraud would be charged with investigating fraudulent insurance acts and enforcing civil penalties for violations of the law.²¹ The Division of Consumer Affairs would implement and enforce market conduct regulations.²² The Office of the Ombudsman would act as a liaison between the Office of National Insurance "and any regulated person adversely affected by the supervisory or regulatory activities of the Office, including the failure of the Office to take a requested action."²³ In addition, the Commissioner would have the authority to provide for the registration of a national insurance self-regulatory organization.²⁴

¹⁶ *Id.*, § 1125(b)(4).

¹⁷ *Id.*, § 1125(b)(3) & 1601(a).

¹⁸ *Id.*, § 1125(b)(3) & (4).

¹⁹ *Id.*, § 1602.

²⁰ *Id.*, § 1601(b).

²¹ *Id.*, § 1104.

²² *Id.*, § 1105.

²³ *Id.*, § 1107(b).

²⁴ *Id.*, § 1106.

While the Treasury Blueprint also contemplates, in the longer term, a new federal insurance regulator within the Treasury Department, it recommends, in the shorter term, the creation of new Office of Insurance Oversight (OIO) within the Treasury Department. The OIO would be established to accomplish two main purposes—to address international regulatory issues such as reinsurance collateral and to ensure that the National Association of Insurance Commissioners (NAIC) and state insurance regulators achieved uniform implementation of U.S. insurance policy goals.²⁵

III. Objectives of Insurance Regulation

Introduction

The underlying rationale for economic regulation is to minimize the social costs of market failures. In fact, economists suggest that social welfare is greatest when regulation reflects the competitive market outcome which would arise in the absence of market failures. In the case of insurance, the market failures are generally thought to be from information asymmetries and lack of bargaining power. There are a number of sources for these information asymmetries in the insurance industry. Informational asymmetries exist from managers of insurance firms knowing more about the value of the insurer (which affects the likelihood that the policy will be honored) than the policyholder and being able to alter that value, by taking on or shedding more risk, outside the control or view of the policyholder. Additional informational problems arise from the potential difficulty of comparing contracts among companies and the likelihood of consumer confusion. Insurance contracts are complicated in their own right and insurers understand the contract terms better than typical purchasers, even business firms. Individual consumers may also lack bargaining power as insurers can fix contract terms which are not subject to negotiation. Further, some insurance is required by law or contract. Thus,

²⁵ Assistant Secretary David G. Nason, Testimony before the House Committee on Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, April 16, 2008.

regulators often set contract rules, price, and policy terms to minimize the effect of potential market failures.²⁶

Asymmetric Information Problems in Insurance

Moral Hazard. The life insurance industry presents an unique problem in the economy. Consumers purchase a contract today with the expectation that it will pay-off at some distant point in the future. Once the contract is purchased it cannot be returned for a “refund”, nor is it easily sold in a secondary market. Thus, it is imperative that consumers have faith in the insurer being able to pay a future claim to their heirs. Because the policyholder has neither the means to discipline and replace poor managers (as stockholders do) and because the stockholders have a different set of incentives (profit maximization), the policyholder is powerless to prevent the insurer from undertaking actions which reduce the value of the policy owner’s future claim.²⁷ This gives rise to moral hazard as owners of a company have incentives which differ from the policyholders’. Specifically, by taking risky but potentially profitable actions today, a firm can reduce the probability that it will survive in the future. This increase in risk reduces the probability an insurer will exist in the future.

The insurance contract itself can be employed as a way to set obligations between the policyholder and the insurer. The insurance contract covers the immediate rights between parties when a claim occurs. It generally does not cover investment fund restrictions or impose other restrictions on managerial discretion. These long-run behaviors are difficult to address by contract. However, this principal-agent problem can be addressed if the insurance regulator can regulate the firm for solvency purposes. While this principal-agent problem is most acute in the

²⁶ For a more complete treatment of the rationale for the regulation of the insurance industry, see Harold D. Skipper, Jr. and Robert W. Klein, *Insurance Regulation in the Public Interest: The Path Towards Solvent, Competitive Markets*, 25 THE GENEVA PAPERS 482-504 (2000).

²⁷ This is the same problem corporate long term bondholders have with respect to the corporation. Bondholders attempt to reduce the opportunities for the corporation to reduce the value of the debt by imposing covenants in the bond that restrict the manager’s ability to act opportunistically against the debt holders. The initial bondholders that negotiate these covenants are able to extract concessions. However, individual policy owners likely do not have the same degree of leverage against an insurer.

life industry, it also exists in the property-liability industry. Certain lines of insurance cover risks that may take many years to reveal themselves. For example, product liability coverage purchased to cover the costs of a particular drug if the drug has a subsequent problem may not arise for many years after the contract was purchased. Thus, there is still the problem of the insurer undertaking actions which reduce the value of the insurance purchased. Again, the regulator may be able to control this.

Imperfect Information and Consumer Confusion. Another informational asymmetry arises from insurers knowing more about risk and risk pricing than consumers. In a perfectly competitive market a consumer would use price to determine everything about the insurer. However, there are numerous prices for the same “insurance”. Thus, to make shopping easier regulators can lower consumer shopping costs by mandating standard coverages. For example, high quality insurers often have higher prices. This is because they are more secure with higher levels of reserves. In addition, high-priced companies may choose to pay their claims quicker. Low priced companies, in contrast, may choose to use independent agents or engage in other cost saving practices. Absent standard contracts, a consumer facing different contract terms and different pricing strategies may not be able to shop effectively for insurance. Thus, regulators can reduce the social costs of price and term comparisons by standardizing coverage. If the regulator can do this less expensively than the unregulated market, then this would benefit society..²⁸In addition, to the policy and form regulations described above, the regulator can examine claims paying practices *ex post* to see if insurers are treating their policyholders fairly. Further, they can examine *ex ante* the firms training and marketing materials to see if the insurer is describing the insurance contract accurately and training the sales agents appropriately. These regulatory activities are designed, in theory, to reduce consumer confusion and to provide

²⁸ This argument might lead to the standardization of all consumer contracts. However, insurance is a complicated contract and the consequences to the typical consumer of a contract misunderstanding are potentially severe. Thus, the social benefits of contract regulation may be positive.

accurate information about complex products. If the regulator can undertake these tasks at a lower cost than the market, regulation is socially beneficial.

Market Power

In addition to information problems, an assertion is often made that certain lines of insurance need to have their prices regulated because of institutional requirements which mandate the purchase of insurance. This argument is made for lines like workers compensation, home owners, and automobile insurance. For example, each state mandates that workers compensation coverage be purchased by businesses. Further, mortgage lenders will require borrowers to have adequate homeowner's coverage on the mortgaged property. Finally, every state has a minimal financial guarantee law which may require the purchase of automobile insurance. The argument is made that since consumers have no choice about whether they buy these products, they need protection from the industry. This argument presumes insurers are acting in concert and there is little competition among the firms for consumers' business.²⁹ If the regulators set prices through regulation to provide the same level of social benefit that the competitive market would provide, then that activity provides social value.

Summary

The rationale for insurance regulation is based upon the assumption that regulators can reduce the social costs of market failures. This rationale is independent of the level of government undertaking the regulation. Thus, it is immaterial whether a state or the federal government undertakes this regulation since we only care about interventions which increase welfare. However, one can add another dimension to this problem which we discuss in the next

²⁹ While every state has adopted solvency regulation to reduce moral hazard costs and every state has adopted consumer protection and market conduct practices, many states have do not regulate prices to the same level or degree that other states do. Thus, there is a great deal of debate about the efficacy of price regulation as mitigating insurer market power. See Scott Harrington, *Effects of Prior Approval Rate Regulation of Auto Insurance*; in *REGULATING PROPERTY-LIABILITY INSURANCE: RESTORING COMPETITION AND INCREASING MARKET EFFICIENCY* (J. David Cummins, ed.), Washington: AEI-Brookings, 2002.

section. In addition to merely reducing the social costs of market failures, efficiency also require that regulation be conducted at the level which internalizes the social costs and benefits to the jurisdiction with the regulatory authority. That is, if we regulate to obtain social benefits, the level of government which has the regulatory power should be able to capture the benefits of regulation for its residents.

IV. Economic Rationale for OFC

Introduction

Regulatory jurisdictions have strong incentives to utilize their resources efficiently when the benefits of the public regulatory services and other public goods they produce are fully internalized to the jurisdiction.³⁰ This additional efficiency requirement is added to the efficiency gain from minimizing social costs of market failure to determine which level of government can provide insurance regulatory services most efficiently.

Efficiency in provision of public goods can also be enhanced by competition between government agencies for their provision since government regulators can be monopolists and suffer from principal-agent problems of their own. Further, as we discuss, below some consumers may value a different bundle of regulatory services than other consumers which generates demand for services not provided by the monopolist. Thus, there may be benefits of regulatory competition.

We see regulatory competition in a number of areas. One area is the potential competition between state and federal banking regulators arising from the choice of chartering between the state and federal jurisdictions, albeit that this competition has been greatly attenuated over time by the imposition of federal standards on state regulation, e.g. federal capital requirements. In theory, consumers can choose which type of bank from which to

³⁰ See e.g., Wallace E. Oates, *FISCAL FEDERALISM* (1972) and Robert Inman and Daniel Rubinfeld, *Rethinking Federalism*, 11 *JOURNAL OF ECONOMIC PERSPECTIVES* 43 (1997) (Inman and Rubinfeld).

purchase their banking services. With the choice of a particular bank, a second bundle of terms which contains the type of regulatory services provided by the particular government regulator is automatically included. Indeed, in the banking system state regulators can compete with each other (as state chartered banks operate interstate) as well as with federal regulators.

We also see the states being able to choose to control a substantive area of federal regulation themselves rather than accept a uniform federal regulatory approach in areas such as occupational health and safety. For example, the Occupational Health and Safety Act allows the states to set up their own regulatory apparatus and regulate at a higher level than the federal government if they desire.³¹ This is similar in some respects to the proposed SMART Act which would set minimal federal guidelines upon which the states could build. In addition, there are various types of law including state corporation codes which provide incentives for businesses to incorporate within its jurisdiction. Thus, the states compete among themselves for companies to attract to their jurisdiction. This latter case forms the basis for the competitive federalism proposal promoted by Butler and Ribstein (2007) discussed further below.

Status Quo

The current regulatory system for insurance is regulators in each of the 50 states, as well as in the District of Columbia and the Commonwealths and Territories of the United States. Thus, some 57 different jurisdictions have the right to regulate insurance within their respective borders. The history of this state based insurance regulatory system is well documented.³² However, it has not always been assumed that the states should be the exclusive regulators of insurance. There have been numerous proposals for a federal role in insurance regulation since the time of the National Banking Act which set up the dual chartering provisions for the banking

³¹ Section 18 of the Occupational Safety and Health Act (OSH Act) permits states to set up their own agencies. This is codified at 29 USC 667.

³² See John Day, *ECONOMIC REGULATION OF THE INSURANCE INDUSTRY* (Washington, DC: US Department of Transportation) 1970.

industry in the 1860s. Current proposals have their roots in the growing interstate presence of the industry and general dissatisfaction with the state regulatory processes. Despite the current proposals, these causal roots have been concerns for some time.³³

One can view the status quo as a costly system with significant duplication of costs. These costs reduce the demand for insurance to the extent they are passed on to customers. Further, the status quo regulatory apparatus is not designed to move quickly as all states must agree to a change if it is to have uniform application. The status quo also suffers (or benefits) from the reality that not all states will agree to various policies since they view their citizens' need for a particular policy as higher (or lower) than proposed by another state or an organization seeking state uniformity, the NAIC. However, this last reality is a critical aspect of the status quo. Each state can represent what it believes is in the best interest of its citizens. By doing so new knowledge about regulatory policy effectiveness is created. This new knowledge can be spread to other states if it appears beneficial. One aspect of state regulatory powers is that we have the federalist's vision of the states being laboratories for good policy being theoretically fulfilled in the regulation of insurance. However, the question still arises as to how quickly good policy can spread throughout the states. Further as pointed out below, states can impose externalities on others by regulating differently than other states. Also, there may be ways to generate new regulatory ideas without creating state laboratories—after all federal regulation is constantly changing in response to new problems and ideas, and we should not ignore the experimental potential available through different approaches in different countries.

The Case for Abandoning the Status Quo

State based regulation is inefficient. Whether one chooses an optional federal charter or a competitive federalism model it is clear that the states are costly regulators. What is not clear

³³ See e.g., Susan Randall, *Insurance Regulation in The United States: Regulatory Federalism and The National Association of Insurance Commissioners* 26 FLORIDA STATE LAW REVIEW 625-699 (1999).

is the types of benefits multistate regulation actually produces. Initially, one can examine the costs of state regulation and compare that to the costs of federal regulation. However, a simple cost comparison between the current state and federal financial regulatory systems are only partially informative on the issue as which level of regulation is more efficient. This is due, in part, to the fact that each state agency has slightly different missions at the state level. For example, some states expend a great deal of time on rate regulation and issues related to pricing, profitability and market conduct. Other states have relatively little price regulation, but may spend more resources and time on issues salient to voters in the state. In addition to mission differences at the state level, there is also mission overlap among the federal agencies. This makes comparisons of state versus federal expenditures on financial service regulation problematic. For example, the FDIC has primary solvency regulatory authority as the FDIC is the deposit insurer, but the OCC and the Federal Reserve also have the ability to assess solvency for their separate purposes. Thus, it is not really possible to compare regulatory efficiency by looking merely at summary financial or budgetary information. However, these data do show the relative scale of the operations of state versus federal regulation of the financial services industry.³⁴

Table I shows the budget, assets, and the number of employees for various financial service regulators in 2006.³⁵ Panel A contains various statistics regarding the separate federal regulators with oversight of financial institutions including the Office of Thrift Supervision (OTS), the Federal Reserve Board (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC). We see, for example, that the budget per employee ranges from \$160,000 for

³⁴ This mission overlap is also a type of regulatory competition as each agency may be able to check the other agency's behavior.

³⁵ This table is a slightly modified version of Table III.3 in Martin F. Grace and Robert W. Klein, *The Effects of an Optional Federal Charter for Life Insurers*, 2007, Working paper Georgia State University (Grace and Klein 2007)..

the NCUA to \$305,000 for the Federal Reserve Board. We also see that the NUCA has a high ratio of its budget to million dollars in assets under supervision, while the FRB has a relatively low ratio. We also see a great deal of difference between the agencies in budgets per regulated firm under its authority which ranges from a high of \$292,000 for the OCC to a low of \$22,375 for the FRB.

Looking at Panel B, we have summed all the federal agencies together to provide a comparison with the state agencies.

Table I. Comparison of State Insurance Regulation with Other Financial Service Regulation Budgets, Employees, and Total Assets, 2006

Panel A. Federal Financial Service Regulators

Organization	Budget	Employees	Entities	Assets in Millions	Budget Per Employee	Budget Per Regulated Firm	Budget/\$Million Assets
Office of Thrift Supervision (OTS)	\$ 199,497,000	918	854	\$ 1,541,206	\$ 217,317	\$ 233,603	\$ 129.44
* Federal Reserve Board (FRB)	\$ 173,000,000	567	7,732	\$ 9,230,400	\$ 305,115	\$ 22,375	\$ 18.74
** Federal Deposit Insurance Corp. (FDIC)	\$ 998,000,000	4,476	8,680	\$ 11,860,296	\$ 222,967	\$ 114,977	\$ 84.15
National Credit Union Administration (NCUA)	\$ 150,800,000	939	5,392	\$ 73,487	\$ 160,631	\$ 27,967	\$ 2,052.07
Office of Comptroller of the Currency (OCC)	\$ 579,401,000	2,886	1,984	\$ 5,800,000	\$ 200,763	\$ 292,037	\$ 99.90

Panel B. Aggregated Regulatory Budgets

Organizations	Budget	Employees	Entities	Assets in Millions	Budget Per Employee	Budget Per Regulated Firm	Budget/\$Million Assets
Sum of Federal Regulators	\$ 2,100,698,000	9,786	24,642	\$ 22,705,389	\$ 1,106,792	\$ 690,959	\$ 2,384
*** State Insurance Departments + NAIC	\$1,196,677,368	12,335	7,601	\$ 6,074,200	\$ 97,011	\$ 157,437	\$ 197.01

Sources:

Annual Report Federal Reserve Board of Governors, 2006

FRB Board of Governors, 2006 Budget

FDIC, Annual Report, 2006

NCUA, website, www.ncua.org

US Department of The Treasury, Budget in Brief, 2006

NAIC Annual Resources Report, 2006

*Includes the number of state member banks and the number of separate banks belonging to bank holding companies

** FDIC has financial regulatory authority over insured banks

***Includes Property-liability and Life, Health and Annuity Companies

Note: The Federal Reserve Board has overlapping jurisdiction with OTS and OCC.

Some of the state insurance regulatory indices of cost are “better” than some of the federal financial service agencies, but it is difficult to determine based on this information whether regulation should be performed at a higher (federal) level of aggregation. First, it is difficult to compare across financial service regulatory functions. Consider the nature of complaints regarding insurance products versus banking products. Insurance complaints are possibly more numerous than say complaints about credit cards or deposits. Even if they are not more numerous the technology needed to resolve the complaints may be different. Second, it appears

that winding up a failed insurer is much more expensive than the similar process for banks. Some argue that a part of this difference in costs is due to the fact that banks liabilities are generally easy to determine relative to insurers which often have long-tail liabilities which take time to resolve. Either way, insurance insolvencies are different than bank insolvencies as they likely have different costs of resolution.³⁶ Thus, other indicators of cost efficiency are needed in order to discuss which level of regulation is appropriate.

One of the major rationales for federal regulation is the economies resulting through elimination of duplicate actions undertaken by the states. So if we aggregated insurance regulation to a higher level of government, many of the duplicated costs imposed by state regulation would be eliminated. This would show up in lower regulatory costs as measured by governmental budgets as well as lower compliance costs to the regulated firms. For example, every state undertakes regulation of insurance agents. According to Laureen Regan the average life agent has about 9 state licenses.³⁷ This cost is born by the agents, their employers, and their customers. Further, every state licenses companies operating within its jurisdiction. In addition, the 2006 NAIC Annual Statement data shows the average property-liability company holds 16 state licenses and the average life and health company holds 25 licenses. Two questions arise at this stage. First, is there is a social value in multiple states undertaking similar or identical licensing activities? Second, could there be an alternative regulatory system which imposes less cost and provides greater benefits to society?

There is not a great deal of evidence on the topic regarding the social value of duplicative regulation, but there is some evidence on the costs. Grace and Klein (2000) attempt to determine the effect of multiple state licensing requirements on insurers and find that the elasticity between

³⁶ Martin F. Grace, Robert W. Klein and Richard D. Phillips *Insurance Company Failures: Why Do They Cost so Much?* (2007) found at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=463103.

³⁷ Laureen Regan, *The Option Federal Charter: Implications for Life Insurance Producers* found at http://www.acli.com/NR/rdonlyres/EF95BEF6-506D-4D2B-B867-EADC09B42565/10737/OFC_ReganStudyFinal090409.pdf

the ratio of total expenses to premiums written and an additional license is about 10 percent.³⁸

This is fairly significant. Pottier (2007) using a different technique finds the total additional costs of having multistate regulation of the life insurance industry is about 1.25 percent of net premiums annually.³⁹ This translates into approximately \$5.7 billion each year in higher expenses due to the multistate nature of insurance regulation. Thus, the evidence suggests a large dollar cost to multistate regulation. While these figures are for the life insurance industry, one would expect a similar result for the property-liability industry..

To answer the second question whether there is a better arrangement that will provide a higher social value, we can look to see whether insurance is regulated at the proper level of political authority. A framework exists for determining whether aggregation of regulatory power is appropriate. The ideal level of regulatory power should be exercised at the jurisdictional level which is best able to capture all the costs and benefits of regulation within its limits.⁴⁰ Thus it is appropriate for county governments, for example, to regulate sanitary conditions at restaurants and swimming pools and the federal government to regulate the allocation of broadcast frequencies or passenger air routes. This is the essential argument underlying the economics of the proper level of regulation. So, in addition to the presence of cost economies from the aggregation of insurance regulation from the level of the state to the federal level, one might need to see evidence regarding the interstate nature of the industry and/or the presence of interstate externalities. The more interstate the business, the stronger the argument is for federal regulation.

³⁸ Martin F. Grace and Robert W. Klein, *Efficiency Implications of Alternative Regulatory Insurance Structures*, in *OPTIONAL FEDERAL CHARTERING AND REGULATION OF INSURANCE COMPANIES* (Peter J. Wallison, ed.) (AEI: Washington) 2000.

³⁹ Steven Pottier, *State Regulation of Life Insurers: Implications for Economic Efficiency and Financial Strength* (2007) found at <http://www.acli.com/ACLI/Issues/GR07-068.htm?Issue=40>.

⁴⁰ See Inman and Rubinfeld note 30 *supra*.

Table II. Domestic and Foreign Activity in States for Property-Liability and Life and Health Industry, 2006

State	Property-Liability			Life and Health			Total Industry	
	Foreign	Domestic	Domestic Market Share	Foreign	Domestic	Domestic Market Share	2006	1995
	Dir. Prens Written	Dir. Prens Written		Dir. Prens Written	Dir. Prens Written		Domestic Market Share	Domestic Market Share
Alaska	\$ 1,326,310	\$ 199,073	13.05%	\$ 834,761	\$ -	0.00%	8.43%	8.70%
Alabama	\$ 5,633,369	\$ 960,141	14.56%	\$ 5,233,207	\$ 298,066	5.39%	10.38%	14.65%
Arkansas	\$ 3,687,606	\$ 225,407	5.76%	\$ 2,779,417	\$ 88,050	3.07%	4.62%	14.99%
Arizona	\$ 7,684,470	\$ 784,508	9.26%	\$ 7,818,979	\$ 117,100	1.48%	5.50%	13.94%
California	\$ 41,325,401	\$ 18,476,141	30.90%	\$ 51,420,394	\$ 76,601	0.15%	16.67%	26.20%
Colorado	\$ 7,414,151	\$ 318,006	4.11%	\$ 8,353,160	\$ 328,631	3.79%	3.94%	8.34%
Connecticut	\$ 5,892,576	\$ 1,159,682	16.44%	\$ 6,870,055	\$ 8,968,009	56.62%	44.24%	36.86%
District of Columbia	\$ 1,499,298	\$ 34,574	2.25%	\$ 1,824,004	\$ 2,917	0.16%	1.12%	2.06%
Delaware	\$ 2,069,795	\$ 293,659	12.42%	\$ 19,148,124	\$ 2,041,821	9.64%	9.92%	15.93%
Florida	\$ 28,341,802	\$ 10,703,313	27.41%	\$ 29,349,453	\$ 117,188	0.40%	15.79%	14.71%
Georgia	\$ 12,380,640	\$ 1,525,419	10.97%	\$ 10,892,022	\$ 94,097	0.86%	6.51%	8.50%
Hawaii	\$ 1,597,695	\$ 727,497	31.29%	\$ 2,329,903	\$ 32,535	1.38%	16.21%	19.23%
Iowa	\$ 3,425,251	\$ 1,146,817	25.08%	\$ 3,709,343	\$ 3,588,079	49.17%	39.89%	37.95%
Idaho	\$ 1,567,678	\$ 286,125	15.43%	\$ 1,804,369	\$ 11,343	0.62%	8.11%	13.11%
Illinois	\$ 11,874,181	\$ 9,279,732	43.87%	\$ 19,126,798	\$ 1,503,516	7.29%	25.81%	36.72%
Indiana	\$ 7,150,200	\$ 1,363,405	16.01%	\$ 8,315,297	\$ 1,463,280	14.96%	15.45%	24.98%
Kansas	\$ 4,052,270	\$ 488,023	10.75%	\$ 6,762,640	\$ 271,152	3.85%	6.56%	20.94%
Kentucky	\$ 4,821,563	\$ 984,111	16.95%	\$ 4,095,719	\$ 40,643	0.98%	10.31%	11.89%
Louisiana	\$ 7,090,656	\$ 1,661,061	18.98%	\$ 6,346,595	\$ 189,099	2.89%	12.10%	12.77%
Massachusetts	\$ 6,639,900	\$ 5,243,219	44.12%	\$ 11,917,922	\$ 1,256,083	9.53%	25.94%	31.02%
Maryland	\$ 7,719,661	\$ 1,236,942	13.81%	\$ 13,559,718	\$ 82,954	0.61%	5.84%	8.46%
Maine	\$ 1,515,482	\$ 457,457	23.19%	\$ 1,819,433	\$ 20,841	1.13%	12.54%	15.72%
Michigan	\$ 8,114,813	\$ 7,205,704	47.03%	\$ 13,784,729	\$ 2,227,780	13.91%	30.11%	25.38%
Minnesota	\$ 7,745,520	\$ 924,741	10.67%	\$ 8,873,038	\$ 1,855,674	17.30%	14.33%	18.31%
Missouri	\$ 7,956,991	\$ 1,097,600	12.12%	\$ 8,715,275	\$ 274,014	3.05%	7.60%	13.90%
Mississippi	\$ 3,670,694	\$ 502,048	12.03%	\$ 2,521,008	\$ 86,937	3.33%	8.69%	13.96%
Montana	\$ 1,530,070	\$ 27,744	1.78%	\$ 941,543	\$ 5	0.00%	1.11%	1.42%
North Carolina	\$ 9,977,225	\$ 1,836,158	15.54%	\$ 13,120,640	\$ 230,361	1.73%	8.21%	11.06%
North Dakota	\$ 1,142,870	\$ 163,328	12.50%	\$ 917,750	\$ 10,877	1.17%	7.80%	11.27%
Nebraska	\$ 2,789,080	\$ 382,762	12.07%	\$ 3,146,838	\$ 482,480	13.29%	12.72%	26.28%
New Hampshire	\$ 1,877,017	\$ 278,221	12.91%	\$ 2,138,006	\$ 3,896	0.18%	6.57%	8.90%
New Jersey	\$ 12,339,874	\$ 5,017,773	28.91%	\$ 23,774,434	\$ 3,997,113	14.39%	19.98%	23.90%
New Mexico	\$ 2,410,956	\$ 154,322	6.02%	\$ 1,822,503	\$ 150	0.01%	3.52%	3.91%
Nevada	\$ 4,351,301	\$ 243,629	5.30%	\$ 2,711,937	\$ -	0.00%	3.33%	1.49%
New York	\$ 26,104,575	\$ 8,613,369	24.81%	\$ 18,763,362	\$ 28,191,295	60.04%	45.06%	36.41%
Ohio	\$ 8,265,065	\$ 5,049,116	37.92%	\$ 16,121,765	\$ 2,078,124	11.42%	22.62%	28.53%
Oklahoma	\$ 4,499,132	\$ 751,287	14.31%	\$ 3,803,658	\$ 67,781	1.75%	8.98%	11.12%
Oregon	\$ 4,052,243	\$ 1,380,963	25.42%	\$ 4,195,542	\$ 319,697	7.08%	17.09%	17.50%
Pennsylvania	\$ 15,013,048	\$ 4,953,342	24.81%	\$ 21,565,944	\$ 451,255	2.05%	12.87%	15.90%
Rhode Island	\$ 1,581,235	\$ 361,172	18.59%	\$ 1,707,491	\$ 28,845	1.66%	10.60%	13.97%
South Carolina	\$ 6,218,784	\$ 370,493	5.62%	\$ 4,969,510	\$ 110,068	2.17%	4.12%	14.87%
South Dakota	\$ 1,381,122	\$ 75,347	5.17%	\$ 1,105,132	\$ 1,131	0.10%	2.98%	5.10%
Tennessee	\$ 7,216,199	\$ 1,174,449	14.00%	\$ 8,215,415	\$ 319,837	3.75%	8.83%	10.45%
Texas	\$ 19,960,335	\$ 14,760,142	42.51%	\$ 25,560,976	\$ 3,685,963	12.60%	28.84%	34.15%
Utah	\$ 2,846,912	\$ 430,184	13.13%	\$ 3,048,829	\$ 228,461	6.97%	10.05%	16.06%
Virginia	\$ 10,287,050	\$ 333,919	3.14%	\$ 10,743,862	\$ 2,451,603	18.58%	11.70%	15.84%
Vermont	\$ 988,760	\$ 122,421	11.02%	\$ 953,128	\$ 19,632	2.02%	6.82%	10.50%
Washington	\$ 7,198,468	\$ 1,629,454	18.46%	\$ 7,992,753	\$ 198,818	2.43%	10.74%	20.06%
Wisconsin	\$ 4,343,890	\$ 3,673,437	45.82%	\$ 8,523,553	\$ 789,986	8.48%	25.75%	31.95%
West Virginia	\$ 2,189,954	\$ 892,214	28.95%	\$ 1,875,780	\$ 635	0.03%	18.01%	1.86%
Wyoming	\$ 775,488	\$ 60,704	7.26%	\$ 695,591	\$ -	0.00%	3.96%	3.32%
Minimum			1.78%			0.00%	1.11%	1.42%
Mean			18.13%			7.52%	13.31%	16.57%
Weighted Mean			24.92%			13.33%	18.93%	22.78%
Median			14.31%			2.43%	10.31%	14.71%
Max			47.03%			60.04%	45.06%	37.95%

Note: Premiums are in \$1000. Data are from 2006 NAIC Annual Statement state pages. Market share calculations are the author's. 1995 Data are from 1995 Annual Statement state page.

Table II shows premiums written by domestic and foreign companies in each state in the United States. In addition, it shows the domestic market share for each line of business (P&L and L&H) and the domestic market share for the total industry within each state for 2006 and 1995. The data in Table II make three points. First, the domestic market share is small compared to the interstate share, the weighted mean domestic market share for all states for both lines of business in 2006 was only 18.93 percent, or put another way out-of-state insurers provided over 80 percent of all insurance. Second, the life insurance business is more “interstate” than the property-liability business. We see that the average domestic market share is 7.52 percent for the life and health industry and 18.13 percent for the property-liability industry. The same is true for the median state: life insurers have much smaller domestic market shares than domestic property liability companies. Even if we look at the overall average (weighted average) which is the sum of the domestic markets’ premiums in each state over the total US premiums written, we see that the life insurance industry has a smaller domestic presence overall relative to the property-liability business. In 2006, domestic firms provided only 13.33 percent of life insurance.

The reason for this is beyond the scope of the paper, but two reasons come to mind. First, life insurance products and risks are more standardized and thus there is little ability for local firms to have a comparative advantage in the provision of contracts. A second complementary reason is that property-liability policies are more likely subject to local restrictions and legal interpretations which provide local providers with a comparative advantage over national companies. However, even property and liability provided by domestic firms is small, with a weighted average of 24.92 percent in 2006.

The third point that Table II makes is that if we compare the total industry in 1995 to that in 2006 we see that it has become more “interstate” in the sense that the indicators of domestic

market share have declined over the 11 year period. Thus, the life industry is more “interstate” than the non-life industry and the entire industry is become more “interstate” over time.

Further, even if the aggregation level is increased from the state level to a census division, as shown in Table III, there still is a significant “interstate” presence at these higher levels of aggregation. The table shows market shares of the domestic industry by census division. A domestic firm for this analysis is one chartered in a state within a given census division. We see that for each of the divisions except for the East South Central and the West South Central, the division’s “domestic” market share decreased between 1995 and 2006. Overall, the total domestic premium written in the census divisions relative to total US premium also fell from 33.08 to 24.92 percent over the time period. Thus, even if we aggregate to a higher level of political jurisdiction (between the state and federal level), we will not likely see the type of internalization of costs and benefits consistent with efficiency. This increased level of aggregation is used suggestively to show how even in the presence of a larger region of analysis there is still a great deal of “interregional” trade.⁴¹

⁴¹ While no one is proposing an intermediate stage of regulation at the census division level, there have been numerous proposals that would create an interstate compact to regulate insurance at a level above the state and below the that of the federal government. See J. W. Schact, and P. G. Gallanis, *The Interstate Compact as an Effective Mechanism for Insurance Receivership Reform*, 12 JOURNAL OF INSURANCE REGULATION 188-220 (1993) and note the start of the Interstate Insurance Product Regulation Compact in 2007. While these compacts will likely not be set up based on census divisions, they will likely operate at some sub-national basis as it is likely that not all states will participate.

Table III. Census Division "Domestic" Market Share, 1995 and 2006

Census Division	2006	1995
	Domestic Market Share	Domestic Market Share
New England	29.18%	46.80%
Mid-Atlantic	25.80%	38.90%
East North Central	40.07%	52.90%
West North Central	13.06%	34.70%
South Atlantic	17.59%	21.10%
East South Central	14.50%	14.46%
West South Central	33.05%	29.80%
Mountain	7.46%	12.20%
Pacific	28.77%	28.90%
Census Region Weighted Average	24.92%	0.00%

Source: NAIC Annual Statement state pages, 1995, 2006

Grace and Phillips try to assess the cost efficiency aspects of regulatory aggregation. They find a number of pieces of evidence supporting an increase in efficiency with an increase in the level of regulation.⁴² First, they find that the typical state has increasing returns to scale in regulation. The presence of economies of scale means that the average state could undertake the oversight of more producers or firms at lower average costs. This is consistent with the notion that the typical state is too small to regulate efficiently. Surprisingly, they also found that the biggest states have decreasing returns to scale. However, upon further investigation Grace and Phillips found there were a different set of externalities operating among the states and these externalities were imposing costs on the relatively large states. Specifically, it appears the large states were doing the regulatory work of the smaller states as the smaller states imposed their regulatory costs on the big states by shirking their regulatory responsibilities. The presence of this externality provides further evidence that the states are not the proper level of political jurisdictional control over the insurance industry.

Uniformity, Innovation, and Speed to Market. Another problem resulting from state regulation is the effect on product innovation, product approvals (speed to market) and interstate

⁴² Martin F. Grace and Richard D. Phillips, *The Allocation of Government Regulatory Supervision Within a Federal System of Government: Fiscal Federalism and the Case of Insurance Regulatory Oversight*, 74 JOURNAL OF RISK AND INSURANCE 207-238 (2007).

uniformity. If products are approved quickly, then firms can compete on product innovation and design. However, if products are approved slowly, it reduces the incentive for insurers to develop and market new ideas. The problem is exacerbated if the product is approved in one state with a certain set of conditions and in another state with a different set of conditions. This differential approval also increases innovation costs. While federal pressure can produce more uniformity, this is not always the case.

Table IV shows a set of model laws obtained from the NAIC. The laws were not chosen randomly, but to make specific points. One model law not included on the list is the Model Risk Based Capital (RBC) Model Act.⁴³ We use it for comparison purposes as it has been adopted by every state quite rapidly, within two years of its promulgation. The law also appears to have been adopted in almost identical form by every state.⁴⁴ This success may have stemmed from the result of federal pressure—Congress had criticized state regulators for the insurance company failures of the late 1980s and early 1990s.⁴⁵

However, federal pressure does not always generate quick adoption and uniformity. For example, the Gramm-Leach-Bliley (GLB) Act required states to adopt reciprocal agent licensing provisions. The NAIC subsequently proposed a model law regarding Producer Licensing that

⁴³ See NAIC MODEL LAWS, REGULATIONS, AND GUIDELINES, 312-1 (2008). Note, while the Model RBC Act has been uniformly adopted across the states, it says nothing about minimum initial (or continuing) capitalization requirements. In fact, each state separately sets these initial and continuing capitalization requirements and they are not uniform. Risk based capital is the capital requirement adjusted for the risk the company undertakes. It is different from the initial or continuing capital requirements which are unadjusted amounts of capital a company needs to start-up or to continue in business. Compare, for example, Florida's initial minimum capital requirement of \$5 million with Georgia's initial capital requirement of \$1.5 million. In contrast, New York has separate requirements for minimum capital and surplus for companies based on the line of business ranging from glass coverage (\$50,000) to life insurance (\$6 million). The state would need to look at the Risk Based Capital law as well as its initial (or continuing) capital requirement statute to determine whether the company can continue to operate. See e.g. NAIC, COMPENDIUM OF STATE LAWS ON INSURANCE TOPICS (2007).

⁴⁴ An additional problem with proposals to promote uniformity is that the states' judges can interpret the law consistent with how the states' legal systems have evolved. This can lead to conflicting interpretations of the same statute that will not easily be remedied given our federal system.

⁴⁵ See e.g., U.S. House of Representatives, *Failed Promises --Insurance Company Insolvencies*. Report by Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, February 1990.

would provide streamline licensing for agents. The adopting states are shown in the first column in Table IV.⁴⁶

Note that the GLB was passed in 2000 and eight years later not all of the states have adopted the law. In addition, the second column shows that states have adopted other measures or other rules that reduce the effect of uniformity among the states. Finally, certain large and important insurance states such as Texas and New York have not yet passed the model law. The GAO asserted in Congressional testimony that the holdout states may believe that their standards are superior and do not desire to lower them.⁴⁷ However, there does not appear to be a cost/benefit analysis that goes along with the assertion of the benefits for higher standards. And even if such an analysis existed, it would not likely account for the costs imposed on others outside the state. Thus, by holding out these states impose compliance costs on owners and policyholders of companies operating nationwide.

⁴⁶The NAIC asserts that states identified in the column titled “Law” have adopted the law in a “uniform and substantially similar manner.” “Related legislation” refers to states which have not adopted the law in a uniform or substantially similar manner. These states may have an older version of the law or laws derived from other sources. See NAIC, MODEL LAWS, REGULATIONS AND GUIDELINES, 2008.

⁴⁷ General Accounting Office, State Insurance Regulation, Testimony Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives at 2. (2002).

Table IV. Summary Data on Model Law Adoption for Select Model Laws

State	Producer Licensing		Life Insurance Disclosure Model Reg		Unfair Trade Practices		Military Sales		PC Actuarial Opinion	
	Law	Related Legislation	Law	Related Legislation	Law	Related Legislation	Law	Related Legislation	Law	Related Legislation
Alabama	x		x			x				x
Alaska	x	x			x	x				x
Arizona	x		x		x		x			
Arkansas	x	x		x	x	x				
California		x	x		x	x				x
Colorado	x	x			x		x			
Connecticut	x	x	x		x	x				x
Delaware	x		x		x					
D.C.	x				x		x			
Florida	x	x	x		x	x				x
Georgia		x	x		x		x			x
Hawaii	x				x					
Idaho	x				x	x	x		x	
Illinois	x		x			x				
Indiana	x	x	x	x	x					x
Iowa	x	x			x		x			x
Kansas	x	x		x	x		x			
Kentucky	x	x		x	x	x				x
Louisiana	x	x		x	x		x			x
Maine	x	x	x		x					x
Maryland		x	x		x				x	x
Massachusetts	x	x	x		x					
Michigan	x	x		x	x	x				
Minnesota	x				x					
Mississippi	x				x					
Missouri		x	x	x	x	x				
Montana		x	x		x					
Nebraska	x	x	x		x				x	
Nevada	x	x	x		x					
New Hampshire	x	x	x		x					
New Jersey	x	x	x		x					x
New Mexico		x	x		x		x			
New York		x	x		x		x			
North Carolina	x	x	x		x					
North Dakota	x	x	x		x					
Ohio	x		x		x		x			
Oklahoma	x	x			x		x		x	
Oregon	x	x	x			x	x			x
Pennsylvania	x			x	x	x				
Rhode Island	x	x	x		x		x			
South Carolina	x		x		x	x	x			
South Dakota	x	x	x		x					x
Tennessee	x	x	x		x		x			
Texas		x			x				x	x
Utah		x	x			x	x			
Vermont	x		x	x	x					x
Virginia		x			x		x		x	
Washington		x	x		x				x	x
West Virginia	x			x	x					
Wisconsin		x	x			x				x
Wyoming	x				x	x			x	

Source: NAIC Model Laws Regulations and Guidelines (January 2008).

A second law shown in Table IV concerns the NAIC's Model Life Insurance Disclosure Regulation. This law provides "rules for life insurance policy illustrations that will protect consumers and foster consumer education" and was adopted in 1976.⁴⁸ Policy illustrations are part of the marketing process for life insurance as they provide information about expected investment returns or credited interest rates on policies. For example, if the previous 20 year return credited to policies was 5 percent, a policy illustration might have a projected 8 percent return rather than the historical 5 percent return. This model law was proposed in light of a wave of creative illustrations which promised high returns on investment performance. As of 2008, only 32 states have enacted it. Non-uniform disclosure regulations are costly. In contrast, all but five have enacted the NAIC's Unfair Trade Practices Rule also shown in Table IV. This model act was proposed in 1947.

The next law in the Table is the Military Sales Model Practices Regulation, proposed in 2007 as a result of a law enacted by Congress.⁴⁹ This regulation is designed to protect young soldiers, sailors, marines, and airmen from aggressive sales tactics directed at military personnel. As of today only 18 states have enacted it. Presumably, this was an important issue for Congress, yet it has not been adopted by a majority of states in its first two years.

Finally, there is the PC Actuarial Opinion Model Law adopted in 2005. This law is designed to require an actuary to issue an opinion regarding the financial state of the insurance company and provides that the opinion must be based on the actuary's best estimate or a range of acceptable estimates. The law also requires certain documentation be part of the opinion. This law was designed to increase the underlying analysis and accuracy of the annual reports of property-liability companies.. The last column in Table IV shows the law has been adopted by

⁴⁸ NAIC, MODEL LAWS, REGULATIONS AND GUIDELINES, 580-1, §1

⁴⁹ *Military Personnel Financial Services Protection Act*, Pub. L. No. 109-290 (2006). See also, *NAIC Adopts Model Regulation On Military Sales*, found at http://www.naic.org/Releases/2007_docs/Military_sales.htm (viewed on May 26, 2008).

eight states since its enactment while another 19 have adopted other related (and possibly different) rules.

In addition to concerns about a lack of uniformity which increases costs, a typical complaint about the current state system is the delays between product development and approval. This is also an issue of uniformity as each state must approve a product before it can be sold in a state. The NAIC has attempted to respond to insurers' concerns about product approval delays. The costs of getting products to market nationally are allegedly high; hence the NAIC's apparent desire to deal with the issue. The GAO in 2002 testified that the initial attempt to streamline product approval was not, in fact, streamlined enough for insurers to obtain value. In fact, there were too many additional individual state requirements.⁵⁰ The NAIC has again tried to improve the process by the formation of the Interstate Insurance Product Regulation Commission (IIPRC), an interstate compact which now has 31 members as of this spring.⁵¹ However, eight years after the NAIC's initial declaration of a desire to introduce speed to market regulatory reform, we still have not seen a final rulemaking by the IIPRC.⁵²

“Horizontal Equity” with other Financial Services Industries. Permanent or cash value life insurance and many types of annuities have significant savings components. If these products are generally viewed as savings vehicles, then a number of potential banking or financial institution (FI) substitutes exist which range from bank accounts to individual stock portfolios. Federally regulated banks have a potentially significant advantage compared to

⁵⁰ GAO, *State Insurance Regulation: Efforts To Streamline Key Licensing And Approval Processes Face Challenges*, Testimony of Richard Hillman, Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives (2002) at 2.

⁵¹ According to the IIPRC's website the states are Alaska, Colorado, Georgia, Hawaii, Idaho, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, Pennsylvania, Puerto Rico, Rhode Island, Tennessee, Texas, Utah, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. Note that certain large insurance states are missing: New York, California, Illinois, Florida, and Connecticut. See, http://www.insurancecompact.org/compact_history.htm (viewed on May 21, 2008).

⁵² See the Commission's docket at http://www.insurancecompact.org/compact_rlmkng_docket.htm (viewed on May 21, 2007).

insurance companies and non-bank annuity providers. FIs can ask their regulator for nationwide approval of a product and receive an answer within a relatively short period of time compared to the time it takes insurers to obtain the states' approvals. This provides a FI a significant advantage over insurers for the marketing of similar types of products.⁵³

Further, states have rules regulating insurer's investments that may put them at further disadvantage to federally regulated FIs. According to Grace and Klein (2007), federally regulated FIs are permitted to use relatively aggressive hedging strategies, whereas insurers typically are not.⁵⁴ The market is quickly and dramatically changing, yet states typically resist allowing insurers to use the strategies commonly used by other FIs. It may be that state regulators are apprehensive because they lack the resources to monitor and evaluate these strategies. A federal regulator with better analytical resources could permit life insurers to engage in broader investment and hedging strategies that would be appropriate, more efficient and more consistent with the rules governing other financial institutions.

Costs and Benefits of OFC.

Costs. Lets first consider the costs of an OFC. First, there are the costs of regulation at two levels of government. Even if there was significant change to a federal charter by many insurers, there still will be many insurers left to be regulated by the states. It would be ideal if we observed a reduction in state expenditures exactly offset by the increase in federal expenditures, but this is not likely to occur as bureaucracies are difficult to eliminate even if the mission changes significantly. Thus, federal insurance regulatory expenses are likely to go up more than the reduction in state regulatory expenses.

⁵³ Mutual funds, for example, have devised products to mimic certain aspects of annuities as well as provide cash to heirs if consumer dies prematurely. See Kelly Greene, *Mutual Funds Pitch Alternative to Annuities*, THE WALL STREET JOURNAL at <http://online.wsj.com/article/SB121287587779954857.html> (viewed on June 9, 2008).

⁵⁴ Grace and Klein 2007, note 35 *supra*.

A second source of costs concerns the imperfection of the federal-state charter competition. While there is the potential for competition between federal and state governments for chartering of insurers, there is the problem of the stickiness of charters. Once a national insurer obtains a federal charter, it will be costly for it to return to a state charter. To the extent that these costs are substantial, insurers could be “held up” by the federal government over specific issues. Congress could also significantly expand its authority over the industry. In fact, this has historically been one of the reasons trotted out as a critique of past federal regulatory proposals.⁵⁵

A third potential cost arises from possibly less consumer protection. There is a concern that consumers will find it more difficult to have their complaints resolved at the federal level. This can be dealt with by adequate federal resources and consumer education. Most consumer complaints are resolved over the telephone not in person. It just as easy to call a toll free number of a federal regulator as it is to call the number of a state regulator. It is possible, however, that state regulators may be more responsive to local complaints due to the political consequences of not doing so.

A fourth cost issue involves arises from the difficulties of maintaining state guaranty funds and federal regulation.⁵⁶ As discussed at more length below when we come to the general subject of guaranty funds, this suggests that the OFC bill be modified to provide for a federal guaranty fund and allow insurers to opt out of state guaranty funds.

Benefits. A number of benefits exist for an OFC. These include cost reductions resulting from regulatory streamlining. In a competitive environment, these costs are passed on in terms

⁵⁵ See e.g. Jon S. Hanson, *The Disadvantages of Federal Insurance Regulation as Highlighted by the Brooke Bill* 13 FORUM 605-622 (1977). And see, Sara Hansard, *Will Optional Federal Charter Lead to More Regulation?* It is also important to understand that even if the hold-up problem existed, overall efficiency could still be improved by the regulatory competition induced by moving to an optional federal charter.

INVESTMENT NEWS (May 26, 2008) at <http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20080526/REG/449438214> (viewed on June 4, 2008).

⁵⁶ See National Association of Mutual Insurance Companies, *Insurance Regulation*, found at <http://www.namic.org/fedkey/07regulation.asp> (viewed on June 2, 2008).

of lower prices for consumers. Grace and Klein suggest that there are also benefits to competition by increasing the size of the market. To the extent that state licensing is costly it acts as a barrier to competitive entry. Removal of such barriers will increase competition. In addition, increased competition will induce efficiency inducing mergers and acquisitions. In fact, economists have pointed out the relatively low average industry efficiency levels for some time.⁵⁷ Increased competition will also bring about product innovation and economic growth.⁵⁸ Finally, if we do adopt an OFC, we reduce the negative externalities imposed on out-of-state customers and insurers resulting from the current state regulatory system.

Competitive Federalism as an Option to an OFC

Butler and Ribstein argue for a framework that would allow the insurer to choose one state to be its regulator and the insurer would then be able to operate nationwide under the laws of its home state.⁵⁹ This model of single state regulation is akin to how state corporate law is employed in an interstate market. Butler and Ribstein try to counter potential “race to the bottom” critiques to their proposal. They argue that with perfect information consumers presumably would shun insurers from states with known lax regulation. Given, however, that there will likely be some residual consumer uncertainty over the insurer’s home state’s consumer protection law in real life, Butler and Ribstein suggest that the home state’s laws require the insurer to disclose which level of consumer protection would be granted: that of the insurer’s

⁵⁷ See Andrew Yuengert, *The Measurement of Efficiency In Life Insurance: Estimates of A Mixed Normal-Gamma Error Model*, 17 JOURNAL OF BANKING AND FINANCE 483-496 (1993) and J. David Cummins and Mary Weiss *Measuring Cost Efficiency in The Property-Liability Insurance Industry* 17 JOURNAL OF BANKING AND FINANCE 463-481 (1993). Cummins and Weiss suggest that there is a great deal of room for mergers to increase efficiency.

⁵⁸ See e.g., Jith Jayaratne and Philip E. Strahan, *The Finance-Growth Nexus: Evidence from Bank Branch Deregulation*, 111 THE QUARTERLY JOURNAL OF ECONOMICS, 639-670 (1996).

⁵⁹ Butler, Henry N. and Ribstein, Larry E., *A Single-License Approach to Regulating Insurance* (May 18, 2008). Northwestern Law & Econ Research Paper No. 08-10 Available at SSRN: <http://ssrn.com/abstract=1134792>. Scott Harrington discusses a similar idea for health insurance in "Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation". Networks Financial Institute Policy Brief, No. 2006-PB-02, March 2006 Available at SSRN: <http://ssrn.com/abstract=923605>

home state or that of the consumer's state. This information disclosure would help the consumer shop for appropriate coverage from a company warranting a given level of consumer protection.

This is not convincing. As we have explained, a key reason for insurance regulation is the existence of asymmetric and imperfect information on the part of the consumers. The idea that some disclosure document (which many consumers will not and perhaps cannot read) will cure the problem is not a credible solution. A key feature of the current system is strong insurance regulation by most states. Those states (and the Congress) will not accept the possibility of their consumers being exposed to lax regulation by another state. There is also the issue of enforcement. Indeed, for the OFC to have any political traction it will have to assure the Congress that it will not lessen current state consumer protection.

The status quo is costly and will never realistically result in a reduction in compliance costs. This is because the states have no real incentive to work together. We see occasional actions such as the quick universal adoption of the risk based capital requirements. This was because the regulators thought there was some real aspect of a federal intervention. However, the agency licensing requirements of GLB have not been accomplished. If the states were going to work together, they would have done so by now. Further, there is evidence that even a Congressional mandate requiring a certain level of market conduct regulation for military personnel has not been adopted in a sufficiently quick manner.

The insurance industry has become more of an "interstate" business over its entire history and this trend is still continuing. In addition, as the industry becomes more "interstate" in nature, the ability of the states to impose externalities on consumers in other states is increasing.

Because of the change in the industry, it needs a new style of regulation. The banking industry, the mutual fund industry and the parts of the insurance industry compete for the savings dollars of consumers. New products become approved quickly in the non-insurance arena, but

innovations in the insurance industry require a long and ponderous review process. This puts the insurance industry at a competitive disadvantage.

While there is evidence of interstate externalities in regulation, there are also those caused by differing state policies. A model of competitive federalism could bring about a reduction in compliance costs and may have the ability to increase efficiency by internalizing costs and benefits to its virtual jurisdiction; we think that an optional federal charter approach also has merit. An optional federal charter law will internalize the costs and benefits of insurance regulation. In addition, we have a model that has existed since the 1860s in the banking industry which shows how the system would work. However, while the OFC presents some potential benefits in the sense that it can internalize costs and benefits of regulation, the current law has some problems which need clarification to enhance the quality of insurance regulation in the United States.

V. External Structure

With these considerations in mind, we now turn to options for how to design a federal insurance regulator to fit within the federal regulatory structure. Certain key issues must be considered.

Independence. Some regulatory agencies, such as the Federal Reserve Board, are independent of the President. Others, such as the OCC, are instead housed within a cabinet department (Treasury, in the OCC's case, albeit with significant insulation from the Secretary of the Treasury). The more independence, the less exposure to political pressure but also the greater difficulty of coordinating policy among different regulators, short of regulatory consolidation in an independent agency. One could provide that the federal insurance regulator become part of a broader supervising agency. For example, the UK's Financial Services Authority (FSA) is an independent, consolidated agency encompassing the regulation of

accounting, asset management, banking, securities, insurance, and other segments of the financial services industry, with separate “sector leaders” for each.⁶⁰ It operates as a company limited by guaranty and financed by the financial services industry, with a Board selected by the U.K. Treasury.⁶¹ There is also a difference between being exposed to political pressure and being political. For example, the SEC’s five commissioners are split 3-2 along party lines, with the party in power having the majority. In practice the commissioners from each party, while independent, have a natural tendency to coordinate their positions with their political benefactors (those that nominated them in the first place).

Chief Official. What should be the characteristics of the insurance regulator’s chief official? Chief officials (and, by implication, agencies themselves) may operate with different degrees of insulation from the President. The most insulated model would involve a multimember chief official body, with characteristics such as staggered terms, bipartisan composition, and “for-cause” removal. The SEC and Federal Reserve Board are examples. Next, the agency might have one chief official with some sort of “for-cause” removal. An example here is the Social Security Administration. Finally, the agency might have one chief official, who serves at the pleasure of the President. An example here is the Federal Bureau of Investigation. Often, agencies that are independent (as described above) also have chief officials that are more insulated. However, this is not always the case – although the Environmental Protection Agency is independent of any cabinet agency, the Administrator serves at the pleasure of the President.

Legislative jurisdiction. Every federal regulator is overseen by a particular Congressional committee. For instance, the OCC and SEC report to the Senate Committee on Banking, Housing, and Urban Affairs, whereas the Federal Trade Commission reports to the

⁶⁰ See <http://www.fsa.gov.uk/Pages/About/Who/Management/Leaders/index.shtml>

⁶¹ See <http://www.fsa.gov.uk/Pages/About/Who/index.shtml>

Senate Committee on Commerce, Science, and Transportation. Which Congressional committee should have jurisdiction over a federal insurance regulator? The banking committees seem appropriate to insure parity of treatment with FIs and to address the concerns on this issue that we raised above.

Ad-hoc oversight. Quite separate from questions of oversight resulting from Congressional committee jurisdiction, formal organizational relationship with the President, appointment and removal of chief officials, and consolidation with other agencies, a federal insurance regulator may also be overseen by more ad-hoc institutions composed of various executive officials. Perhaps the most relevant group for an insurance regulator is the President's Working Group on Financial Markets, which currently counts the Treasury Secretary, Chairman of the Fed, Chairman of the SEC, and Chairman of the CFTC as members. The new insurance regulator would be added to the mix.

Funding: Some regulators, such as the SEC, receive substantial amounts of their funding from congressional appropriations. Others, such as the FDIC and the OCC, receive no appropriations and are entirely funded by premiums, assessments, other fees, and earnings on investments. Reliance upon appropriations increases accountability to Congress, but at the cost of independence from Congress.

Lessons From State Insurance Regulation⁶²

In considering what a federal regulator might look like, it is useful consider how state insurance regulators are organized and funded. The typical state insurance regulator is constituted as an autonomous agency, formally part of the executive branch, with one chief official appointed by the governor. An example of this paradigm is New York, where the New York State Insurance Department is headed by a Superintendent, appointed by the Governor. No

⁶² N.B. The information on state regulation is based on research done before May 2007 and has not yet been updated.

state insurance regulator appears to operate through a multimember commission. Within state legislatures, the three most common options for committee jurisdiction over insurance regulation are either a committee on banking and financial regulation (21 states), on commerce or consumer protection (12 states), or on insurance specifically (11 states). A minority of states has an elected chief official for insurance, and these states often grant more formal independence from the executive to the insurance regulator. Delaware is one such state, with an elected Insurance Commissioner, subject only to removal for “reasonable cause.”⁶³ This structure cannot be constitutionally replicated within the federal administrative structure. In and of itself, this means that a federal regulator may be more responsive to popular political pressure.

Another minority of states brings insurance regulation within another executive department, which is usually devoted either to commerce and consumer affairs or to banking and other financial services. Most of these states go further by consolidating regulation within this department, such that the insurance regulator merely is a division of a larger regulator, akin to the U.K.’s FSA.⁶⁴ An example of this is Michigan, where insurance regulation is one of the functions of the Office of Financial and Insurance Services, which also oversees banking and securities. This Office is itself a part of the Department of Labor and Economic Growth.

Oversight by an ad-hoc authority is highly uncommon. The only significant example might be Florida, where the Commissioner of the Office of Insurance Regulation is appointed and overseen by the Financial Services Commission. The Financial Services Commission is itself composed of the Governor and cabinet. The Commission also appoints and oversees the head of the Office of Financial Regulation, which oversees banking and securities. Both the

⁶³ See, 18 Del. C. §§ 301& 303.

⁶⁴ Sixteen states have consolidated financial supervision for insurance, banking and securities; twelve states have consolidated supervision for banking and securities; one state (New Jersey) has consolidated supervision for banking and insurance, one state (Tennessee) has consolidated supervision for insurance and securities; twenty two states have separate supervision for all three sectors. See, Elizabeth F. Brown, *E Pluribus Unum – Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 22 (2005).

Office of Insurance Regulation and the Office of Financial Regulation are within the larger Department of Financial Services, which is headed by a constitutional officer and also has regulatory jurisdiction over Florida's state accounting and auditing, state funds, and worker's compensation system.

State insurance departments may take their operating revenue from a variety of sources, including premium taxes, fees and assessments, appropriations, and penalties.⁶⁵ There is considerable diversity among the states. In California, the Department of Insurance collects fees for licensing and examination of insurance companies and agents, and deposits them into a dedicated fund; fines and penalties are deposited into the state's general fund. In Maine, the Bureau of Insurance gathers operating revenue by making an annual assessment against all licensed insurers in proportion to each company's direct gross premium. In Nevada, the legislature appropriates monies for the Department of Insurance from the general fund. Nevertheless, the most common approach gives the state insurance department considerable freedom to collect fees for service, allowing for a degree of independence and self-funding.

Summary

Some characteristics of state regulation are so prevalent that they may seem to be presumptively worthy of replication at the federal level. First, multimember insurance commissions are entirely absent among the states, which suggests that a Federal Reserve or SEC approach would not be appropriate at the federal level. However, state insurance regulators are not independent from the political process, perhaps because some of the consumer issues they deal with are so highly political. Multimember setups may be more appropriate for independent regulators, to assure that the independent agency has political balance—a substitute for more active political control. Second, the latitude given to state insurance departments in the setting and collecting of fees suggests that a national insurance regulator should be self-funding, at least

⁶⁵ Justin L. Brady, et al., *THE REGULATION OF INSURANCE* 89-91(1995).(Brady)..

in part. Self-funding would allow the regulator a degree of independence from the political process, akin to that enjoyed by the Federal Reserve System. However, the creation of another independent federal agency with its own wellspring of funds may not be a desirable result.

The Treasury Blueprint contemplates the creation, in the medium term, of an Office of National Insurance (“ONI”) within the Treasury to license and oversee federally chartered insurance companies. The Office would be headed by a Commissioner of National Insurance (“CNI”) which would be self-funded by assessments on federally chartered firms. In the longer term, the Blueprint contemplates splitting the function of this office, like the functions of other existing regulatory agencies, among the Market Stability Regulator (the Fed), the Prudential Financial Regulator (within the Treasury) and a Business Conduct Regulator (apparently an independent agency). These three regulators would join the existing FDIC, together with a new independent Corporate Finance Regulator, to form a federal regulatory structure with five “peaks”.

In our view, we should create the federal charter option now and not wait for the medium-term.. In doing so, it would be a mistake to create an independent agency to regulate insurance. This would further fragment federal regulation, a step in the wrong direction. However, it would also not be wise to merge the insurance and banking regulators because banking considerations are likely to be dominant, given our history and the public concern with systemic risk. Insurance would be a poor step child.⁶⁶ The best approach would be to create a separate insurance regulator but use that occasion to strengthen the powers and resources of the President’s Working Group on Financial Markets, which currently includes the Treasury, the Federal Reserve, the SEC and the CFTC, over all the federal regulators. The Treasury Blueprint

⁶⁶ Jack Chesson of NAIC remarks: “The bank regulators would not be suitable...as we know from the savings and loan experience, the regulators had no trouble subordinating regulation and disclosure to their primary function of protecting the banks.” Chesson, *The Views of the National Association of Insurance Commissioners*, OPTIONAL FEDERAL CHARTERING AND REGULATION OF INSURANCE COMPANIES, ed. Peter J. Wallison (2000) 74.

contemplates strengthening these powers, and one expects an Executive Order to this effect to be issued soon. Such an arrangement might replicate the benefits of oversight provided by Florida's Financial Services Commission.

As an overall matter, in the medium term (not the long-term as contemplated by the Treasury) we should pursue a more integrated regulatory structure. Rather than the Treasury's five peak plan, we should create a structure similar to the U.K.'s twin peaks, a central bank (Bank of England) and one overall financial regulator and supervisor (Financial Services Authority ("FSA")).⁶⁷ While the Bank of England has no supervisory authority, one could well envision giving the Fed such power, either exclusively or concurrently with authority of a U.S. FSA. These twin peaks would supervise and regulate federally chartered insurance firms, along with the other financial institutions. While some have argued that we should no longer regulate by labels and that it is hard to identify exactly what "insurance" is,⁶⁸ it should be noted that the U.K.'s FSA organizes its regulatory efforts across nine sectors, including insurance. Indeed, given the unique aspects of insurance, there should be a division of insurance within the U.S. FSA. The FSA would be an independent body, so that all supervision of financial institutions, including insurance, would be outside the Treasury.

As the failure of Northern Rock in the United Kingdom demonstrated, even twin peaks can have coordination problems. A memorandum of understanding currently governs the relationship of the Bank of England, FSA and the UK Treasury in dealing with financial system issues. Going forward, the U.K. envisions the need for stronger coordination.⁶⁹ Any revamp of U.S. regulation should include a similar memorandum among U.S. regulators.

⁶⁷ Statement by Hal S. Scott, Director of the Committee on Capital Markets Regulation, in response to the Blueprint, http://www.capmksreg.org/pdfs/4-4-08_Hal_S_Scott_Press_Release.pdf.

⁶⁸ Elizabeth F. Brown, *The Fatal Flaw of Proposals to Federalize Insurance Regulation*, Research Symposium on Insurance Markets and Regulation, Searle Center (April 2008).

⁶⁹ Bank of England, H.M. Treasury and Financial Services Authority, *Financial Stability and Depositor Protection: Strengthening the Framework*, CM 7308 (January 2008).

Consolidated regulation could increase efficiency and allow coordination between insurance regulators and other financial regulators. This coordination is important for ensuring fair competition between insurance and other financial institutions which increasingly offer similar products. It is also important in dealing with foreign states as it ensures a unified voice for U.S. regulation and allows for a more rapid response to changing international events. Other virtues of consolidated regulation may include better handling of issues unique to financial conglomerates (such as conflicts of interest),⁷⁰ greater resistance to capture by a particular sector in financial services,⁷¹ and reduced confusion for consumers seeking information or to file a complaint.⁷² And as the subprime crisis has taught us it may prevent issues from falling through the jurisdictional cracks. On the other hand, a consolidated regulator might become large and unwieldy⁷³ and unresponsive to the needs of small firms.⁷⁴

VI. Internal Structure

The internal structure of the federal chartering agency must be determined in large part by the lines of insurance to be governed by a federal charter. This section considers the issues posed for the internal structure of the federal chartering agency by three lines of insurance: life, and two lines of property and casualty insurance, individual passenger automobile (“auto”), and commercial general liability (“commercial”). No state has a distinct set of rules for each line, nor would such regulatory tailoring be sensible given the existence of common issues and the fact that few remaining insurers are “monoline” companies. The principal rationale for states retaining solvency regulation is their concern with consumer protection, e.g. of life insurance policy holders, or successful maintenance of guaranty funds. However, maximum cost savings of an optional federal charter are achievable only if all these functions are regulated at the federal

⁷⁰ Brown, *E Pluribus Unum – Out of Many, One*, *supra* note xx, at 38-46.

⁷¹ *Id.*, at 50-52.

⁷² *Id.*, at 59.

⁷³ *Id.*, at 94-96.

⁷⁴ *Id.*, at 97.

level. Further, any split of functions between the states and the federal government will be difficult to design and administer.

Nonetheless, the Treasury Blueprint apparently contemplates that there would be federal chartering by line of insurance, not by insurance firm.⁷⁵ Thus, for a given insurance firm, some lines could be regulated at the federal level and others at the state level. Another approach might be the licensing of types of regulation. Thus, it would be possible but not optimal for firms to have the choice of being regulated at the federal level for solvency and other forms of state regulation that do not vary by line, with the states regulating solvency requirements that do vary by line, e.g. capital requirements.⁷⁶ However, the cleanest and most efficient solution would be to license firms, rather than lines or functions. Indeed, we have no historical experience with federal licensing of financial products—the entire national bank experience is based on the chartering of firms.

Different insurance products may operate in more or less competitive markets, face different non-insurance competitors, and give rise to more or less concern for consumer protection. As Table V demonstrates, state regulators have taken different approaches to the regulation of life, individual auto and commercial insurance.

Table VI: Overview of State Regulation of Life, Auto and Commercial Insurance

Regulatory Functions	Life	Auto	Commercial
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⁷⁵ Blueprint, note 9 *supra* at 129.

⁷⁶ Minimum capitalization requirements vary by line, and by state. During the 1990s, the National Association of Insurance Commissioners (NAIC) sought to harmonize state regulation by adopting model minimum risk-based capitalization (RBC) requirements for most lines (including life and property/casualty). *See, e.g.*, N.Y. Ins. L. § 4103; *see also*, Kathleen Heald Ettliger, et al., STATE INSURANCE REGULATION 15-19 (1995) (Ettliger). A multistate, multiline insurer generally must meet the greater of its minimum RBC requirements or the minimum capital requirements of each state in which it is licensed to do business. There is no reason that a federal regulator could not promulgate solvency regulations that would be equally sensitive to the different risks posed by different product lines—and more uniform.

<i>Chartering & Licensing</i>	State-by-state <ul style="list-style-type: none"> • Capital & surplus requirements • Revocation w/ notice & hearing 	State-by-state <ul style="list-style-type: none"> • Capital & surplus requirements • Revocation w/ notice & hearing 	State-by-state <ul style="list-style-type: none"> • Capital & surplus requirements • Revocation w/ notice & hearing
<i>Financial Reporting</i>	Annual <ul style="list-style-type: none"> • Certified • Audited financial statements Quarterly	Annual <ul style="list-style-type: none"> • Certified • Audited financial statements Quarterly	Annual <ul style="list-style-type: none"> • Certified • Audited financial statements Quarterly
<i>Financial Examination</i>	≤ 3-5 years “Zone System”	≤ 3-5 years “Zone System”	≤ 3-5 years “Zone System”
<i>Policy Form Regulation</i>	Prior approval (PA) in most states	PA in most states	PA in most states
<i>Rate Regulation</i>	Generally “file and use” (FU) or “use and file” (UF). Some no filing (NF)	PA in most states. Some FU or UF.	Mixed. Some states require PA. Most FU or UF. Few NF.
<i>Residual Risk Mechanism</i>	No.	Yes. Many states have universal coverage or no-fault.	No.
<i>Market Conduct Regulation/Examination</i>	Yes.	Yes. Highest level of scrutiny.	Yes. Lower level of scrutiny.
<i>Consumer Services</i>	Yes. <ul style="list-style-type: none"> • Brochures /guides • Complaints / inquiries 	Yes. <ul style="list-style-type: none"> • Brochures /guides • Complaints / inquiries 	Yes. <ul style="list-style-type: none"> • Guides for certain lines (e.g., medical malpractice & workers’ comp.)
<i>Fraud Investigation</i>	Most states have distinct insurance fraud bureaus. Nine states rely upon police and prosecutors.	Most states have distinct insurance fraud bureaus. Nine states rely upon police and prosecutors.	Most states have distinct insurance fraud bureaus. Nine states rely upon police and prosecutors.

Life Insurance

Life insurance companies offer life insurance contracts and other financial products (e.g., annuities) to retail customers, businesses, and groups. The market for life insurance products is highly competitive,⁷⁷ a situation enhanced by increasing competition from banking and securities

⁷⁷ Gtace and Klein 2007, note 35 *supra*.

products. As industry executives and observers note, this is not simply a matter of banks offering life insurance in the wake of the Gramm-Leach-Bliley Act, but of a more fundamental convergence taking place in the financial services industry. Life insurance companies have been among those most interested in a federal chartering option.

Solvency Regulation. Life insurers are subject to solvency regulation in each of the states and territories in which they do business. Solvency regulation encompasses chartering and licensing, and involves periodic financial reporting and examination requirements over the “life” of the insurer. As a rule, an insurer must be chartered as either a life insurance company or a property/casualty company, and will be licensed to issue one or more lines within these broad categories.⁷⁸ In order to be chartered and licensed, insurers must meet minimum capital and surplus requirements, which vary by category and line. Considerable uniformity already has been imposed upon states’ capital and surplus by their adoption of Risk Based Capital Model Acts promulgated by NAIC. However, almost every state has retained their own fixed minimum capital and surplus requirements. A multistate, multiline insurer generally must meet the greater of NAIC’s minimum risk-based capital requirements or the minimum capital requirements of each state in which it is licensed to do business.⁷⁹ In addition to minimum capital requirements, states regulate market entry through “seasoning” and other requirements. After becoming licensed, both life and property/casualty insurers must file annual and quarterly financial reports, and submit to periodic “full-scope” and occasional “targeted” financial examinations.

⁷⁸ The separation between life and property/casualty insurers seems to be the historical legacy of “monoline” insurance regulation, which began with the New York legislature’s 1849 decision to require each insurance company to issue only a single line. Insurers began offering multiple lines during the early twentieth century; however, legislation providing for the licensing of multiline insurers was not adopted by the states until after 1945. See Brady, et al., *THE REGULATION OF INSURANCE*, note 67 *supra* at 36-40.

⁷⁹ See note 44 *supra*.

Because the underwriting risks faced by life insurers are distinct (see, e.g., the long time frame of life insurance contracts), state regulators have subjected these companies to chartering/licensing requirements and accounting standards that differ from those applied either to property/casualty insurers or banks. Life insurers are subject to investment restrictions that differ from those imposed upon property/casualty insurers, and are required to account differently for their policy reserves. Moreover, both life and property/casualty insurers must comply with accounting principles that are more conservative than those applied to banks. Insurers are required to file financial reports in keeping with statutory accounting principles (SAP) rather than generally accepted accounting principles (GAAP). SAP differs from GAAP in terms of the valuation, realization, and continuity issues imposed on reporting companies (e.g., SAP generally takes a liquidation rather than going concern perspective). Otherwise, the financial reporting and examination requirements imposed upon the life insurance industry by state regulators are similar to that imposed upon the banking industry by the OCC.

Many states already base their financial reporting requirements upon universal standards prescribed by NAIC and accept “zone examinations” of multi-state insurers; therefore, insurers and the federal regulatory will reap limited (though welcome) cost savings from a single federal reporting and examination system.⁸⁰ However, federal regulatory oversight of insurer solvency could further enhance the efficiency of the insurance industry. A federal regulator could abolish the traditional division of insolvency regulation between life and property/casualty insurance. While these types of insurance face distinct risks, so do the different individual sublines of property/casualty insurance, which nevertheless may be offered by a single insurer.⁸¹ Following

⁸⁰ The federal regulator may reduce costs by conducting financial examination on an as-needed or prioritized basis (i.e., in response to a complaint or law-breaking), rather than a strictly periodic basis. The current proposal would require the Commissioner to conduct an on-site examination of each federally chartered insurance company at least once every three years; however, insurance agencies would be subject to examination only in response to a complaint or law-breaking. *See*, NIA § 1125.

⁸¹ *See, e.g.*, N.Y. Ins. L. §§ 4101-4102.

state regulators' shift to a risk-based capital model, the federal regulator may contemplate chartering consolidated federal insurance companies authorized to do business in any line of insurance at all, provided it has adequate risk-adjusted capital and surplus.⁸²

Second, a federal regulator could consider either the elimination of capital/surplus requirements for life insurance companies, or a convergence with banking capital requirements and accounting standards. To the extent that the capital requirements of life insurers are more conservative than those of banks and securities firms offering similar products, insurers will be at a competitive disadvantage. Reconciliation of SAP and GAAP would eliminate inconsistencies that may give either insurers or their competitors an advantage in the market for financial services, and would provide regulatory efficiencies (e.g., consistency and comparability) as financial services converge. Finally, a federal regulator should ensure relative ease of entry and exit.

Rate/Policy Form Regulation and Consumer Protection. Life insurance rates generally are lightly regulated or unregulated by the states. However, this light touch is significantly offset by requirements in most states that policy forms be subject to prior approval of the state insurance department. Thus, in order to introduce a new product, a life insurer must seek the approval of the insurance regulator in each state in which it does business. Life insurers also are subject to state market conduct regulation and examination (e.g., advertising restrictions).

Life insurers report significant direct and indirect costs arising from this contradictory and fragmented mélange of state regulation.⁸³ For example, life insurers may have to create different versions of products tailored to the policy forms of particular states, and may employ

⁸² The current proposal would not allow a National Insurer to hold licenses for both life and property/casualty insurance. *See*, NIA § 1203.

⁸³ ACLI, ECONOMIC IMPACT OF AN OPTIONAL FEDERAL CHARTER ON THE LIFE INSURANCE INDUSTRY (Aug. 2005).

multiple state-based compliance staffs. This puts life insurers at a competitive disadvantage vis-à-vis banks and securities firms.

Unification of the regulation of rates and policy forms in a single federal regulator obviously would reduce compliance costs to life insurers; elimination of prior approval of rates and policy forms would be a further boon, enabling life insurers to compete with banks and securities firms on a more even playing field.⁸⁴ Because the market for life insurance products is highly competitive, the main consumer protection issue facing the federal regulator will be that of retail consumers' informational inadequacy. This consumer protection should take the form of simple regulations regarding market conduct, along with efforts to inform retail consumers.

Summary. Full optional federal chartering of life insurance, safety and soundness and product regulation seems to create more opportunities than challenges. State product regulation of life insurance is mainly concerned with policy form issues, given the competitive nature of pricing in this market. If the federal charter also encompassed the regulation of the solvency of property/casualty insurers, the federal regulator could consolidate its regulation of these two lines.

An important internal structure issue raised by the need to protect life insurance consumers is whether the consumer protection function should be separated from the solvency regulation function—i.e., into two separate Divisions, a Division of Financial Services and a Division of Consumer Protection. Most state regulators have a separate bureau of consumer affairs, and one is contemplated by the NIA. To the extent that market regulation/examination and consumer education/complaints may be “scaled” across lines, e.g. the federal regulator deals with consumer issues in multiple lines, a single bureau of consumer affairs will be desirable.

⁸⁴ As noted above, the NIA would establish a “file and use” system for life insurance policy forms, and allow the Commissioner to exempt particular categories from the filing requirement. Life insurers would be allowed to classify policyholders and set rates freely. NIA § 1213.

Another issue is whether the enforcement function should be separated from the supervisory function—as, for example in the SEC, which has a separate Division of Enforcement. The Office of the Comptroller of the Currency is an example of a more integrated approach: primary responsibility for enforcement is allocated by “line” to the senior deputy comptrollers for Bank Supervision Operations for Community/Mid-Size Banks and for Large Banks. The difference between the SEC and OCC is a product of the agencies’ distinct “regulatory styles”: the SEC seeks to protect investors on a transactional basis; the OCC endeavors to align the market conduct of banks on a broader supervisory basis. The Committee on Capital Market Regulation and others have suggested that the SEC move to a more prudential approach to regulation, only using enforcement if the prudential approach fails.⁸⁵ This approach would counsel against creating a separate enforcement division.

Commercial Insurance

Property/casualty companies offer commercial general liability insurance to businesses, often along with other lines like commercial auto and workers’ compensation insurance. The market for commercial insurance is highly competitive, and purchasers of commercial insurance generally are large and informed.

Solvency Regulation. Like life insurers, commercial property/casualty insurers are subject to minimum capital and surplus requirements for chartering and licensing, as well as periodic financial reporting and examination by state insurance regulators. The rationale for these requirements obviously is to ensure the solvency of insurers who have promised to deliver future contingent benefits to policyholders or their beneficiaries. A federal insurance regulator could lower regulatory costs through more uniform and consistent chartering, licensing, and financial reporting requirements. And, competition may be enhanced by a consolidated federal insurance company option.

⁸⁵ INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION (November 30, 2006): 9 & 66-67.

Insofar as their products are sold in competitive markets to presumptively sophisticated buyers, a federal insurance regulator may decide to eliminate capital and surplus requirements altogether for commercial insurers. Commercial insurers face increased competition from the growing market in alternative risk transfer mechanisms, such as credit derivatives. To the extent that suppliers of alternative risk transfer products are subject to lower (or no) capital requirements, prices and consumer choice may be distorted in the market for commercial lines. Minimum capital and surplus requirements also hamper the entry of new commercial insurers whose products might find willing, sophisticated buyers. Financial reporting and examination may be justified insofar as it cost-effectively reduces the risk of insolvency, in part by eliminating duplicative diligence costs undertaken by customers.

Rate/Policy Form Regulation and Consumer Protection. Like life insurance, commercial insurance enjoys de facto rate deregulation, but (rather surprisingly) remains subject to considerable policy form regulation.⁸⁶ Prior approval of policy forms increases commercial insurers' time-to-market, disadvantaging them vis-à-vis securities firms offering alternative risk transfer products. As with life insurance, it is not clear what purpose prior approval of policy forms serves when rates are deregulated.⁸⁷

Other than fraud investigation, consumer protection issues are not implicated by commercial general liability insurance.

Summary. As with life insurance, full optional federal chartering of commercial insurance, safety and soundness and product regulation, seems to create a number of opportunities to reduce regulatory costs and enhance product market efficiency. Commercial insurance generally poses few consumer protection problems. However, workers compensation

⁸⁶ Richard J. Butler, *Form Regulation in Commercial Insurance*, DEREGULATING PROPERTY LIABILITY INSURANCE: RESTORING COMPETITION AND INCREASING MARKET EFFICIENCY, ed. J. David Cummins (2001) 321.

⁸⁷ As noted above, the NIA would establish a "use and file" system for property/casualty insurers, and would prohibit the Commissioner from requiring property/casualty insurers to use "any particular rate, rating element, price, or form." NIA § 1214.

insurance, which operates in a distinct market and regulatory environment,⁸⁸ may be offered by commercial general liability insurers in most states.⁸⁹ This raises a serious question for those who would limit federal chartering of insurance only to life and/or “commercial” insurance:⁹⁰ Will a national commercial insurer be limited to commercial general liability insurance alone? Such limited licensing would require a “full service” national commercial insurer to be simultaneously chartered for workers’ compensation insurance in each state in which it seeks to do business.

Auto Insurance

Property/casualty insurers also offer voluntary auto insurance to retail consumers in strictly regulated markets. Universal coverage often is mandated or encouraged by regulators, and is provided by residual risk mechanisms such as assigned risk pools. Consumer groups have objected to the extension of federal chartering to auto insurance and other retail property/casualty insurance on the grounds that the federal regulator would be unable or unwilling to provide adequate consumer protection.

Solvency Regulation. Retail auto insurance, like other lines, is subject to minimum capital and surplus requirements for chartering and licensing, and periodic financial reporting and examination by state insurance regulators. The rationale for such supervision is strong in the case of auto insurance, when it may be necessary to protect consumers with limited information and monitoring capacity from unscrupulous “fly-by-night” insurers. The basic contours of federal solvency regulation and its benefits are substantially the same as those discussed above.

⁸⁸ Workers compensation rates and forms are strictly regulated; indeed, a few states retain monopoly state workers’ compensation funds.

⁸⁹ *See, e.g.*, N.Y. Ins. L. § 4102(b)(1).

⁹⁰ Ernest T. Patrikis, *Optional Federal Chartering for Property and Casualty Companies*, OPTIONAL FEDERAL CHARTERING AND REGULATION OF INSURANCE COMPANIES, *supra* note xx, at 47-51 (advocating federal chartering for commercial property/casualty). House Financial Services Capital Markets Subcommittee Chairman Rep. Paul Kanjorski said in 2007 that optional federal chartering should be available only for life insurance. *See*, Bill Swindell, *Kanjorski Backs Federal Regulator; Insurance Groups Split*, CONGRESS DAILY (Feb. 8, 2007).

The need for strong communication between financial supervision and consumer affairs bureaus is greatest for proper solvency regulation of auto insurers.

Rate/Policy Form Regulation and Consumer Protection. Auto insurance regulation touches all aspects of consumer protection, including rates and policy forms, market conduct, and consumer education and complaints. Some states strictly regulate rates and policy forms. For example, until 2008, Massachusetts set uniform rates and rating classes for insurance companies. It still requires prior approval of rates. However, rate and policy form regulation differs greatly between states. Even two “prior approval” states may impose different burdens upon insurers, depending upon the stringency and speed of review, as well as the use of such regulation to suppress rates.⁹¹ Moreover, rate and policy form regulation is intimately tied to state policies favoring universal coverage. State regulators are strict in enforcing market conduct regulation and swift in responding to consumer complaints.

The variety of state rate and policy form regulation imposes considerable direct and indirect costs upon auto insurers and results in various cross-subsidies between consumers with different risk profiles. Even if a federal regulator required prior approval of rates and/or policy forms, regulatory costs would be lowered. However, because the market for voluntary auto insurance in most states is highly competitive, a federal regulator may choose to deregulate rates and/or policy forms. Illinois has completely deregulated rates for voluntary auto insurance since 1971 (it still regulates insolvency, market conduct, etc.). Observers report that auto insurance is widely available and rates are competitive in Illinois; moreover, deregulation seems to have been no adverse effect upon loss ratios, the size of the uninsured and residual market, or insurer

⁹¹ See, Scott Harrington, INSURANCE DEREGULATION AND THE PUBLIC INTEREST (2000) 11-14.

solvency.⁹² Consumer protection in a deregulated rate environment may be buttressed by the elimination of the federal antitrust exemption for national insurers (to prevent rate collusion).⁹³

Even in a competitive, rate deregulated national auto insurance market, the federal insurance regulator may desire to regulate market conduct for the protection of consumers. Such an initiative may require a distinct division of market conduct and consumer protection dedicated to retail policyholders and beneficiaries. The more lines that can be regulated at the federal level that raise such consumer concerns, the more justification there would be for a separate division.

Residual Risk Mechanism. In order to guarantee the availability of auto insurance, every state has a residual risk market or assigned risk pool for drivers unable to secure voluntary auto insurance. Like state guaranty plans, discussed below, auto insurers doing business in a state participate in its residual risk market on a pro rata basis. State workers compensation insurance generally has a similar mechanism. The NIA would not create a national residual risk mechanism. Instead, federally chartered insurers would remain subject to applicable state law relating to participation in assigned risk pools. The Treasury Blueprint seems to take the same approach.⁹⁴

If auto insurance is offered a federal chartering option, the internal structure of the federal regulator will be affected greatly by the legislative decision regarding the creation of a national residual risk mechanism. If national insurers are required to participate in state residual risk markets, regulatory supervision will be divided between federal (solvency and consumer protection) and state (residual risk compliance). This may raise direct compliance costs to insurers, as well as indirect costs related to increased time to market for new products.

⁹² Stephen P. D'Arcy, *Insurance Price Deregulation: The Illinois Experience*, DEREGULATING PROPERTY LIABILITY INSURANCE: RESTORING COMPETITION AND INCREASING MARKET EFFICIENCY 281-282,, J. David Cummins ed. (2002).

⁹³ California's Proposition 103 did this at a state level.

⁹⁴ Blueprint, note 9 *supra* at 129.

There are two other alternatives: the creation of a national residual risk mechanism, or the preemption of state residual risk mechanisms without the creation of a new one. Obviously, the existence of a national residual risk mechanism would require national administration of a regulatory function unique to this kind of insurance. More importantly, national pooling would alter the spread of the costs of underwriting losses among insurers. If broader spreading of risks were to result in cost-savings to national insurers, presumably they (and their policyholders) would benefit to the detriment of state-chartered insurers. On the other hand, particular insurance companies (which predominantly insure policies in states with safer drivers) might believe that wider risk-spreading would raise costs. Abolishing all residual risk insurance would not be a practical alternative.

Summary. Auto insurance is distinct in two respects: it raises consumer protection issues different (and greater) than those raised by life and commercial insurance; and, it poses distinct problems of residual risk mechanisms. The distinct nature of auto (and other retail property/casualty) insurance may offer some support to those who would restrict optional federal chartering to life and/or commercial lines. But the potential regulatory and market efficiencies achievable by a universal federal chartering option (of all firms and lines) may outweigh these concerns.

Table II presents the major issues raised in the design of the federal chartering agency's internal structure. As is clear from the table, there is considerable harmony across lines in terms of solvency regulation. This is not surprising, given the fact that solvency is a firm-based, rather than product-based, phenomenon, and given as well the trend toward convergence across product lines. As is equally clear, the major differences between lines arise in the area of consumer protective regulation. Neither life nor commercial insurance requires great market conduct regulation or examination, given the relative simplicity of these products and the competitiveness

of the markets for them. The ultimate questions, then, are whether and how the whole or partial integration of auto (and other retail property/casualty) insurance may be effected.

Table VII: Issues Raised in Internal Design of OFC

Regulatory Depts. & Functions	Life	Auto	Commercial
<i>Chartering & Licensing</i>	<ul style="list-style-type: none"> • Consolidated chartering and licensing • Consolidated capital/surplus requirements 		
<i>Financial Reporting</i>	<ul style="list-style-type: none"> • Consolidated or separate reporting • Reconciliation of SAP & GAAP? 		
<i>Financial Examination</i>	<ul style="list-style-type: none"> • Consolidated regulator to oversee banking & insurance exam? • As-needed/prioritized examination? 		
<i>Policy Form Regulation (Competition)</i>	Competition: Banks	<ul style="list-style-type: none"> • Currently no competitive threat from non-insurance financial services 	Competition: Self-insurance, alternative risk transfer products
<i>Policy Form Regulation (Consumer Protection)</i>	Informative prices Two consumers: retail & wholesale (business, group)	Consumer protection <ul style="list-style-type: none"> • Complexity • Fair v. unfair discrimination 	Informed, sophisticated buyers
<i>Rate Regulation</i>	Competitive mkt Voluntary	Competitive mkt Often required/ socially desirable	Competitive mkt Voluntary
<i>Residual Risk Mechanism</i>	No	<u>Options:</u> <ul style="list-style-type: none"> • Participation in state pool • Creation of national pool • No national pool 	No
<i>Market Conduct Regulation/Examination</i>	Unfair competition Deceptive Conduct <ul style="list-style-type: none"> • Informative prices • Regulatory Style: Disclosure v. Prescription 	Unfair competition Deceptive Conduct <ul style="list-style-type: none"> • Complexity • 	Unfair competition
<i>Consumer Services</i>	Education	Education	Complaints?

	Complaints	Complaints	
<i>Fraud Investigation</i>	Separate fraud bureau?		

Guaranty Funds

The state guaranty fund system is an important facet of insurance regulation that has been a cause of concern for federal chartering. These funds are in place to compensate for the losses suffered by third parties and policyholders due to insurance company insolvency. Since insurance regulators are responsible for preventing this insolvency, guaranty funds may be framed as a sort of “product warranty” for the quality of regulation.⁹⁵ The general perception is that the administration of state guaranty funds has been one of the most effective components of state insurance regulation. The proposed federal legislation and the Treasury Blueprint would keep the state guaranty system in tact and require federally chartered insurance firms to participate in them.

States, at the behest of insurance companies, began to create these funds starting in 1969, perhaps in response to pressure for federal regulation. The first wave of funds provided protection for life and health insurers, with subsequent waves spreading coverage to property and casualty insurers. These product divisions remain today, and often include subdivisions, or “accounts,” for particular lines of insurance. Assessments for policyholder claims against insolvent insurers are made against the appropriate “account.”⁹⁶ The funds typically are organized as compulsory membership nonprofit associations of all insurance companies licensed in the state. They are administered by a board composed of representatives from insurance companies and the state insurance regulator, with some states including representatives of the public as well. Most state guaranty assessments are not risk-sensitive, which has been a source

⁹⁵ Bert Ely, *The Fate of the State Guaranty Funds after the Advent of Federal Insurance Chartering*, OPTIONAL FEDERAL CHARTERING AND REGULATION OF INSURANCE COMPANIES 137-138, Peter J. Wallison ed. (American Enterprise Institute 2000) (Ely).

⁹⁶ Ettliger, et al., STATE INSURANCE REGULATION, note 78 *supra* at 224-225.

of criticism. Also, some states allow insurers, especially life and health insurers, to offset the taxes they pay on premiums by the amount of guaranty fund assessments paid. As a result, some of the cost of insolvency losses is passed along to taxpayers, who must make up for any shortfall in taxation created by these offsets.

The two most often praised features of the state guaranty fund system are its basis for assessments and level of coverage. With the exception of New York, every state administers its guaranty fund on a post-assessment basis. That means that member insurance companies do not pay into a fund until around the end of the year, and only to the extent necessary to compensate for losses. This may be contrasted with funding on a pre-assessment basis, wherein companies would pay into the fund before losses are known, as is the case with the FDIC fund for banks. In 2007, the New York state legislature took advantage of its state's pre-assessment fund by siphoning off the fund's resources for general spending. This suggests that any prefunding mechanism needs to be highly insulated from the political process.

Additionally, state guaranty funds generally have low coverage limits. Commentators hail these limits as promoting efficient behavior by insurance companies. Due to the low limits, companies have incentives to self-insure by controlling their risk of insolvency. These incentives tend to minimize losses. Were coverage limits to be higher, insurance companies would be more likely to engage in risky behavior, such as writing more high risk policies, due to moral hazard. These are the same issues encountered in setting the level of FDIC insurance for banks.

Owing to this positive appraisal of state guaranty funds, many commentators have adopted an approach along the lines of "if it ain't broke, don't fix it." Indeed, post-assessment funding and low coverage limits suggest that state guaranty funds do not suffer from the same weaknesses of over-regulation and inefficiency that might justify more general reform of

insurance regulation. Of course, post-assessment funding and low coverage could also be implemented at the federal level.

If we operate from the perspective that state guaranty funds operate well and should continue in operation, then we should pay attention to whether optional federal chartering of insurers might impair the effectiveness of the state guaranty system. There are a few reasons to think that such impairment might occur. First, federal regulators might worry about relying upon state funds in the case of insolvency. If a large national insurance company were to fail, then some state funds might have insufficient assessment resources to compensate for the losses of third parties and policyholders within that state's jurisdiction. Also, state funds do not exhibit a uniform level of protection,⁹⁷ which means that different federally chartered insurers would have different insolvency protection, depending upon where they operate. Federal regulators might insist upon uniform minimum standards for the operation of state guaranty funds.

Unsurprisingly, the insurance industry and state regulators have generally supported the state guaranty approach.⁹⁸

However, federal regulation with state guarantys necessitates severing the link between regulation and guaranty that is the backbone to the idea of guaranty as product warranty. This idea is premised upon the notion that regulators will act more effectively if they must bear the cost of poor regulation. This efficacy will not obtain if state funds bear the costs of poor federal regulation. It was precisely this concern that led to federal involvement in safety and soundness regulation for state chartered banks using federal deposit insurance.⁹⁹

Concerns about the potentially adverse impact of federal regulation upon the state guaranty system might be grounds for installing a federal guaranty fund for federally chartered

⁹⁷ “[C]overage limits vary from state to state, up to \$500,000, by type of insurance product and by type of liability (prepaid premiums versus actual loss, cash values versus life insurance death benefits, and so forth).” Ely, note 97 *supra* at 142.

⁹⁸ Harrington, note 10 *supra* at 19.

⁹⁹ See Ely, note 97 *supra* at 136-37.

insurers. Such a fund would successfully tie federal regulation to federal guaranty, thereby satisfying the product warranty rationale. There might also be some subsidiary benefits of a federal fund. It would imply uniformity of protection for federally chartered insurers. If a diverse group of insurers choose to operate under federal charter, then there might be better pooling of risk as compared with state funds, which have a more limited geographic base from which to draw members.

Additionally, there would be no passing off of externalities from one state to another.¹⁰⁰ Currently, state regulators have less incentive to regulate multistate insurers because other states' funds share the costs of insolvency. A federal fund would eliminate this practice for federally chartered insurers because the federal fund would not be able to pass the buck of insolvency on to other funds. On the other hand, some have argued that the possibility of externalities to insolvency actually improves state regulation because it gives state regulators an incentive to monitor the quality of regulation in domiciliary states.¹⁰¹

Were legislators to opt for establishing a federal guaranty fund, then there are number of structural concerns they would need to address. First, as discussed earlier, most state funds have divisions and subdivisions keyed to different insurance products. The presence and extent of such divisions in a federal fund is something to be decided. Next, legislators would have to consider whether state chartered insurers would be eligible for the fund, just as state chartered banks are eligible for federal deposit insurance. Also, like federal deposit insurance, there is a question as to how premiums would be assessed. Risk-based premiums seem ideal, if difficult to implement. If the federal guaranty fund is structured like federal deposit insurance, then it might

¹⁰⁰ See Martin F. Grace and Richard D. Phillips, *The Allocation of Governmental Regulatory Authority: Federalism and the Case of Insurance Regulation*, Center for Risk Management and Insurance Research No. 96-2 6, available at <http://ssrn.com/abstract=146609> (1999)..

¹⁰¹ Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 NYU L. REV. 13, 79 (1993).

even make sense for the FDIC to administer the fund.¹⁰² Regardless, the relationship between the fund and federal regulators, possibly including a federal insurance regulator, should be clarified. Additionally, there are a number of unique concerns that would arise during the transition by insurers from membership in state funds to membership in a federal fund.¹⁰³

If, as contemplated by the Blueprint, lines and not firms were federally chartered, the administration of the guaranty funds would become even more complicated. The same firm could be engaged in state chartered and federally chartered activities, and the states would obviously have an interest in the solvency of the state activities. Under this scenario, the state guaranty funds could guarantee the state lines, while the federal guaranty fund would guaranty the federal lines.

VII. Conclusion

There are several important issues to be considered in designing a regulatory structure for the optional federal chartering option for insurance. First and foremost, the objectives of insurance regulation and the rationale for optional federal chartering must guide regulatory design. Second, lessons learned from existing federal and state financial services regulators regarding the external structure of such an agency must be borne in mind. Chief among these lessons is the disjunction between the accelerating convergence of financial services and the current fragmentation of our regulatory system. Third, it would be preferable to charter firms, rather than lines or regulatory functions, at the federal level. The extent of federal chartering of lines would be a major factor in designing the internal structure of the federal agency. Fourth, the participation of national insurers in state residual risk mechanisms and guaranty funds must

¹⁰² See Ely, note 97 *supra* at 145.

¹⁰³ Examples include need for exit fees to prevent exodus from state to federal regulation in lieu of an assessment due to failure of a large company and for a mechanism for dealing with insolvency of newly chartered federal companies. Lissa Broome, *A Federal Charter Option for Insurance Companies: Lessons from the Bank Experience*, in FINANCIAL REGULATION AFTER GRAMM-LEACH-BLILEY (Pat McCoy, ed., 2002), available at <http://ssrn.com/abstract=334440>.

be determined, with reference to both consumer protection and efficiency goals. Finally, in the medium term we should strive to make insurance supervision and regulation part of a new twin peak regulatory function, consisting of the Fed and a new U.S. FSA.

In the shorter term, while the federal government should have primacy in the regulation of insurance, it would be a mistake to establish an independent Office of National Insurance (as contemplated by the NIA), further fragmenting federal regulation of financial services. Neither would it be wise to consolidate federal regulation of banking and insurance under a single agency (a point upon which both NAIC and multistate insurance companies agree). In my view, the optimal external structure would involve the establishment of a distinct insurance regulator subject to oversight by the President's Working Group on Financial Markets. This approach is most likely to provide the greatest benefits arising from optional federal chartering of insurance—cost savings from uniformity, economies of scale, and appropriate deregulation, along with the benefits of coordinated financial services regulation—at the lowest cost. It also would combine regulatory expertise and independence with strong political oversight and accountability. Finally, it might serve as a first step toward consolidated federal financial services regulation, beginning with the reconciliation of capital requirements and accounting standards for all financial services firms.

The federal regulator of insurance should provide a true federal “option”: national insurers should be subject only to federal regulation of their solvency and product offerings, and should be able to offer many lines of insurance. A federal regulator would be well situated to set and enforce appropriate risk-based capital requirements for national insurers, based upon product line and other relevant risk factors. Indeed, a federal regulator could consider removing the traditional barrier between life and property/casualty insurers. The benefits of optional federal chartering of insurance would be maximized, and the potential for duplicative and conflicting

regulation reduced, by allowing national insurers to offer as many lines of insurance as possible. Retaining state policy form regulation for national auto and workers' compensation insurance (as contemplated by the NIA) would reduce greatly the benefits of rate deregulation for these lines, as we have seen from states' "deregulation" of commercial insurance. Alternatively, limiting national property/casualty insurers to commercial insurance would require them to charter separate workers compensation companies in each state in order to provide "full service."

Clearly, licensing national insurers to offer certain lines, such as auto insurance, would implicate important consumer protection issues. Generally speaking, regulation of insurers, like that of banks, should be prudential in approach, and effected through the examination process. However, the more "retail" lines offered by a national insurer, the more a federal regulator would be required to promulgate market conduct regulation, investigate consumer complaints, enforce penalties for violations, and provide for consumer education. If such lines are offered, the federal regulator should create a distinct division of market conduct and consumer protection dedicated to retail policyholders and beneficiaries.

Furthermore, the relationship of national insurers to state residual risk mechanisms and guaranty funds must be determined. The creation of a national residual risk mechanism and a national guaranty fund would require federal administration of regulatory functions unique to insurance, and historically the province of the states. However, federal administration of these functions would enable national pooling of residual and insolvency risks, and would allow for regulatory innovations (e.g., risk-based premiums for the national guaranty fund). Indeed, either or both "pools" could be open to the participation of state chartered insurers, allowing them to enjoy any economies of scale provided by federal administration. An important issue to consider is that allowing national insurers to participate in state residual risk mechanisms and guaranty funds, however well administered, might lead to different or even contradictory regulation of

federally chartered insurers. In contrast, a national guaranty fund would allow the federal government to consolidate solvency regulation from “cradle to grave,” albeit at some cost and risk.

In conclusion, design of a regulatory structure for the optional federal chartering option for insurance should provide for strong and efficient federal regulation of what is a national and international financial service activity. Insofar as is possible, the federal option should give insurers the choice to be subject only to federal, rather than state, regulation and law enforcement. And, insofar as the convergence of financial services is accelerating, creation of a federal option should be a first step towards more complete consolidation of federal financial services regulation. Such a system would level the playing field both nationally and internationally, and provide consumers with the most efficient and transparent “options.”

Finally, this paper has assumed that federal chartering would be optional. However, it may well be that federal regulation, if not chartering, will become mandatory for the systemically important insurance companies, given the Federal Reserve’s new potential exposure of lending to such firms after Bear Stearns. For example, there are large insurers which have a potential for imposing systemic risk to the economy. Should the Federal Reserve have the power to lend to or rescue such firms? This issue is outside the scope of this paper but is illustrative of the continuing evolution of regulatory issues facing the financial services industries.