

## The Ongoing Battle for Insurance Regulatory Reform

Written by Martin F. Grace, PhD, JD and Robert W. Klein, PhD

Insurance regulation in the U.S. is at a crossroads. It is the last major sector of financial services regulated primarily at the state level. The state framework and its policies are becoming increasingly out of synch with the evolution of insurance markets nationally and internationally. Significant segments of the industry support some form of federal regulation to remove artificial state barriers that impede competition and undermine insurers' efficiency. Advocates of federal regulation also hope that it will adopt policies that will further promote efficient markets. However, federal regulatory proposals are strongly opposed by the states and other industry segments which has resulted in a fierce debate about how insurance should be regulated.

The issues surrounding the Future of Insurance Regulation will be examined in an important conference on July 9 in Washington, DC. Experts in insurance and financial regulation will present and discuss scholarly papers on several topics including federal versus state regulation, regulatory policy reform, and their implications for financial convergence and international trade. The conference is being coordinated by the Department of Risk Management and Insurance at Georgia State University and co-sponsored by the American Enterprise Institute and the Brookings Institution with funding support from the Risk Foundation. Readers can obtain more information and register for the conference at <http://www.rmi.gsu.edu/insurance-regulation.html>.

One of the principal subjects of the conference will be the proposal to create an Optional Federal Charter (OFC) for insurance companies and agents that would preempt state regulation for federally-chartered firms. An OFC is the vehicle preferred by federal regulation advocates and there is a strong push for its adoption. It is also supported as an intermediate step for insurance by the Treasury in its blueprint for overall financial institution regulatory reform. While an OFC would allow insurers and agents to choose to remain state-regulated, the states and their supporters believe that it would substantially diminish their grip on the industry.

The legislative vehicle for the OFC approach is the National Insurance Act (NIA) – S. 40 – introduced in 2007 by Senators John Sununu (R-NH) and Tim Johnson (D-SD). While there are many details that may or may not be in a

final bill approved by the Congress, there are a number of important provisions that are likely to be present in any legislation that is enacted. Other approaches have been proposed such as federal standards for state regulation and a single-state licensing system, but an OFC has the most currency.

The NIA would set up an Office of National Insurance (ONI) within the Department of the Treasury akin to the Office of the Comptroller of the Currency (OCC). The NIA would permit both life and non-life insurance companies and agents to apply to the ONI for a charter and license to sell particular products in all states. It further permits the ONI to regulate the solvency and market conduct of insurers within its jurisdiction. Additionally, it authorizes the Commissioner of National Insurance to establish a comprehensive insolvency resolution scheme which includes the state guaranty associations (funds) which meet minimum qualifications.

The NIA would allow the states to continue to regulate insurers and agents who wish to remain state-regulated. The states also would be allowed to continue to collect premium taxes from all insurers as long as they did not discriminate against federally-chartered insurers. Federal insurers also could be required to participate in state residual market mechanisms.

Thus, the ONI would oversee solvency, policy forms, other aspects of market conduct, and insurer insolvencies. It would not regulate prices (except that prices and reserves have to be based upon sound actuarial principles) or underwriting standards. Further, assuming that the states' solvency guaranty system is adequate, a national insurer would participate in the state solvency guaranty association. If a state system does not qualify, there would be a federal plan that would cover these insolvent OFC insurers' obligations in the state. How the ONI would regulate "market conduct" remains uncertain.

In general, the OFC is promoted by the larger life and non-life insurers. To its proponents an OFC has three main benefits. First, the business of insurance is essentially an interstate business. As such it is hindered by the fifty-state regulatory apparatus. This implies increased costs for insurers for additional and sometimes conflicting regulatory requirements. Second, if costs are higher for insurers, then some of these costs are likely passed onto consumers. Third, the states never will have a simple and uniform approach to product approval or pricing and other market practices. This prevents the timely introduction of new products and reduces consumer choices.

In contrast, other financial service providers have a one-stop approval for new products. Over time, the benefits of financial innovation will accrue to the providers of non-insurer financial service firms to the detriment of the insurance industry.

One of the major benefits of state regulation of insurance is the fifty different state systems which act as a laboratory for regulation. Over time good regulation will prevail as other states adopt successful regulatory approaches. In conjunction with this is the fact that regulation should be subject to local control as it is local voters whose tastes and preferences dictate the type of regulatory system they would prefer. Both of these arguments for state regulation require that good regulation will eventually be adopted by a super-majority of states and that a state's regulatory philosophy does not impose costs on other states' residents or out-of-state insurers. Proponents of an OFC make the argument that the benefits of state regulation do not exist in reality. The states counter that an OFC will undermine the consumer protections currently existing in state laws. However, we seriously question whether many state regulations ultimately benefit consumers as well as the proposition that the federal government cannot adequately protect consumers.

The strong state opposition to OFC legislation has caused some of its legislative supporters to consider alternative paths to the Holy Grail. It is possible that legislation will be introduced for an OFC that would apply only to life insurers. There appear to be fewer legislative concerns about (and perhaps less political opposition to) a life-only OFC.

Life insurance products already tend to be more standardized across states and life insurance is subject to less state-specific preferences, e.g., price regulation, than property-casualty insurance. Obviously, property-casualty insurers would be

greatly dismayed if an OFC was restricted to life insurance, although they might still hope that their day would come.

A new wrinkle was recently added with the introduction of legislation by Rep. Paul Kanjorski (D-PA) that would establish an Insurance Information Office (IIO) within the Treasury. The IIO would obtain insurer financial and market conduct data from state regulators and develop greater insurance expertise within the federal government. Some federal advocates are concerned that an IIO will undermine the impetus for an OFC, while others may view it as helping to pave its way.

It is important to not lose sight of the need for significant reforms in insurance regulatory policies regardless of who are the regulators. The current prescriptive, accounting-based system for solvency regulation needs to be revamped consistent with modern financial risk management and international standards. Insurance markets are greatly over-regulated in terms of prices, products and other market practices. Carefully crafted deregulation that would preserve essential consumer protections but allow markets to operate more freely and efficiently is essential.

Many observers believe that the creation of an OFC or something like it is more a matter of when than if. If history is any guide, we may see incremental changes which gradually increase the federal role in insurance regulation until the ultimate objective is achieved. Insurance regulation is at a crossroads with many paths that eventually lead to the same place – a modern, national system of insurance regulation.

*Professors Martin F. Grace and Robert W. Klein are respectively the Associate Director and Director of the Center for Risk Management and Insurance Research at Georgia State University's Robinson College of Business.*

**“The strong state opposition to OFC legislation has caused some of its legislative supporters to consider alternative paths to the Holy Grail.”**

*This reprint contains information from an article originally published in the July 2008 issue of the U.S. Insurance News® Monthly Periodical. Any reprinting, copying or reproducing without the express written permission of U.S. Insurance News® is strictly prohibited. For more information regarding U.S. Insurance News®, please visit our website at [www.usinsurancenews.com](http://www.usinsurancenews.com).*

U.S. Insurance News®

Corporate Headquarters  
410 Park Avenue - 15th Floor  
New York, NY 10022  
(888) 476-9475

**Published by FirstInsure, Inc.**