



2006-PB-02
February 2006

Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation*

Scott Harrington

Abstract: This paper provides an overview of the rationale and options for federal intervention in insurance regulation. Despite a number of positive and incremental reforms throughout the past decade, several key aspects of state insurance regulation, including regulation of rates, rate classification, and policy forms, remain substantially dysfunctional in many states – with no end in sight and with significant burdens on interstate commerce. A transformation of insurance regulation to reduce those burdens by promoting healthy price and product competition and eliminating regulatory micromanagement of price and product decisions will not be achieved without federal intervention. A well-designed system of optional federal chartering and regulation represents one means for attempting to achieve such a transformation. Two alternatives for transforming insurance regulation without creating a federal regulator and perhaps with less risk than optional federal chartering include: (1) enact minimum federal standards for state insurance regulation that would preempt non-conforming state regulation, and (2) allow life, health, and property/casualty insurers to designate a “primary state,” and to operate nationwide subject primarily to the regulations of that state.

About the Author: Scott E. Harrington is the Alan B. Miller Professor in the Health Care Systems and Insurance and Risk Management Departments at the Wharton School of the University of Pennsylvania. A former president of both the American Risk and Insurance Association and the Risk Theory Society, he has published articles in numerous academic and policy journals including the *Journal of Business*, the *Journal of Law and Economics*, the *Review of Economics and Statistics*, the *Journal of Financial Intermediation*, the *Journal of Risk and Insurance*. He is coauthor or coeditor of numerous books including *Cycles and Crises in Property/Casualty Insurance* and coauthor of the McGraw-Hill textbook, *Risk Management and Insurance*.

* This paper was prepared for the 3rd Annual Insurance Reform Summit, Networks Financial Institute, Washington, D.C., March 1, 2006

The views expressed are those of the individual author and do not necessarily reflect official positions of Networks Financial Institute. Please address questions regarding content to Scott Harrington at harring@wharton.upenn.edu. Any errors or omissions are the responsibility of the author.

NFI working papers and other publications are available on NFI's website (www.networksfinancialinstitute.org). Click “Research” and then “Publications/Papers.”

Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation

Scott Harrington

Introduction

Well-functioning insurance markets are fundamental to the economy and consumer welfare. In contrast to the U.S. banking sector's dual system of federal and state chartering and regulation, insurance companies are chartered exclusively at the state level and subject to rules and regulation in each state where they conduct business. State regulation of insurance originated in the early 19th century. In 1868 the U.S. Supreme Court held that insurance was not commerce and therefore not subject to laws affecting interstate commerce (*Paul vs. Virginia*, 75 U.S. 168). States, rather than the federal government, had the power to regulate insurance.

Subsequent decades saw the development of insurance rating bureaus that established property insurance rates for most insurers, in principle to ensure adequate prices and reduce insolvency risk. In 1944 the Supreme Court ruled that insurance is commerce, that it is interstate commerce when it takes place across state lines, and that Congress could therefore regulate insurance. It held that state laws contrary to federal law were invalid, and that the Sherman Antitrust Act applied to insurance, including activities of rating bureaus (*United States v. South-Eastern Underwriters Association*, 322 U.S. 533, 1944).

The Congress followed by enacting in 1945 the McCarran-Ferguson Act, which remains the law of the land. The Act states that the continued regulation and

taxation of insurance by the states is in the public interest, and that no act of Congress “shall be construed to invalidate, impair, or supersede” any state law enacted for the purpose of regulating or taxing insurance. It also provides the “business of insurance” with a limited exemption from federal antitrust law.

Significant pressure exists among many insurers, insurance intermediaries (agents and brokers), and banking organizations with insurance interests for some system of optional federal chartering and regulation of insurance. Much of this pressure reflects the hope that federal regulation will produce more streamlined, less duplicative, and pro-competitive regulation. The debate and pressure for change in large part reflect multiple and diverse rules, duplication, delays, and other costly red tape associated with state-based regulation, as well as restrictions on rates and underwriting that impede competition and often produce cross-subsidies among insurance buyers.

This paper provides an overview of the rationale and options for federal intervention in insurance regulation. It begins with detailed discussion of the key shortcomings in state regulation of life, property/casualty, and health insurance that have generated substantial pressure for optional federal chartering or some other form of federal intervention. This discussion is relevant to understanding why change is desirable and appropriate forms of intervention. The paper then highlights potential benefits, risks, and design issues for optional federal chartering. Alternative modes of federal intervention that might redress some of state regulation’s biggest shortcomings without creating a federal regulator are then discussed.¹

The paper's main thrust is straightforward. Despite a number of positive and incremental reforms throughout the past decade, several key aspects of state insurance regulation, including regulation of rates, rate classification, and policy forms, remain substantially dysfunctional in many states – with no end in sight and with significant burdens on interstate commerce. A transformation of insurance regulation to reduce those burdens by promoting healthy price and product competition and eliminating regulatory micromanagement of price and product decisions will not be achieved without federal intervention.

A well-designed system of optional federal chartering and regulation represents one means for attempting to achieve such a transformation, albeit with a number of risks and the necessity of creating a new federal bureaucracy. At least two alternative approaches could help transform insurance regulation without creating a federal regulator and perhaps with less risk than optional federal chartering. One approach, which has been discussed extensively and been the subject of a number of hearings in the U.S. House, would be to develop minimum federal standards for state insurance regulation that would preempt non-conforming state regulation after a waiting period. A second approach, recently advocated for individual health insurance, would be to allow health, life, and property/casualty insurers to designate a "primary state," and to operate nationwide subject primarily to the regulations of that state.

Pressure Points for Federal Intervention

The state-based system of insurance regulation varies widely across states and types of insurance. There are three broad insurance product lines: (1) property/casualty insurance, (2) health insurance, and (3) life insurance / annuities.²

State regulation encompasses all three lines, with the primary exception that self-funded, employer-sponsored health insurance plans for employees are largely exempt from state insurance regulation due to federal preemption under the Employee Retirement Income Security Act (ERISA) of 1974.

The most important facets of state insurance regulation are:

- Licensing of insurers and agents/brokers (all states and all types of insurance)
- Solvency regulation (all states and types of insurance)
- Regulatory approval of policy forms (most types of coverage in all states, except for "large" business buyers in some states)
- Regulatory approval of rate changes (many states for some types of property/casualty insurance, especially personal auto, homeowners, and workers' compensation insurance; some states for health insurance)
- Significant restrictions on factors that may be used in rate classification and underwriting (some states, especially for personal auto insurance and individual and small group health insurance)
- State-mandated residual markets that allow virtually all prospective buyers to obtain coverage at a regulated rate (a large majority of states for auto insurance; many states for workers' compensation, homeowners, urban property, and individual health insurance; some states for property insurance in coastal areas)
- Provision of coverage by a state- or state-sponsored entity, often in competition with private insurance (about 20 states for workers' compensation insurance; a few states for insurance against losses from natural disasters)
- Regulatory oversight of trade practices and "market conduct" (all states; primarily for individual and small business insurance)
- Mandates that policies cover certain types of losses or expenses (many states for many types of insurance, most notably individual and small group health insurance)
- Although not part of insurance regulation, per se, state laws that mandate the purchase of minimum insurance coverage or require qualification to "self-insure" (virtually all states for auto liability and workers' compensation insurance; many states for medical liability and environmental liability insurance; some states for automobile uninsured motorist and personal injury coverage)

The traditional rationale for economic regulation is to protect the public interest by efficiently mitigating “market failures.” As explained in detail, for example, by Supreme Court Justice Stephen Breyer in his 1981 treatise *Regulation and its Reform*, the test for efficient regulation is two pronged. First, there should be a demonstrable market failure compared to the standard of a reasonably competitive market. Second, there should be substantial evidence that regulation can efficiently address this failure, that is, that the benefits of regulation exceed its direct and indirect costs. Economically efficient regulation also requires matching the appropriate regulatory tool to the specific market failure.

From this perspective, and given the competitive structure of most modern insurance markets, the primary rationale for public oversight and regulation of the insurance business is to reduce cost-effectively the extent to which insurance companies or intermediaries misrepresent what is being promised at the time of sale, or renege on their promises after sale through insolvency or deficient claims settlement. Fundamentally, that objective requires regulatory oversight of insurance company solvency. It also favors some degree of regulatory oversight of sales and claim practices to supplement competitive discipline and contractual and tort liability remedies for fraud, misrepresentation, and breach of contract.

At its best, any type of economic regulation is necessarily imperfect. It would be far too expensive to eliminate all insurer insolvencies and insurance company or insurance intermediary misbehavior, even if it were technically feasible. Reasonably competitive insurance markets will produce good results most of the time.

Regulation can cost-effectively increase the prevalence of good results. But beyond some point, the benefits of additional regulation will be less than the costs.

In practice, state insurance regulation involves the waste of too much time and money on administering and complying with diverse regulations across the states, which often are either unnecessary or deal with activities that are amenable to much less oversight and red tape and much more uniformity across jurisdictions. In addition to excessive “administrative/compliance” costs that flow from the form and implementation of some regulations, insurance regulation is often used as a tool to redistribute income among insurance buyers. These “redistributive” activities are often (if not always) economically inefficient in that the total benefits to parties that receive subsidies are less than the total costs of parties that pay the implicit taxes necessary to finance those subsidies. The policies are typically opaque to the public and would not be supported by the median voter if they were transparent. Although excessive administrative/compliance costs, and the use of regulation to redistribute income, are not unique to state insurance regulation, insurance regulation might be especially vulnerable to the latter problem given available mechanisms for achieving sustainable cross-subsidies among insurance buyers.

To elaborate, current pressure for optional federal chartering or other fundamental changes in state insurance regulation is concerned with four main issues:

- 1) Costs and delays associated with regulatory approval of policy forms (contract language) in 51 different jurisdictions,
- 2) Costs, delays, and possible short-run suppression of rates below costs associated with regulatory approval of insurers’ rate changes,

- 3) Restrictions on insurers' underwriting (risk selection) decisions and risk classification systems, and
- 4) State mandates that insurance policies provide coverage for certain types of benefits or losses.³

Pressure Points for Optional Federal Chartering

<u>State Regulatory Policy</u>	<u>P/C Insurance</u>	<u>Health Insurance</u>	<u>Life Insurance</u>
Approval of policy forms	**	*	**
Approval of rate changes	**	*	
Underwriting / classification restrictions	**	**	
Benefit Mandates	*	**	

**Perceived as major problem; *perceived as moderate problem

The degree to which these issues are salient varies across states and types of insurance (see above table, which provides my subjective assessment of the importance of each issue by type of insurance). Several issues are important for both property/casualty insurance and health insurance. Regulation of policy forms is the overriding issue in life insurance. Before elaborating on these problems, it is useful first to discuss two issues that have played central roles in one or more prior episodes of strong pressure for federal regulation: state insurance solvency regulation, and the limited antitrust exemption for the “business of insurance.”

Solvency Regulation

In contrast to the early 1970s and early 1990s, current pressure for optional federal chartering of insurance companies has relatively little to do with solvency regulation. The main characteristics of state solvency regulation – regulatory monitoring, controls on insurer risk taking, risk-based capital requirements, and limited guaranty fund

protection – are sensible given the rationales for regulating solvency and for partially protecting consumers against the consequences of insurer default. Having domiciliary regulators play a lead role in solvency regulation reduces duplication in effort and cost. A substantial degree of coordination and uniformity among the states has been achieved through the National Association of Insurance Commissioners (NAIC), including its promulgation of financial reporting requirements and its solvency regulation certification program. The state system of limited, ex-post assessments to pay a portion of insolvent insurers' obligations is appropriate and has worked reasonably well, despite a large increase in required assessments this decade.

A significant drawback of government guarantees is that they are likely to increase the incidence of insolvency. Accurate risk-based premiums for guarantees are likely to be infeasible in practice, and government guarantees therefore involve moral hazard: policyholders have less incentive to buy coverage from safe insurers and some insurers will have less incentive to be safe. The degree of systemic risk (e.g., the possibility that failure of one insurer or rumors of trouble could produce a run that would adversely affect otherwise solvent insurers) is materially smaller for insurers, especially property-liability insurers, than for banks, thus reducing the need for comprehensive guarantees. Contrary to periodic complaints that state guaranty fund protection may be inadequate, limited coverage under state guaranty funds represents a significant strength of the state system. Some states have reduced levels or no guaranty fund protection for commercial insurance buyers with substantial net worth, which encourages those buyers to deal with safe insurers.

Ex post assessments avoid the accumulation of funds that could be appropriated by legislatures for non-insurance purposes or undermine incentives for financially strong insurers to press for effective solvency surveillance and efficient liquidation of insolvent insurers. The reason is that unexpected increases in the costs of assessments are likely to be borne at least in part by insurers, as opposed to being fully shifted to customers or taxpayers.⁴ Compared to banking and the broader protection provided by deposit insurance and implicit federal guarantees, insurance markets are generally characterized by stronger market discipline. This difference in part reflects the system of state guarantees, which provides substantial protection with fewer effects on market discipline than federal deposit insurance.

The Antitrust Exemption

The limited antitrust exemption under the McCarran-Ferguson Act, which has been narrowed considerably over time by the courts, does not support a fundamental change in insurance regulation. The limited exemption facilitates a number of potentially beneficial cooperative activities, including the development of policy forms and estimation and dissemination of "prospective loss costs" by industry advisory organizations. Advisory organizations in principle can help promote healthy competition and thereby benefit consumers by providing valuable, low cost information to insurers concerning projected loss costs. Advisory organizations pool information from a large number of insurers, forecast losses, and make the results available to companies at cost for use as they see fit. This process lowers the cost of rate-making, reduces entry barriers, and increases forecast accuracy (and thus lowers insolvency risk), especially for small insurers with little data of their own. Cooperative

development of policy forms also reduces costs, facilitates comparisons of price and quality of service by consumers, and helps make claim cost data comparable across companies. While the antitrust exemption is sometimes alleged to facilitate collusion to raise rates, those allegations are not convincing in modern times.

Unnecessary Complexity, Delays, and Red Tape: Prior Approval of Forms

Life insurers compete with banks and securities firms in the asset management and accumulation business. Banks have the option of a federal charter. Bank holding companies and securities firms are essentially regulated at the federal level. The patchwork process by which life insurers have to obtain approval for their products under state regulation, and the associated costs, delays, and refusals at the state level place life insurers in particular at a competitive disadvantage with federally regulated competitors.

The NAIC and many state regulators and legislatures have taken a number of steps to streamline and homogenize the approval process for life insurance and annuities, including creation of an interstate compact for one-stop form approval, which has thus far been adopted by twenty states. State regulators regard these changes as representing substantial and rapid progress. Many managers and investors in life insurance companies disagree.

The form approval issue is also important for property/casualty insurers and to a lesser extent (apart from the mandated benefits issue discussed below) for health insurers. Except for states that have substantially eliminated prior approval of policy forms for "large" commercial risks, property/casualty insurance policy forms are subject to regulatory approval in all states, with associated direct costs, compliance

costs, and delays. Prior regulatory approval of policy forms is unnecessary and counter-productive for commercial lines of property-casualty insurance (except perhaps for very small businesses). The case for eliminating prior approval regulation of policy forms for personal lines of property-casualty insurance is less compelling. However, even in that case, insurer competition, coupled with contract and tort law remedies and unfair trade practice legislation, provide substantial protection to unsophisticated buyers that reduces the need for strict prior regulatory approval.

Antiquated Price Controls: Prior Approval of Rate Changes

Economists generally agree that market structure and ease of entry are highly conducive to competition in auto, homeowners, workers' compensation, and most other property/casualty insurance lines. Notwithstanding the Spitzer allegations, plea agreements, and settlements related to commercial insurance brokerage and placement for large commercial buyers, modern insurance markets that are relatively free from regulatory constraints on prices and risk classification generally exhibit strong evidence of competitive conduct and performance. Insurers vary substantially in terms of price, underwriting, and service. Accounting data at the insurance industry level provide no indication of large profitability compared to other industries.

Competition creates strong incentives for insurers to forecast costs accurately and to price and underwrite so as to avoid adverse selection, thus producing highly and increasingly refined systems of rate classification. Prices vary across insurers in relation to rate classification systems and underwriting standards. Substantial evidence, including small "residual markets" in states with little or no regulatory intervention in pricing, indicates that competition in pricing and risk selection promotes the availability

of coverage if rates are sufficient to cover expected costs and provide insurers with a reasonable expected profit. However, competition by itself cannot ensure that coverage is “affordable” to all prospective buyers.

Given economic theory and evidence, prior approval rate regulation cannot be justified as an efficient response to monopoly or oligopoly pricing in insurance markets, nor can it be justified as necessary to prevent collusion. The desire to protect consumers from inadvertently purchasing coverage from high price insurers also does not justify prior approval. Rate regulation is not the correct tool for addressing information problems, assuming that consumer difficulty in comparing prices could allow some high priced, inefficient insurers to survive. If difficulty in price comparisons by prospective insurance buyers justifies government action, the preferred mode of regulation, practiced in some states, is greater information disclosure rather than regulation of prices.

Prior approval regulation entails significant costs of administration and compliance, which are ultimately borne by consumers. If insurance departments allocate much of their budgets to rate regulation, they possibly may fail to address other problems efficiently (such as insolvency risk). The rate approval process has sometimes been contentious and biased toward rate suppression that distorts the supply of coverage.

Prior approval regulation generally cannot be expected to affect insurer profits in the long run. Insurers must expect a reasonable profit over time in order to continue to supply coverage. If prior approval rate regulation allows adequate rates on average, regulatory delay associated with prior approval can still have adverse effects. Because

of the time and expense of the rate filing and approval process, insurers are less likely to increase or decrease rates in response to new information about expected costs than would be true without prior approval. Regulatory lag associated with prior approval tends to produce fewer but larger rate changes and greater swings in availability of coverage and insurer profitability. Uncertainty about approval of proposed rate changes increases insurers' risk, with possible adverse effects on policyholders in other states. Regulatory suppression of rates reduces voluntary market sales by current insurers, increases residual market size, reduces entry by new insurers, and reduces incentives for insurers to provide valuable services and to invest in product distribution and service.

Although progress has been made among the states in reducing the scope of prior approval regulation, it seems virtually certain that a significant number of states, including some of the largest, will retain such policies unless motivated to change through some form of federal action. The reasons are basically political. Politicians / regulators benefit when they claim to save consumers money. Some consumers are deeply suspicious of insurers and resent having to pay significant amounts of their income for insurance. Some consumer organizations continue to press for rate regulation, claiming that "true" competition does not exist and that consumers must be protected (by them). That pressure and the organizations' ability to generate media coverage contribute to the status quo. Perhaps more important and not surprisingly, the regulatory staff in some states apparently are wedded to the mistaken notion that price controls protect consumers and serve a useful social purpose.

Redistributive Price Controls: Classification and Issue Restrictions

Some states directly and significantly restrict insurance underwriting and rate classification for health insurance (e.g., “community rating”) and/or some types of property/casualty insurance (e.g., restrictions on rate variation across geographic regions within a state). These restrictions generally lower premium rates for “high risk” buyers and raise rates for “low risk” buyers. In order to ensure that high risk buyers can obtain coverage at rates that insurers recognize as lower than expected costs, insurers are required to offer coverage to virtually all applicants. Those requirements are known as “guaranteed issue” in health insurance circles, and “take-all-comers” in property/casualty insurance.

To illustrate, in individual health insurance, Maine, Massachusetts, New Jersey, New York, and Vermont require guaranteed issue of all products to all residents by all insurers. New Jersey, New York, and Vermont require pure community rating (rates can only vary by benefits provided and geographic location within the state, and thus not by age, gender, or health status). Massachusetts and Maine required modified community rating (rates can vary by age). Oregon and Washington require modified community rating, with guaranteed issue required for certain populations. Many other states have limited forms of guaranteed issue, and a number significantly restrict (without prohibiting) variation of rates in relation to health status.

Guaranteed issue and rating restrictions may allow some high risk individuals (or businesses) to purchase coverage who otherwise might find it difficult to locate a willing health or property/casualty insurer. Their predominant motivation and function, however, is to lower premium rates for buyers with relatively high expected

claim costs by charging above-market premium rates for buyers with relatively low expected claim costs. In the case of health insurance, in principle this might help higher risk persons afford coverage, receive the types and quality of medical care that flow to insured persons, and cut down on both costly emergency care and bad debts for hospitals and providers. In the case of auto liability insurance, it may encourage more drivers to comply with compulsory insurance requirements, thus reducing the number of uninsured motorists and costs borne by other parties.

Unfortunately, significant restrictions on rating and risk selection coupled with guaranteed issue requirements have a number of serious drawbacks:

- 1) Average premium rates tend to go up as more high-risks insure and some lower risk buyers reduce or drop coverage. In the case of health insurance, the ability to buy coverage at subsidized rates after developing a chronic health problem reduces the incentive to purchase coverage before becoming ill, aggravating increases in average rates.
- 2) Standard economic theory stresses that competitive rating and risk classification provide some incentive for higher risk buyers to take actions to control losses and thus qualify for lower premiums and/or have lower uninsured losses (e.g., buying crash-resistant vehicles, installing security systems in homes or businesses, and, in principle, not smoking, weight management, and regular exercise to reduce health risk). Restrictions on classification dull those incentives, increasing losses and premiums over time for the insured population.
- 3) When insurers are forced to accept applicants at regulated rates that are below their expected costs for some buyers and above expected costs for others, it is very likely that the relative proportions of under- and over-priced buyers will vary across insurers. Some mechanism generally is needed to ensure a stable market. Insurers may be permitted to reinsure high risk buyers in a state pool, with the deficits of the pool spread among insurers in proportion to their retained business (or broadly among the insured population). Alternatively, a "risk-adjustment" mechanism can be used to transfer money among insurers based on the ex ante risk characteristics of their customers. The latter approach provides insurers with stronger incentives to monitor claims of high risk buyers than the former, but both approaches involve significant administrative and compliance costs.
- 4) Significant rating restrictions coupled with guaranteed issue may require

additional restrictions and regulations to keep insurers from tailoring coverage offerings and services to segment buyers according to risk, at least in the case of health insurance.

These problems help explain why many states have eschewed such policies in whole or in part. In the case of automobile insurance, the bulk of the states use residual market mechanisms (mostly assigned risk plans) to narrowly target intervention to ensure availability of coverage to the relatively few buyers who might find it hard to locate a willing insurer. Drivers can apply for coverage in the plan at a regulated rate, which then assigns the business to insurers in proportion to their voluntary business. On the other hand, some states have used voluntary market rate caps and residual markets as an alternative method of holding down rates for high risk buyers in automobile or workers' compensation insurance. The result has been large residual market deficits and the need for those insured in the voluntary market to pay higher rates to subsidize those deficits.

In the case of health insurance, over 30 states have established high risk pools to guaranty coverage to persons with chronic health conditions at subsidized rates, including all jurisdictions without any other guaranteed issue requirements. The pools generally are designed to provide subsidized coverage to a relatively narrow, high-cost segment of the public. Premium rates usually are capped at 125% to 150% of typical rates for comparable non-pool, individual coverage. The pools' deficits commonly are recouped through pro rata assessment of all health insurers in the state (but not employer-sponsored, self-funded plans), sometimes with partial or full offsets against insurers' premium tax obligations.

Mandated Benefits

Virtually all states have compulsory insurance laws that require the purchase of minimum auto liability insurance coverage and workers' compensation insurance. Many states have compulsory insurance requirements for a number of other types of legal liability exposures (e.g., environmental liability). While their merits can be debated, these compulsory insurance laws generally can be rationalized, in principle if not in practice, as reducing externalities associated with the failure to buy insurance voluntarily.

"Mandated benefits" refer instead to state requirements that *if insurance is purchased, it must cover specified losses*. The state-based system of insurance legislation and regulation is characterized by a complex web of such requirements. Benefit mandates are most widely recognized and debated for health insurance, where there existed over 1,800 mandates across the country as of 2004. Many observers argue that these mandates produce significant increases in the cost of coverage in some states, and significant reductions in the number of people covered by private health insurance. Common mandates include minimum benefits for maternity (almost all states), mental health parity (most states), and coverage of chiropractic care (almost all states). More exotic examples include acupuncturists (11 states), in vitro fertilization (15 states), marriage therapy (4 states), and massage therapy (4 states).⁵

Non-trivial mandates also exist in many states for other types of insurance. Examples include requirements that homeowners and/or auto insurance policies cover tort liability claims brought by one family member for injuries caused by another; requirements that auto insurance buyers buy coverage for losses caused by uninsured

motorists, including pain and suffering; and mandates (mooted by the Terrorism Risk and Insurance Act and its recent extension) that property insurance policies cover fire losses caused by terrorism and in a few states prohibit any terrorism exclusions. More generally, many states significantly limit allowable deductibles and co-payments, which can significantly drives up the cost of coverage.

Many mandates are argued to serve some consumer protection function. In reality, and when they are not simply redundant (i.e., mandating what a large majority of buyers would willingly insure), mandates often simply force people or businesses to purchase and pay for insurance coverage of losses they would not willingly insure, and where there would be little or no spillover on other parties that might justify a mandate. Benefit mandates increase the demand for and utilization of various services, thus implicitly subsidizing providers of those services. The implicit taxes on insurance buyers to fund the resulting subsidies make insurance less affordable. It reduces the “consumer surplus” from purchasing insurance and the incentive to buy any coverage.

Optional Federal Chartering

In the early part of this decade, the American Bankers Insurance Association (ABIA, the leading trade group for bank insurance interests), the American Council of Life Insurers (ACLI, the leading trade group for life insurers), and the American Insurance Association (AIA, the leading trade group for large property/casualty insurers) each proposed an optional federal chartering plan. The ABIA proposal was patterned largely after a 1993 bill introduced by Rep. John Dingell (D-MI) and federal regulation of depository institutions. The ACLI proposed optional federal chartering for life insurers; the AIA proposal dealt with property/casualty insurers.

The ABIA, ACLI, and AIA subsequently agreed on a number of principles for optional federal chartering to encompass life and property/casualty insurers:

- 1) Creation of a unified federal regulator to license insurers choosing the federal option and regulate solvency, market conduct, and accounting of federally chartered entities
- 2) Federally chartered insurers would not be subject to rate regulation, and the federal regulator would not be allowed to require prior approval of policy forms
- 3) Preemption of state rules to help ensure a single set of federal rules for federally chartered insurers
- 4) Repeal of the McCarran-Ferguson limited antitrust exemption for federally chartered insurers (but not for state-chartered insurers)
- 5) Federally chartered insurers would participate in a more uniform state guaranty fund system, subject to federal minimum standards
- 6) Federally chartered insurers would continue to pay state premium taxes

A bill proposing optional federal chartering, which might well contain many of these features, is expected to be introduced very soon in the U.S. Senate by Senators John Sununu (R-NH) and Tim Johnson (D-SD). Optional federal chartering along these lines would streamline, modernize, and homogenize regulatory requirements for federally chartered insurers. It would almost certainly achieve efficiencies in oversight/regulation of policy forms. The results would include helping to level the playing field between life insurers and federally regulated institutions. Very importantly, federally chartered insurers would be substantially freed from archaic and Byzantine prior approval rate regulation.

While there has been some discussion of the possibility of adopting optional federal chartering for life insurers only, it is expected that the Sununu-Johnson bill will encompass both life and property/casualty insurers. A "life only" approach might be

argued as sensible because many life insurers' products have more in common and compete more directly with federally regulated firms involved in asset management and accumulation than do most property/casualty insurers. However, large multistate property casualty insurers also compete with such institutions on a number of dimensions, and they face the previously described problems with state regulation of rates and rate classification. Thus, rationalization of a "life only" outcome would likely be very difficult apart from possible political considerations.

Support among life insurers for federal chartering is broader and perhaps more intense than among property/casualty insurers (and health insurers), where relatively more insurers and intermediaries oppose federal regulation. The "life only" option would allow state regulators and various interest groups to retain their power and influence over rates and rate classification in property/casualty and health insurance.

Participation in State Residual Markets and Guaranty Funds

Optional federal chartering for property/casualty insurers would likely require federally chartered insurers to participate in state residual markets. If federally chartered property/casualty insurers could be exempted from such participation, residual market rate regulation could not be used to produce sustainable cross-subsidies among insurance buyers. States that wanted to cap rates for higher risk buyers would have to finance the necessary subsidies some other way. However, exemption seems unlikely given legitimate state interests in ensuring the availability of mandatory coverages and political considerations.⁶ In order to reduce the ability of states to use residual markets to cap property/casualty insurance rates for high risk buyers (e.g., in auto and workers' compensation insurance), the best approach

(incorporated in the original AIA proposal) is probably to make participation of federally chartered insurers in property/casualty residual markets contingent on rates being set at self-sustaining levels, recognizing the inevitability of subsequent disputes as to whether that criterion is being met.

Requiring federally chartered insurers to participate in the state guaranty fund system, subject to some minimum standards, is sensible. The guaranty system would likely evolve towards nationalization or quasi-nationalization with uniform coverage, ideally retaining state-based assessments. Insolvency of a multi-state, federally-chartered insurer with different coverage limits in different states would very likely create strong pressure for uniform coverage with a national imprimatur. Insolvency of a number of state chartered-insurers would likely create similar pressure. It would be very important to maintain reasonable coverage limits overall and to include significant restrictions on coverage for commercial insurance, at least for buyers with substantial net worth.

The initial ABIA proposal would have created a pre-funded guaranty system for federally chartered insurers along the lines of federal deposit insurance. A federal guaranty system for federally chartered insurers would destabilize and eventually completely crowd out the state system. Moreover, the creation of a pre-funded, federal system for all insurers, possibly with broader protection, should be avoided. Pre-funding of a federal guaranty system could reduce insurer pressure for effective solvency regulation. Broader protection would undermine policyholders' incentives to seek out financially strong insurers, thus increasing moral hazard. The resulting

reduction in market discipline would increase insolvency risk and ultimately result in stricter solvency regulation.

Regulatory Competition

Optional federal chartering could promote beneficial regulatory competition. If insurers are able to switch charters and regulators at relatively low cost, optional federal chartering under a dual chartering system should help discipline the potential excesses of either state or federal regulators. In the short run, optional federal chartering would presumably provide additional motivation for state regulators to modernize their systems. In the longer run, the ability of federally chartered insurers to switch back to state regulation might discourage the adoption of potentially inefficient federal regulatory practices or programs. It generally is agreed that dual chartering of banks has resulted in a certain degree of beneficial regulatory competition, including motivating regulators to consider the direct costs of oversight and associated fees paid by banks (e.g., for examinations by state banking regulators). State banks have thrived under dual chartering. Although considerably smaller on average than federally chartered banks, about 70 percent of all banks are state chartered.

There are at least two factors, however, that may lessen benefits from regulatory competition under optional federal chartering for insurers. The threat of federal regulation already provides a source of discipline to state regulators, which in principle reduces, at least marginally, the potential benefits from actual competition. More important, the cost to multistate, federally chartered insurers to switch back to a state charter and return to state regulation in multiple states might be larger than in

banking. If so, there is a greater risk that federal chartering could become dominant and entrenched for larger, multistate insurers.

Other Potential Benefits

Many observers perceive that federal regulators often help educate and influence the Congress on policies that are central to banks and other federally regulated institutions, in ways that are not possible in insurance with its exclusive state regulatory system. Moreover, a federal regulator and federal regulation possibly may prevent or deter questionable actions by state attorneys' general with extra-territorial reach. A New York court, for example, has upheld the right of the Comptroller of the Currency to prevent investigation (discovery) of federally regulated sub-prime lenders by the New York Attorney General, who alleges racial discrimination in lending practices. This decision blocked the Attorney General's attempt to use the extensive investigative / prosecutorial powers granted by New York's Martin Act to investigate lending activities subject to federal regulatory oversight.

Will Optional Federal Chartering Substantially Eliminate Price Controls?

The debate over optional federal chartering and the proposals described above suggest that optional federal chartering could substantially or completely eliminate prior approval rate regulation for federally chartered insurers. The substantial elimination of prior approval rate regulation *should* be the *sine qua non* for optional federal chartering of property/casualty insurers. That elimination would very likely sound the death knell for most prior approval of rates for state chartered insurers as well. There are uncertainties, however, concerning the scope of federally chartered

insurers' exemption from rate regulation that will be included in any bill that might be passed, and regarding whether any exemptions will persist over time.

It is also uncertain, at least over the long run, whether federal regulation would resist temptation to redistribute wealth through restrictions on rate classification, guaranteed issue, and mandates. Temptation to use insurance regulation to redistribute wealth will not necessarily be lower at the federal level, even though such redistribution may not appear imminent. The federal crop insurance and flood insurance programs involve significant taxpayer subsidies beyond the scope that might be argued as appropriate for remedying alleged failures in private markets.

Although state regulators in some states have succumbed to political pressure for using rate and classification restrictions to redistribute income, state regulation is largely unable to achieve cross-subsidies between states (or between lines of business within a state). While federal regulators may be more resistant to the types of local pressures that produce within-state cross subsidies, they may face similar pressures on a national level and significant pressure over time for adopting or endorsing policies that promote cross-subsidies within and between states. Consumer groups have proposed consumer protections as part of any optional federal chartering that would produce cross-subsidies among insurance buyers. In addition, the role that federal regulators would play in future debates about government backstops for insurance against losses from terrorism and / or natural catastrophes is far from clear. They might end up advocating policies that provide too much protection to their regulated constituents, at the expense of taxpayers or insurance buyers with less exposure to such risks.

Federal bank regulation has been more active than state insurance regulation in mandating disclosure under the guise of discouraging unfair discrimination. The Home Mortgage Disclosure Act of 1975 and later amendments mandate detailed reporting and disclosure of a lender's loans by zip code. Insurance consumer groups have thus far been largely unsuccessful in achieving disclosure of proprietary data under state regulation. The Community Reinvestment Act of 1977 and later amendments impose significant costs on many banks. Optional federal chartering conceivably could extend CRA type requirements to insurance, if not initially then later. The Congress periodically has faced strong pressure for significant restrictions on sub-prime lending.

While perhaps inconceivable now, the possibility of significant federal restrictions on risk classification, such as the use of zip code data in auto and homeowners' insurance rating, for both federal and state insurers cannot be ruled out. The McCarran-Ferguson Act creates a barrier to federal regulation of rates and rate classification. Optional federal chartering would reduce that barrier.

Alternatives to Optional Federal Chartering

The case for insurance regulatory modernization through substantial deregulation of rates and forms is overwhelming. Optional federal chartering might go a long way towards achieving this result. But there are risks, and it would require substantial investment and costs in creating and maintaining a federal regulatory agency. Potential unintended consequences, or mistaken policies in response to political pressure, would have national effects. Two alternatives to improve insurance regulation without creating a federal regulator and which might entail less risk are:

- (1) federal preemption of state regulations that do not meet minimum standards, and
- (2) allowing insurers to choose a state for primary regulation with authorization to operate nationwide primarily under the rules of that state.

Minimum Standards and Preemption

Following extensive discussions with interested parties and a number of hearings, Representatives Michael Oxley (R-OH) and Richard Baker (R-LA) released a draft of the State Modernization and Regulatory Transparency (SMART) Act in August, 2004. This complex proposal would establish minimum and uniform federal standards for numerous activities of state regulation, with federal preemption of state laws and rules failing to meet such standards after specified periods. The proposal deals with regulation of insurer and producer licensing, market conduct, policy forms, rates, surplus lines, reinsurance, fraud, solvency oversight, receivership of insolvent insurers, and the viatical market. A "State-National Insurance Coordination Partnership" would be created to oversee rules, changes, and compliance.

Regarding rates and forms, the proposal would:

- 1) Encourage states to participate in an interstate compact for a Uniform Multistate Filing System for life insurance within three years that would involve one-stop filing, review, and approval of policy forms
- 2) For commercial property/casualty insurance, require states to achieve competitive rating (no prior approval, excepting medical malpractice insurance), one-stop filing of forms with expedited review and self-certification for some filings, single-state governance of policy form requirements based on primary location of the policyholder, and exemption of rate and form filing for qualified large buyers
- 3) Except for credit, title, medical malpractice, mortgage, and Medicare gap insurance, preempt other prior approval of rates after two years (flex rating would be required during the two-year transition) and require expedited review and one-stop filing of forms

- 4) Stipulate that states cannot establishing residual market rates below an entity's expected losses and expenses

Current state regulators, including the NAIC leadership, have strongly rejected the SMART approach, in part due to philosophical and constitutional issues concerning federalism and state prerogatives. However, the NAIC response in significant part attacks the Act's "deregulation" provisions and defends states' rights to control prices in order to "protect consumers." That position is aligned politically with the populist dogma of various consumer, labor, civil rights, and community groups. According to one of these groups, the SMART Act "would gut consumer protections, undermine competition and encourage (sic) return of redlining."⁷

The SMART approach would avoid creating a true federal regulator and associated bureaucracy. Its potential effectiveness as a means to remedy the key problems of rate and form regulation is not clear. Prohibiting prior approval rate regulation, for example, by itself would not prevent regulators in some states from subsequently challenging rates based on allegations that they are excessive or unfairly discriminatory. The threat of such actions could contribute to a de facto prior approval environment. More generally, any minimum standards approach faces the difficulty of monitoring compliance with the letter of the standards, let alone compliance with the spirit of the standards. States that do not wish to comply can be expected to do their best to circumvent and evade the requirements. Enforcement could be problematic, and increasingly so the greater the number of standards.

The Smart Act is broad and complex. The attempt to be reasonably comprehensive, while understandable, increases the difficulty of careful design and enforcement, and the likelihood of unintended consequences, if not excessive catering

to special interests. A narrower and simpler standards / preemption approach would focus on policy forms, rates, and possibly mandates.

Primary State Regulation

Another approach to spurring modernization without federal regulation would be for the Congress to enact legislation that would allow insurers to choose a “primary state” for the purpose of rate, form, and possibly a number of other types of regulation and allow them to operate in all other states where they are licensed (“secondary states”) without having to meet the corresponding requirements in those states. The general concept has its roots in corporate law, where corporations choose a state in which to be chartered, with that state’s laws governing the rights of management and shareholders throughout the country. The concept is to some extent reflected in federal authorization of risk retention groups for certain types of property/casualty insurance.⁸ The AIA briefly floated this concept for property/casualty insurance a year or so before proposing optional federal chartering.

The Health Care Choice Act, proposed by Rep. John Shadegg (R-AZ) and Sen. James DeMint (R-SC) adopts this approach for individual health insurance. Insurers would be subject primarily to regulation by the primary state, but they could operate in secondary states subject to primary state rules. The proposal includes a number of safeguards and minimum standards for primary state regulation regarding, for example, solvency regulation, guaranteed renewability of contracts, and independent review of disputed claims. The bill requires clear disclosure / warning to consumers that primary state regulation applies and that various secondary state regulations do not.

The main purpose of the Shadegg-DeMint plan is to allow consumers in states with mandated benefits, guaranteed issue, and/or community rating rules that drive up the cost of individual health insurance coverage to have the opportunity to buy coverage not subject to those constraints. Many consumers would likely be able to obtain less costly coverage that is more closely related to their needs and ability to pay. The freedom to choose would provide a strong deterrent to state policies that harm significant numbers of consumers to benefit other consumers or special interests within a state.

A common argument against this general approach is that it could lead to a “race to the bottom.” That risk is reduced significantly by would-be primary states’ concerns with their own citizens’ welfare and by buyers (and agents/brokers) concerns with their own welfare. It can be managed with well-designed minimum standards and clear disclosure. It also, for example, would not be necessary to rely mainly on the primary state for solvency oversight and/or market conduct regulation. In the case of property/casualty insurance, insurers would presumably be required to cover minimum liability limits and statutory workers’ compensation benefits in secondary states.⁹

Conclusion

Significant and justified pressure exists among many insurers, insurance intermediaries, and banking organizations with insurance interests for some system of optional federal chartering and regulation of insurers. Much of this pressure reflects the hope, if not belief, that federal regulation would result in more streamlined, less duplicative, and pro-competitive regulation. Certain aspects of state regulation are

clearly broken, most importantly regulation of rates, rate classification, and policy forms in many states, with significant burdens on interstate commerce. Federal intervention is a necessary condition for fundamental change – even if it might not be sufficient.

A well-designed optional federal chartering system would have a number of potential advantages and risks. The alternative of allowing insurers to designate a “primary state” and to operate nationwide subject primarily to the regulations of that state might have the potential to improve significantly the performance of insurance regulation with relative simplicity, less risk, and without creating a federal regulator. A narrowly targeted program of minimum federal standards that would preempt non-conforming state regulation also has the potential to improve insurance regulation without creating a federal regulator, and perhaps also with fewer risks than federal chartering.

Notes

¹ I have discussed these issues in a number of articles listed in the suggested readings. See especially my 2002 monograph, which focused on the narrower issue of whether optional federal chartering of property/casualty insurers was at that time preferable to state regulation. (The study was sponsored by the Alliance of American Insurers, a trade group opposed to federal regulation, which subsequently merged with the National Association of Independent Insurers to become the Property Casualty Insurers Association of America.) Consistent with several articles I wrote during the 1990s, I concluded that the risks of optional federal chartering outweighed the potential benefits given the history of federal regulation of banks and saving and loans, and the trend towards state reforms. Much has happened since then: the persistence of costly, unnecessary, and counter-productive regulatory policies in some states, which place a substantial burden on interstate commerce; the Baker-Oxley SMART proposal for minimum federal regulatory standards and state regulators' strong opposition to that approach; the enactment and renewal of the Terrorism Risk and Insurance Act, which in part reflected strong support by trade groups opposed to federal intervention in insurance regulation; the investigations and litigation by the New York Attorney General, which used bad behavior by some players to condemn entire industries and legitimate industry practices, with extraterritorial reach. I also had the opportunity for first-hand observation of important aspects of state regulation during my brief tenure as a "funded consumer liaison" with the National Association of Insurance Commissioners.

² Some large "multiline" insurance entities have a major presence in more than one of these broad product lines, with separate subsidiaries specializing in different lines. However, most insurance entities receive the lion's share of their revenues from a single sector. In addition to life insurance and annuities, many life insurers sell some health insurance, disability insurance, and/or long-term care insurance.

³ In addition, implicit direct mandates that flow from state laws that affect the likelihood and potential severity of insured losses and thus the cost of insurance for those losses (e.g., the types and scope of workers' compensation benefits, state law governing tort liability, state laws restricting medical care contracting) have influenced insurance regulation, the affordability of insurance, and consequently the current debate, albeit less directly.

⁴ The desire to avoid loss of premium tax revenue in states that allow offset of guaranty fund assessments against premium taxes also might produce pressure for controlling the cost of assessments.

⁵ Counts as of 2004 as reported in *Health Insurance Mandates in the United States 2004*, American Council for Affordable Health Insurance.

⁶ If optional federal chartering encompasses health insurance, there may be stronger policy reasons to have federal insurers participate in funding high risk pools.

⁷ "Consumer, Labor, Civil Rights and Community Groups Join Forces to Oppose House Insurance Deregulation Bill," press release, Consumer Federation of America, May 2, 2005.

⁸ Proposals for authorizing association health plans, such as the Small Business Health Fairness Act, have some similar features.

⁹ In principle, allowing employers / employees choice in statutory workers' compensation benefits might have some advantages, but the issues are more complex than for health insurance benefit mandates.

Suggested Readings

American Bankers Insurance Association, 2003, Optional Federal Charter: A Strategic Description, dated November 11.

American Council for Affordable Health Insurance, *Health Insurance Mandates in the United States 2004*.

Bair, Sheila, *Consumer Ramifications of an Optional Federal Charter for Life Insurance*, Isenberg School of Management, University of Massachusetts.

Berrington, Craig, 2003, Optional Federal Charter: A Remedy for America's Antiquated Insurance Regulatory System, *Washington Legal Foundation*, Vol. 18, April 4.

Breyer, Stephen, 1981, *Regulation and its Reform* (Cambridge, Mass.: Harvard University Press).

Cummins, J. David, 2002, *Deregulating Property-Liability Insurance: Restoring Competition and Improving Market Efficiency* (Washington, D.C.: AEI/Brookings).

Greves, Michael, 2002, Free Eliot Spitzer, *Federalist Outlook*, AEI Online, May 1.

Harrington, Scott, 1999, Federal Involvement in Insurance Regulation: An Historical Overview, in Peter Wallison, ed. *Optional Federal Chartering of Insurance Companies* (Washington, D.C.: American Enterprise Institute).

_____, 2000, *Insurance Deregulation and the Public Interest*, AEI-Brookings Joint Center for Regulatory Studies, Washington, D.C.

_____, 2002, *Optional Federal Chartering of Property/Casualty Insurers*, Alliance of American Insurers.

Kimball, Spencer L. and Barbara P. Heaney. 1995. *Federalism and Insurance Regulation*. Kansas City, Mo.: National Association of Insurance Commissioners.

National Association of Insurance Commissioners, 2000, Statement of Intent, Kansas City.

_____, 2005, NAIC's SMART Act Review Team Findings, Kansas City.

Scott, Kenneth E., 1977, The Dual Banking System: A Model of Competition in Regulation, *Stanford Law Review* 30: 1-49.

Wallison, Peter, ed. 2000. *Optional Federal Chartering of Insurance Companies* (Washington, D.C.: American Enterprise Institute).