Optional Federal Chartering of Property-Casualty Insurance Companies

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For the

Alliance of American Insurers

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Foreword

It has been a decade since state insurance regulation was last in the mainstream of public policy debate in Washington. Today, however, the topic is again under scrutiny in the halls of Congress. The reasons for questioning the state system of insurance regulation have changed significantly since the last time this topic was a popular subject of debate. Have the answers changed as well? In keeping with our long tradition of research and discourse to promote the public interest, the Alliance has commissioned this study to consider the new questions directed at state regulation of property and casualty insurance. The research concludes that the state system of insurance regulation still makes more economic sense, although modernization is much needed and long overdue.

During the 1970s, insurance company insolvencies were generating concern about the state regulatory model and whether state regulators were able to regulate adequately the financial strength of insurance companies. More sophisticated tests were developed to monitor solvency, and the federal threat melted away. Again, the public's confidence in state regulation was shaken in the late '80s and early '90s as prices escalated in the wake of tort liability, workers compensation, and auto insurance crises. And again state regulation responded as the National Association of Insurance Commissioners took aggressive steps, in the form of an accreditation program of insurance departments, to shore up their effectiveness in the face of Congressional criticism led by Representative John Dingell (D-MI). Despite a prolonged review, ultimately no federal action was taken.

Now, the public debate is of a different origin. Today, there are broad economic issues at play. Chief among them is the convergence of the financial services sector after enactment of the Gramm-Leach-Bliley Act

(GLB) that permits banks and insurance companies to be owned within the same financial holding company structure for the first time since the Depression. Because GLB preserved functional financial services regulation, it created a system of multiple regulators for holding companies choosing to invest and create companies that offer different types of financial services under a single brand umbrella. In the wake of these changes some banks and insurers have expressed their frustration and concern about the efficiency of dealing with fifty-one insurance regulators. These firms have called for regulatory reform and modernization and, in some instances, the abolition of the existing regulatory system and the creation of a new federal regulator for companies wishing to exercise this option.

Economic pressures also have added to the GLB impetus for change. The property-casualty industry has experienced a significant drop in investment income as capital markets have retrenched. At the same time, long-held frustrations concerning the industry's rate of return have been magnified when insurers have compared their performance to that of banks in the newly blended financial services sector. Naturally, this frustration has spilled over to the regulatory system as insurers have compared their regulatory burden to that of banks and brokerage operations. In particular, critics have focused on outmoded insurance rate and form-filing requirements, the inefficiencies that remain in the licensure system, and the persistent use of "desk-drawer" rules lacking clear statutory authority that slow down an insurer's ability to get new products to market.

Finally, Congressional debate regarding the need for a federal backstop for terrorism losses has also swept in many questions about state insurance regulation. As insurance prices have escalated and availability has fallen, some in Congress have wondered aloud about the efficiency of state regulation and have called for federal oversight of the industry, including product pricing.

The events driving the debate this time, and particularly those associated with concerns about the drag of regulation on economic performance, differ from the issues driving the debate in the ’70s, ’80s, or ’90s, and different answers are needed. To respond to the broad economic issues now in play, the Alliance has commissioned this study, conducted by Dr. Scott Harrington of the Moore School of Business of the University of South Carolina, to evaluate state regulation versus the concept of an “optional federal charter” using both historical evidence and economic principles. The study looks at issues such as: the broad characteristics of economically efficient insurance regulation, state regulations’ performance, and whether federal chartering would be more or less efficient than the current system. In analyzing these issues, the impact of globalization has also been examined.

The results show that optional federal chartering of property and casualty insurers is not in the best interest of policyholders and taxpayers. Consequently, reforming the state system is a more sensible approach to solving the efficiency problem, rather than destroying the system and starting over, or developing a competitive system that confers special regulatory benefits that could otherwise skew the nature of product market competition.

We hope this research will enable public policy makers to respond wisely to the arguments for change being presented and that it will encourage ongoing efforts to improve the efficiency of the regulation of the property and casualty insurance industry.

Rodger S. Lawson, Ph.D.
President
Alliance of American Insurers

I. Introduction and Summary

The Commerce Clause of the U.S. Constitution authorizes the federal government to regulate interstate commerce. The 10th Amendment reserves powers "to the states and to the people" that are not delegated to the federal government or prohibited to the states. In contrast to banking, where federal chartering was permitted in 1864, all insurance companies are chartered at the state level and subject to rules and regulation in each state where they conduct business. The states' largely exclusive franchise for insurance regulation represents a remarkable exception to the broad expansion of federal legislation and regulation that accompanied Supreme Court interpretations of the Commerce Clause and 10th Amendment during the 20th century.

State insurance regulation evolved rapidly in the 19th century following the Supreme Court's 1868 decision in *Paul v. Virginia* holding that insurance was not commerce, let alone interstate commerce. The Court's *South-Eastern Underwriters Association* decision in 1943 overturned that ruling, implying that federal antitrust law would apply to insurance. The Congress enacted the McCarran-Ferguson Act in 1945. This Act endorses state insurance regulation and provides the insurance business with an exemption from federal antitrust law for activities that are regulated by the states and that do not involve boycott, threat, or coercion. In response, most states made property-casualty insurance rates subject to prior regulatory approval, often requiring or strongly encouraging insurers to adhere to uniform rates developed by rating bureaus (cooperative industry organizations for developing rates and standard policies). The next two decades saw the gradual breakdown of regulation mandating or strongly encouraging adherence to bureau rates. Beginning in the late 1960s and early 1970s, many states eventually adopted competitive rating laws for certain types of business, which generally require rates to be filed with regulators but do not require regulatory approval before their use. A few states instead increased the intensity of prior approval regulation, periodically used it to limit rate increases in the face of rapid growth in claim costs, and/or restricted rate classification. Although nearly half of the states deregulated property-casualty insurance rates and policy forms (i.e., contract terms and language) for "large" commercial policyholders during 1998-2001, many states continue to regulate rates for personal automobile, homeowners, workers' compensation, and other property-casualty insurance coverages.

State insurance regulation has thus far remained preeminent because insurance markets have generally performed reasonably well under state oversight, despite occasional upswings in the frequency or severity of insurer insolvencies. Many states have economically sensible regulatory systems that focus on promoting healthy competition and safety and soundness. Changes in state regulation that have accompanied periodic threats of federal regulation have dissuaded federal intervention, and insurers have traditionally supported state regulation. But pressure for some form of federal chartering and regulation of insurance has recently resurfaced. The American Bankers Insurance Association, the American Council of Life Insurance, and the American Insurance Association have each proposed systems for optional federal chartering; two optional federal chartering bills have been proposed in the Congress. Increased competition across financial sectors and national borders and the enactment of the Gramm-Leach-Bliley (GLB) Act have been accompanied by more frequent criticism of state regulation of rates, forms, and producer licensing. Although optional federal chartering and regulation proposals in the 1960s, 1970s, and early 1990s were largely driven by concerns that there was too little regulation of insurers (see the Appendix), much of the current pressure for optional federal chartering reflects the desire for less regulation and greater reliance on competition to determine rates and coverage terms.

This study evaluates the potential benefits and costs of optional federal chartering. The project was undertaken at the request of the Alliance of American Insurers, a property-casualty insurance trade association representing over 340 companies. While much of the discussion applies to all types of insurance, the specific focus is property-casualty insurance. The analysis considers seven main issues:

1. Whether federal chartering would curtail inefficient rate and form regulation;

2. Whether federal chartering would produce material scope and scale economies, beneficial streamlining and homogenization of regulatory requirements, and higher quality regulation;

3. Whether federal chartering would create beneficial regulatory competition;

4. Whether federal chartering would encourage fair, global competition;

5. The potential effects of federal chartering on data sharing arrangements and attendant effects on market competition and safety and soundness;

6. The likelihood and possible consequences of a federal guaranty system with optional federal chartering; and

7. Regulatory risk, litigation, and other transitional costs that would accompany optional federal chartering.

Direct expenditures on insurance regulation are negligible compared with total premiums. Insurers' compliance costs and the indirect costs of undesirable market dislocations from regulation are almost certainly larger than direct expenditures, but they have not and very likely cannot be measured with much precision. If reasonably accurate cost estimates were feasible and available, the lack of an appropriate benchmark for comparison would still limit their implications for the federal chartering debate. My analysis therefore relies on historical evidence and economic principles that shed meaningful, qualitative light on whether optional federal chartering would likely produce more efficient regulation.

The overall conclusion is that optional federal chartering of property-casualty insurers is not in the best interests of policyholders and taxpayers. The possible benefits from optional federal chartering – a reduction in inefficient regulation of rates and forms, achievement of regulatory scale and scope economies, and promotion of desirable regulatory competition – are hypothetical. They are subject to real uncertainties and are probably modest at best. The potential risks and costs of optional federal chartering are comparatively large. They include modifications in insurance guaranty funds and data sharing arrangements that would undermine safety, soundness, and healthy competition. Optional federal chartering also could ultimately produce broader restrictions on insurance pricing and underwriting, which would increase cross-subsidies among policyholders, place taxpayers at risk, and inefficiently distort policyholders' incentives to reduce the risk of loss. The better and more prudent policy is to reject federal chartering and encourage and support further modernization of state regulation.

The details of the analysis can be summarized as follows:

1. Insurance regulation's primary purpose should be to promote safety and soundness and healthy competition. State solvency regulation and guaranty funds have performed reasonably well, despite recent insolvency problems, especially in view of the inherently large risks that characterize the sale of property-casualty insurance. They have not substantially undermined private market incentives for safety

and soundness. The state guaranty fund system has several strengths compared to federal deposit insurance. The McCarran-Ferguson exemption and modern state mechanisms that facilitate cooperative activity among insurers foster healthy competition and safety and soundness.

2. Overly intrusive regulation of rates and policy forms and significant restrictions on underwriting and risk classification are unnecessary and inefficient. The adverse effects are primarily, but not exclusively, confined to the states that practice those policies.

3. Whether optional federal chartering would significantly curtail inefficient rate and form regulation is highly uncertain. Federal chartering will be unlikely to exempt federally chartered insurers from participation in state residual markets, which could still be used to cap rates for high-risk policyholders and thus produce chronic cross-subsidies. The McCarran-Ferguson Act represents a formidable barrier to federal regulation of rates and rate classification in politically sensitive insurance lines; optional federal chartering would remove that barrier. Federal regulation would likely face strong pressure to restrict insurance rates, classification, and other insurer decisions in ways that would increase costs, create cross-subsidies, and place taxpayers at risk, with detrimental effects on private sector risk management and resource allocation.

4. Optional federal chartering might yield regulatory economies of scale and scope, but those economies are unlikely to be large given existing coordination among the states, the local nature of many property-casualty insurance coverages, differences in substantive state law related to those coverages, and the likelihood of significant overlap between federal and state regulation.

5. Federal chartering might promote regulatory competition between state and federal governments, which could lead to more efficient regulation. But the scope of any increase in competition and attendant benefits is uncertain. The present system involves material competition because the federal government's credible threat of intervention disciplines some inefficient state practices. Effective state-federal regulatory competition with optional federal chartering would probably require a federal guaranty system that applies to both state and federally chartered insurers, with a number of attendant disadvantages (see paragraph 8 below). It also would require that many insurers be able to switch charters at relatively low cost. That condition might not be met for many multi-state insurers once they have chosen a federal charter. In addition, fixed costs associated with changing charters would limit the ability of many small insurers to switch to a federal charter, and plausibly disadvantage them compared to larger competitors, thus undermining small insurers traditional role of making coverage more widely available.

6. Financial modernization and economic globalization provide slender support for optional federal chartering, especially in an environment of functional regulation (i.e., where separate and specialized regulatory agencies oversee the banking, securities, and insurance activities of multi-product financial institutions). State regulation does not materially deter vigorous cross-sector and cross-country competition.

7. Optional federal chartering could be accompanied by elimination or substantial elimination of the limited antitrust exemption for federally chartered insurers and perhaps state chartered insurers. The integrity and value of current systems of information sharing would likely be undermined. The results could include less competition, reduced safety and soundness, and higher costs of ratemaking. The effects would fall disproportionately on small insurers.

8. Even if optional federal chartering legislation did not establish a federal guaranty system, federal guarantees of insolvent insurer liabilities would likely be inevitable, including their expansion to encompass state chartered insurers. Inclusion of state chartered insurers would be accompanied by some federal monitoring/regulation of their solvency. The history of deposit insurance suggests that, sooner or later, optional federal chartering and federal guarantees would likely be accompanied by more complete protection of policyholders against loss from insurer insolvency, which would undermine market discipline, increase insolvency risk, and ultimately produce pressure for more regulatory constraints on insurer operations rather than less regulation.

9. The state regulatory system involves substantially less regulatory risk than a centralized system (whether the latter is optional or mandatory). Regulatory mistakes tend to be localized; cautious experimentation and learning are facilitated. Centralization amplifies mistakes; contagion is inherent.

10. A transition to optional federal chartering would involve large frictional costs, including substantial litigation over the scope of the antitrust exemption, federal pre-emption of state regulation, and the borders between state and federal regulation.

Many of these points are not new; a few have been recognized for decades.[1]

The remainder of this study is organized as follows: Sections II, III, and IV provide background and context for the evaluation of optional federal chartering. Section II describes the broad features of economically efficient

[1] See, for example, Kimball (1966) and, for a textbook treatment, Mehr and Cammack (1966). I have emphasized several of them in my earlier work on rate regulation, solvency regulation, and the antitrust exemption (see note 2 below).

insurance regulation. Section III evaluates state regulation's performance. State modernization efforts and recent optional federal chartering proposals are summarized in Section IV. Given this background, Section V evaluates the possible benefits and costs of optional federal chartering. Section VI concludes. The Appendix provides an overview of state insurance regulation for unfamiliar readers, including a short history of federal-state interaction and earlier proposals for optional federal chartering.[2]

[2] The material in the Appendix draws from chapters 5 and 24 of my 1998 textbook with Greg Niehaus and my chapter in Peter Wallison's collection of essays on optional federal chartering (Harrington, 1999), which in turn drew from Mehr and Cammack (1966) and benefited greatly from the collection edited by Spencer Kimball and Barbara Heaney (1995). The discussion of rate regulation in Section III draws from my AEI/Brookings monograph (Harrington, 2000) and chapter (Harrington, 2002). I have previously published two other essays dealing with possible federal regulation of insurers (Harrington, 1991 and 1992a).

II. Economically Efficient Regulation

My analysis is based on the classical view that regulation should serve the public interest by promoting economically efficient transactions, recognizing regulation's costs and inherent limitations. This section first describes the relationship between efficient regulation and market competition. I then summarize the main types of insurance regulation that can be justified on efficiency grounds and the tradeoffs that efficient regulation must confront. The section concludes with a brief discussion of regulators' incentives to strive for efficient regulation.

Efficiency and Competition

The traditional rationale for regulation is to protect the public interest by efficiently mitigating market failures. As discussed by Supreme Court Justice Stephen Breyer in his 1982 treatise, *Regulation and Its Reform,* the test for whether government intervention will likely be efficient 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 that failure, that is, that regulation's benefits will exceed its direct and indirect costs. Efficient intervention necessarily requires matching appropriate regulatory tools to the specific market failures. Regulation should be allocatively efficient: the types and quality of regulation should maximize the difference between the benefits from mitigating market failures and the direct and indirect costs of regulation. Regulation also should be technically efficient: given the desired types and quality of regulation, the total cost should be minimized.

According to the efficiency standard, the decision to regulate and the types of intensity of regulation should be based on whether market characteristics differ significantly from those of a reasonably competitive market characterized by: (1) large numbers of sellers with relatively low market shares and low cost entry by new firms; (2) low cost information to firms concerning the cost of production and to consumers concerning prices and quality; and (3) an absence of material spillovers (i.e., all costs are internalized to sellers or buyers). Desirable conduct and performance will characterize markets with these structural characteristics. Markets that significantly deviate from these characteristics and therefore exhibit conduct and performance that differ significantly from a competitive market are candidates for regulation to move the market's structure, conduct, and performance towards the competitive ideal. But the costs and limitations of regulation must be considered in the design of efficient regulation. Regulatory tools are necessarily imperfect. Regulation always involves direct and indirect costs, and it risks unintended consequences. These problems justify the two-pronged test for any government intervention.

The basic rationale for the efficiency standard is the same as that for capitalism, as opposed to socialism. Efficient regulation maximizes society's wealth. Equivalently, in the specific context of risk management and insurance, efficient regulation minimizes the total cost of risk, which includes the cost of losses, loss control, and loss financing. The emphasis on making total wealth as large as possible (the total cost of risk as small as possible) generally precludes using economic regulation to redistribute wealth. Efficient regulation implicitly considers the long-run effects on all people, rather than the short-run effects on relatively few people.

Broad Implications for Insurance Regulation

Market structure and ease of entry are highly conducive to competition in auto, homeowners, workers' compensation, and most other property-casualty insurance lines.[3] Modern insurance markets that are relatively free

[3] See, for example, Joskow (1973), Cummins and Weiss (1992), and Klein (1995).

from regulatory constraints on prices and risk classification exhibit pervasive evidence of competitive conduct and performance. Insurers vary substantially in terms of price, underwriting, and service. As I elaborate in Section III, these conditions obviate the need for prior approval regulation of rates. Instead, the principal imperfections in insurance markets that justify some degree of government regulation take the form of costly and imperfect information and spillovers. The primary rationale for insurance regulation is to improve efficiency by promoting safety and soundness and healthy competition in view of those problems.

Some form of solvency regulation is efficient because of costly/imperfect information and potential spillovers. Property-casualty insurers bear enormous risk of loss from natural catastrophes and unexpected events, such as the World Trade Center attack. Liability insurers have paid billions of dollars for claims brought many years after policies were sold, and after legal liability standards and legal interpretation of policy provisions had changed substantially. The risk of many property-casualty losses is very difficult to evaluate and price accurately. Insurers must hold large amounts of capital to maintain reasonably low probabilities of insolvency. Competition creates relentless pressure for low prices, which in some cases may contribute to inadequate rates and increase insolvency risk, especially for difficult to price coverages subject to large, but slow developing losses.

With solvency regulation, policyholders who would find assessing and monitoring insurer insolvency risk very difficult (or who might have little incentive to do so) delegate the major responsibility for monitoring to regulators. Such monitoring might detect insurer financial problems early enough to prevent insolvency. In other cases, monitoring can help regulators intervene before the deficit between an insolvent insurer's assets and liabilities gets any larger. Some degree of regulatory restrictions on insurer risk taking (e.g., investment limitations and capital requirements) also is efficient.

Limited, government-mandated protection of policyholders with claims against insolvent insurers is likely to be efficient in view of costly/imperfect information and possible spillovers on other parties (such as those with legally valid workers' compensation or liability claims against policyholders of insolvent insurers). The insurance industry has a collective interest in bonding its promises to pay claims. Given costly and imperfect information, in the absence of any guarantees insolvencies might damage the reputations of most insurers, including many financially strong ones, therefore motivating many or most insurers to participate in a joint guaranty system. Joint guarantees help maintain collective pressure for efficient solvency regulation by giving member insurers a direct stake in the outcomes of such regulation. Government mandated rather than voluntary associations ensure broad participation by insurers and obviate antitrust concerns that might otherwise arise with privately initiated and managed joint guarantees.

Regulatory systems that facilitate information sharing by property-casualty insurers to develop more accurate rates at lower total cost can efficiently promote safety and soundness and healthy competition. Costly and imperfect information also justify some degree of market conduct regulation and regulatory oversight of contract terms, at least for relatively unsophisticated policyholders. While such regulation can become excessive, it can mitigate problems and help reduce the incidence of costly litigation.

The design of efficient insurance regulation necessarily confronts difficult tradeoffs. For example, beyond some point lowering insolvency risk through tighter regulatory constraints, such as higher capital requirements, inefficiently increases the total costs of insurance. Regulatory monitoring and controls to reduce insolvency risk involve direct costs, such as salaries paid to regulators and data collection and processing costs. They also produce indirect costs, for example, by distorting the decisions of some financially sound insurers in ways that increase their costs. A tradeoff also exists between protecting people against loss when insurers fail and incentives for insurers to be safe. Protection against loss reduces policyholders' demand for lower insolvency risk and their incentives to seek safe insurers, thus dulling insurers' incentives to hold more capital.

Incentives for Efficient Regulation

Regulators (and legislators) can be viewed as agents of the public for the purpose of designing and administering efficient regulatory policies. As with all principal-agent relations, regulators (legislators) may seek their own interests, which may include weighing the interest of particular groups more than dictated by efficiency concerns, to the net detriment of their principals (the public at large). Thus, regulation involves agency costs: regulators need to be monitored, and they sometimes deviate from efficient policies that would serve the broad interest of the public. A well-designed regulatory system will mitigate such costs and provide suitable incentives for regulators to pursue efficient policies.

III. State Regulation's Performance

The competitive structure of property-casualty insurance markets implies that insurance regulation should focus on promoting safety and soundness and healthy competition. This section considers state regulation's performance in three main areas: (1) solvency regulation, (2) facilitation of beneficial cooperative activity among insurers, and (3) rate and form regulation. Despite several historical episodes of insolvency problems and recent/impending insolvency problems for a number of insurers, including the largest insolvency to date (Reliance Insurance Group), state solvency regulation and guaranty funds have sensible structures and have performed reasonably, especially in view of the inherently large risks that characterize property-casualty insurance. They have not eviscerated private market incentives for safety and soundness. The McCarran-Ferguson exemption and modern state mechanisms that facilitate cooperative activity among insurers help foster healthy competition and safety and soundness. However, overly intrusive prior approval regulation of rates and policy forms and significant restrictions on underwriting and risk classification are demonstrably inefficient and anti-competitive.[4]

Solvency Regulation

The main characteristics of state solvency regulation – regulatory monitoring, risk-based capital requirements and other controls on insurer risk taking, and limited guaranty fund protection – are sensible given the efficiency rationales for regulating solvency and protecting policyholders against the full consequences of insurer default. Regulators in an insurer's home state (its state of domicile) traditionally have played a lead role in regulating its solvency, thus reducing duplication in cost and effort. A significant degree of

[4] While I focus on rate and form regulation, some insurers also have criticized some states' practices related to market conduct examinations and regulation. See, for example, Alliance of American Insurers (2001).

coordination and uniformity among the states has also been achieved through the National Association of Insurance Commissioners (NAIC), including its promulgation of financial reporting requirements and its solvency regulation certification program. In addition, state regulation has responded reasonably and generally with acceptable speed to previous insolvency problems and threats of federal intervention (see the Appendix). With the possible exception of the state liquidation process, little of the current pressure for optional federal chartering reflects perceived failures in the area of solvency regulation.

The design of solvency guarantees is critical to safety and soundness. Even well designed government (or government-mandated) guarantees run the risk of increasing the incidence of insolvency. Accurate risk-based premiums for guaranty protection, which could mitigate the dulling effects of guarantees on incentives for safety and soundness, are infeasible in practice. 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 design of state guaranty funds contributes to the efficiency of state solvency regulation. Insurance markets are characterized by stronger market discipline than the banking sector, with its broad explicit protection provided by federal deposit insurance and its history of implicit federal guarantees (e.g., the "too big to fail" doctrine, which protected nominally uninsured deposits at very large banks).[5] This difference in part reflects the system of state guaranty funds, which provides substantial protection with much smaller effects on market discipline than federal deposit insurance.

A modest increase in insolvency risk and insolvencies following the breakdown of adherence to bureau rates, greater reliance on competition to determine rates in many states, and regulatory pressure toward rate inadequacy in others made such limited guarantees of insolvent insurers' obligations more

[5] See Epermanis and Harrington (2001) and Billet, et al. (1998).

advantageous beginning in the late 1960s. State guarantee funds developed with substantial input from insurers. The vast majority rely on ex post assessment funding mechanisms, which avoid the accumulation of funds that could be appropriated by state legislatures for non-insurance purposes and enhance incentives for financially strong insurers to press for effective solvency surveillance and efficient liquidation of insolvent insurers. Such incentives are generated because unexpected increases in the costs of assessments are likely to be borne in large part by insurers, as opposed to being fully shifted to customers or taxpayers.[6]

The degree of systemic risk (e.g., the possibility that financial difficulty or insolvency of one insurer could adversely affect otherwise solvent insurers and spillover on other sectors) is smaller for insurance than for banking, thus reducing the efficient level of guaranty fund protection. Contrary to some complaints that state guaranty fund protection may be inadequate, limited coverage under state guaranty funds is advantageous. About a third of the states reduce protection for large business insureds or exclude them from coverage, which encourages those businesses to seek out and trade with safe insurers and discourages them from buying coverage that they believe may be under-priced. Those systems are very likely more efficient than state systems without such restrictions.

The recent insolvency of Reliance Insurance Group, with an estimated $1.1 billion excess of liabilities over assets, is expected to cause guaranty fund annual assessment caps to be reached in a number of states, perhaps for several years, and especially in the states' separate workers' compensation insurance

[6] The desire to avoid loss of premium tax revenue in states that allow offset of guaranty fund assessments against premium taxes might produce legislative pressure for controlling the cost of assessments. A poorly designed guaranty system that spread the cost of insurer insolvencies broadly among taxpayers could reduce pressure by insurers and policyholders for the government to commit resources and adopt internal controls that are necessary for efficient monitoring.

guaranty funds. Although existing procedures that permit or facilitate borrowing by guaranty funds should allow America's largest property-casualty insurer insolvency to be handled in a relatively smooth fashion, the possible insolvency of any other sizable insurer with a relatively large workers' compensation portfolio would stress the system. Proposals are being discussed for new funding arrangements where solvent insurers would advance funding above the caps to be credited against future assessments.

The Reliance insolvency and the recent financial difficulties of a number of other insurers in large part reflect intense price competition during the prolonged "soft" market for commercial property-casualty insurance in the 1990s and unexpected growth in claim costs for business written at relatively low rates. Thus, in many respects these problems illustrate the inherent risks of insuring property-casualty risk. There is no reason to expect that federal regulation or guarantees would have prevented these problems or reduced their costs. Under the state guaranty system for property-casualty insurers, the costs will ultimately be borne by insurance consumers and investors.

Efficient Cooperative Activity and the Antitrust Exemption

The limited exemption from federal antitrust law for state regulated activities under the McCarran-Ferguson Act facilitates beneficial cooperative activity through insurance advisory organizations. These organizations help promote healthy competition and thereby benefit policyholders by providing valuable, low cost information to insurers about projected loss costs (known as "prospective loss costs"). Loss forecasting involves the estimation of ultimate costs for claims already incurred using data on paid claims and reported reserves for unpaid claims (known as "loss development") and prediction of cost trends for new and renewal coverage using this and other information (often known as "trending"). Advisory organizations pool information from a large number of insurers, develop and trend losses, and make the results available to companies at cost for use as they see fit. This process lowers the cost of ratemaking, 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 standard policy forms through advisory organizations also reduces costs, facilitates comparisons of price and quality of service by policyholders, and helps make claim cost data comparable across insurers.

Although sharing of data on paid claims and some form of cooperative development of policy forms might survive antitrust scrutiny, substantial and lengthy litigation would be expected following a repeal of the exemption. Loss development by advisory organizations might survive a repeal of the exemption, again following substantial delay and litigation. Loss trending by advisory organizations almost certainly would not.

While the antitrust exemption is sometimes alleged to facilitate collusion to raise rates, those allegations strain credulity in modern insurance markets.[7] Modern property-casualty insurance markets are ill suited for cartel behavior given their competitive structure, heterogeneity, and multiplicity of product lines and sublines. Unless prevented by price regulation, property-casualty insurance markets are characterized by substantial heterogeneity in prices and underwriting standards, which is prima facie inconsistent with price fixing. Commercial insurance pricing is characterized by substantial flexibility, including the widespread use of individual risk rating. Modern advisory organizations make no attempt to compel the use of prospective loss costs (or previously, advisory rates that included benchmark expense and profit factors). Major automobile and homeowners insurers file rates based on their own projections, as opposed to adopting advisory organization prospective loss costs. Thus, both theory and

[7] Numerous studies of the mid-1980s liability insurance crisis concluded that collusion is an implausible explanation and suggest a variety of economic factors that led to those problems. See, for example, Clarke, et al. (1988) and the Appendix for further discussion. Also see Gron (1995).

evidence imply that cooperative activities facilitated by the limited antitrust exemption are efficient: they reduce costs and promote safety and soundness without chilling healthy price competition.[8]

Prior Approval of Rates

As noted above, market structure and ease of entry are highly conducive to competition in auto, homeowners, workers' compensation, and most other property-casualty insurance lines. Insurance markets that are relatively free from regulatory constraints on prices and risk classification exhibit pervasive evidence of competitive conduct and performance. Insurers vary substantially in terms of price, underwriting, and service.[9] Prior approval rate regulation therefore cannot be justified as an efficient response to monopoly or oligopoly pricing, nor is it necessary to prevent collusion.

The desire to protect policyholders from purchasing coverage from high priced insurers does not warrant prior approval. Rate regulation is an inefficient 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 policyholders justifies government action, the preferred mode of regulation, practiced in many states, is greater information disclosure.[10] Some observers suggest that selective regulatory suppression of rates could motivate some parties to insure who otherwise would engage in risky activity without adequate assets or insurance. A related argument is that mandatory purchase requirements, or the "essential" nature of insurance, support using rate

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[8] The Alliance of American Insurers (2002) provides more detailed discussion of many of the practical, pro-consumer features of the limited antitrust exemption.

[9] Accounting data at the industry level provide no indication of large profitability compared to other industries.

[10] See Breyer (1982) for general discussion.

regulation to make coverage affordable to all policyholders. One problem with those arguments is that price regulation is a crude method of subsidizing low-income policyholders. Prior approval regulation also entails significant administration and compliance costs, which policyholders ultimately pay. Moreover, if insurance departments allocate much of their budgets to rate regulation, more appropriate regulatory activities may suffer.

Prior approval regulation cannot affect insurer profits in the long run. Insurers must expect a reasonable profit over time in order to supply coverage. Some states have constrained insurers ability to exit unprofitable markets through surcharges and other "lock-in" mechanisms. Even if constitutional, however, such constraints cannot repeal the underlying forces of supply and demand.[11] Inherent delays associated with prior approval regulation adversely affect policyholders. Given the time and expense of rate filing and approval, insurers are less likely to increase or decrease rates in response to new information about expected costs than would be true without prior approval. The resulting regulatory lag tends to produce fewer but larger rate changes and greater swings in availability of coverage and insurer profitability.[12] Uncertainty about approval of proposed rate changes increases insurers' risk, with adverse effects on policyholders.

Competition motivates insurers to forecast costs accurately and to price and underwrite to avoid adverse selection, thus producing highly refined rating systems. Substantial evidence, including small residual markets in states with little or no regulatory intervention in pricing, indicates that competitive pricing and risk selection promote the availability of coverage. In contrast, prior

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[11] See Harrington (1992b) and Epstein (1999). In principle, price regulation cannot deprive insurers of a fair rate of return on capital without violating constitutional protections (*FPC v. Hope Natural Gas*, 320 U.S. 591, 1944). In practice, the fair rate of return, whether rates are sufficient to produce this return, and related issues are subject to considerable dispute.

[12] See MacAvoy (1977) for early evidence. Also see Harrington (2002).

approval regulation and restrictions on risk classification have periodically produced large residual markets in some states.[13] In addition, and very importantly, competitive rating helps reduce the total cost of risk. It provides incentives for higher risk policyholders to take actions to control losses and thus qualify for lower premiums and/or have lower uninsured losses. Because they reflect expected costs, competitive insurance prices also provide information to policymakers and other parties about the cost of accidents and the efficacy of institutional arrangements that affect the probability and severity of losses (such as traffic safety enforcement, crime prevention, and liability rules). Rate regulation undermines these important functions.

Some arguments suggest that restrictions on competitive risk classification could improve "fairness" compared to market outcomes. Those arguments go beyond the goal of using regulation to mitigate demonstrable market failures efficiently.[14] Attempting to achieve greater fairness through classification restrictions requires rates for many policyholders to increase if insurers are to cover their average costs and obtain a reasonable expected profit. Because competitive underwriting and risk classification provide desirable incentives for policyholders to control losses, classification restrictions tend to increase total claim costs by distorting these incentives. Higher risk persons or businesses whose rates are lowered by rate regulation

[13] Some observers suggest that the seemingly compelling evidence from automobile insurance residual market data that competition promotes availability is misleading, because so-called non-standard insurers insure many drivers. But insurer specialization according to expected claim costs and expense characteristics of buyers is expected in a well-functioning competitive market, and the non-standard market reflects insurer specialization to achieve greater refinement in cost-based classification. Rate regulation can prevent persons insured by non-standard insurers from being served voluntarily; that is, it can replace the non-standard market with a larger residual market with inadequate rates.

[14] See Abraham (1986) and, in the context of restrictions on auto insurance classification, Harrington and Doerpinghaus (1993) for further discussion.

may engage in more risky activity and take fewer precautions to avoid loss.[15]

Many studies have compared insurance loss ratios (ratios of losses to premiums) in prior approval and competitive rating states, most commonly for personal auto insurance.[16] Consistent with rate suppression, the evidence suggests higher loss ratios in some states with prior approval regulation during the 1970s and early 1980s. But, consistent with the inability of prior approval regulation to affect rates materially in the long run without significantly lowering quality or producing widespread insurer exit, there is no consistent difference over time. Prior approval, however, is persistently associated with larger residual markets and greater volatility in loss ratios, and evidence suggests that regulatory rate suppression can increase growth in claim costs.[17]

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[15] See, for example, Harrington and Doerpinghaus (1993) and Danzon and Harrington (1998).

[16] See, for example, Ippolito (1979), Grabowski, Viscusi, and Evans (1989), Harrington (1987), and Harrington (2002), which use multiple regression to control for one or more factors that could cause differences in loss ratios across states apart from rate regulation.

[17] My most recent research on rate regulation (Harrington, 2002) analyzes automobile insurance loss ratios, residual market shares, and volatility of expenditure growth rates with cross-state data for the past 25 years. The estimated average effect of prior approval regulation on loss ratios is positive, but it is negligible in magnitude, primarily attributable to the 1970s, and at most weakly significant in a statistical sense. Consistent with earlier work, my study documents that prior approval regulation is persistently and reliably associated with larger residual market shares, even when states with reinsurance facilities or related residual market mechanisms and the largest residual market shares are excluded from the comparison. Prior approval regulation also is associated with greater volatility in loss ratios and expenditure growth rates. My overall findings therefore suggest that – on average – prior approval regulation had little or no effect on the relation between rates and claim costs over time, but that it reduced coverage availability and increased volatility to insurers and policyholders. My work with Patricia Danzon (Danzon and Harrington, 1998) developed models to show how rate regulation that produces temporary suppression of rate

Prior Approval of Forms

Apart from states that have eliminated filing and approval of rates and policy forms for large commercial policyholders, policy forms remain subject to regulatory approval in most states.[18] The requirement for insurers to file forms for approval has become more burdensome over time, especially for commercial policyholders with locations in multiple states. Administrative costs and delays of form regulation are dysfunctional in the modern environment characterized by rapid product innovation and increased insurer competition with other financial institutions and alternative risk transfer products.[19] Prior approval of forms is unnecessary and inefficient for commercial lines of property-casualty insurance. The case for eliminating prior approval regulation of forms for personal lines of property-casualty insurance is much less compelling – and less consequential in the debate over optional chartering.

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changes or chronic cross-subsidies from low to high-risk employers can produce higher workers' compensation claim costs by distorting incentives of employers and insurers. We tested these predictions using data during the 1980s cost surge in workers' compensation. The evidence suggests that rate suppression increased claim costs.

[18] If a commercial insurance buyer cannot find necessary coverage with an insurer licensed in the state, it usually can arrange coverage in the non-admitted (excess and surplus lines) market with an insurer not subject to customary rate and form approval regulation. Some states also permit the use of policies with terms mutually negotiated between very large policyholders and insurers.

[19] Butler (2002) presents evidence that form regulation "substantially reduces sales of commercial insurance." Form regulation encourages policy standardization, which in turn facilitates comparison-shopping by buyers. Some standardization also is necessary for pooled loss data across insurers to convey meaningful information for forecasting future costs. But valuable standardization can be achieved without prior approval through pro-competitive, cooperative agreements.

Spillovers of Inefficient Regulation on Other States

The adverse effects of prior approval regulation in some states arguably have had some impact on states that have avoided such practices. Regulatory rate suppression has at times probably weakened the financial strength of some multi-state insurers, especially in view of economic, political, and regulatory constraints on exit from particular markets. The risk of rate suppression might increase the total capital that multi-state insurers need to hold to be reasonably safe and sound. The incidence of any cost increase may not be tightly linked to the practices of different states. State rate and form requirements increase the total cost and decrease timeliness of commercial insurance programs for businesses with operation in multiple states and impede commercial insurers' ability to develop cost effective and innovative risk management programs for such customers.

On the other hand, insurers now recognize the risk of rate suppression and can prospectively structure their operations to reduce spillovers on operation in other states. Moreover, future statewide rate suppression might be less prevalent than in the past given the growing recognition that rate suppression is inefficient. There is no evidence that any cost spillovers from state regulation materially increase the total cost of risk for multi-state, corporate policyholders. As a result, although inefficient state regulatory practices generate some spillovers across state lines, those spillovers would not appear large.

IV. State Modernization and Optional Federal Chartering Proposals

Current debate on state regulation and optional federal chartering focuses on the direct and indirect costs of state regulation of rates, policy forms, and producer licensing. Rate regulation in some states has both constrained rate increases below cost increases during periods of rapid cost growth and promoted inefficient cross-subsidies among policyholders. These problems largely reflect (1) the overhang of post-McCarran-Ferguson prior approval systems that initially produced substantial rate uniformity across insurers, and (2) some state regulators' futile efforts to make insurance more affordable with rate regulation. This section provides a brief overview of state responses to recent criticisms and then briefly describes current proposals for optional federal chartering.

State Modernization

The states have responded to the GLB Act and increased concern about outmoded and inefficient regulatory practices in a variety of ways (see Table 1). Very importantly, nearly half of the states have eliminated prior approval regulation of rates and/or policy forms for "large" commercial policyholders. Working through the NAIC, state regulators have also pursued a variety of other modernization initiatives. The NAIC's Improvements to State-Based Systems Working Group is developing procedures for streamlining and homogenizing rate filing and review processes, for expanding electronic filing, and for promoting regulation that recognizes competition. It has been working on revised model laws to encourage competitive rating. Its revised model law for commercial lines, approved by the NAIC in March 2002, encourages "use-and-file" systems for commercial lines rates and "file-and-use" regulation for commercial lines forms. The Working Group is striving for all states to have 50 percent of rate and form filing reviews completed in

20 days or less and 100 percent of filings reviewed within 60 days by December 2002.

In order to meet GLB reciprocity provisions for non-resident producer licensing and thereby prevent formation of a federal licensing entity ("NARAB"), most states have passed the NAIC Producer Licensing Model Act. The NAIC's NARAB Working Group is reviewing state laws for compliance with GLB. The National Treatment and Coordination Working Group is pursuing national treatment of selected transactions, including the coordinated licensing and approval of mergers and acquisitions for multi-state insurers. The Functional Regulation Working Group has addressed consumer protection regulation for bank insurance sales in order to preserve and clarify functional regulation of insurance in relation to the Safe Harbors in Section 104 GLB.

In March 2002, the NAIC established an Interstate Compact Working Group to work towards creation of an interstate compact to establish uniform standards and one-stop approval of life-annuity and related policy forms. The Working Group released a draft proposal for such a compact in May and revised the draft in June.[20]

Optional Federal Chartering Proposals

State modernization efforts have not prevented the introduction of a number of major proposals for optional federal chartering. The American

[20] The interstate compact initiative for life-annuity products could be highly germane to property-casualty insurance if it reduces pressure among representatives of life-annuity insurers for optional federal chartering. In a prior initiative, the Coordinated Advertising, Rate and Form Review Authority (CARFRA) Working Group worked towards development of uniform state standards and one stop approval for policy form and rate filings for "appropriate" product lines. A pilot program was launched in May 2001 for individual term life, annuity, and Medicare supplement products in 10 states.

Bankers Insurance Association (ABIA) has proposed an optional federal chartering bill patterned largely after a bill introduced by Representative John Dingell (D-MI) in 1993 (see the Appendix) and federal regulation of depository institutions. The American Insurance Association (AIA), which primarily represents relatively large property-casualty insurers that specialize in commercial lines, has proposed optional federal chartering for property-casualty insurers. Senator Charles Schumer (D-NY) has proposed an optional federal chartering bill that incorporates some of the features of the ABIA and AIA proposals. Representative John LaFalce (D-NY) has introduced optional federal chartering legislation for property-casualty and life-annuity insurers. The American Council of Life Insurers has proposed an optional federal chartering bill for life-health-annuity insurers. Table 2 summarizes the main features of the proposals that encompass property-casualty insurance.[21]

American Bankers Insurance Association. The ABIA proposal would create an Office of the National Insurance Commissioner within the Treasury Department to regulate federally chartered insurers. The agency would be patterned after the Office of the Comptroller of the Currency and the Office of Thrift Supervision. The proposal encompasses all insurance

[21] The major insurance agents/brokers trade groups also are developing proposals. The ACLI proposal would create an Office of National Insurers (within Treasury) to regulate federally charted life insurers and reinsurers and federally licensed producers. Federally chartered insurers would participate in state guaranty funds, provided that a state's fund met minimum federal requirements. A national plan would be established for any state that did not meet federal standards. The national regulator would have no authority to regulate rates. There would be no prior approval of forms, which would be filed before use and have to comply with federal regulations. There is no provision for residual markets or antitrust. Trade practices / market conduct of federally chartered insurers would be regulated federally. The Schumer and LaFalce bills have some provisions similar to the ACLI proposal. A more detailed comparison of the ABIA, ACLI, AIA, Schumer, and LaFalce bills is available at the ABIA website (see references).

and annuity contracts issued by federally chartered insurers except those related to state residual markets, and it would authorize national insurance agencies. Federal regulatory authority for federally chartered insurers would include financial examinations, minimum capital requirements, risk-based capital requirements, investment limitations, rehabilitation, liquidation, and a system of prompt corrective action patterned after bank regulation. A National Insurance Guaranty Corporation, patterned after federal deposit insurance and funded by risk-based assessments, would be created to guaranty specified obligations of national insurers and, at their option, state insurers.[22]

The ABIA proposal provides for no state or federal regulation of rates for federally chartered insurers. Forms would not be subject to prior approval. They would have to be filed and meet federal standards or, at the insurer's option, state standards and law in an insurer's principal place of business. Federally chartered insurers would be required to participate in state residual markets. The proposal would establish federal standards and regulation of trade practices / market conduct, including prohibition of unfair discrimination. The antitrust exemption would be eliminated for federally chartered insurers.

American Insurance Association. The AIA proposal would establish a Federal Insurance Chartering Office (within Treasury) to regulate federally chartered property-casualty insurers. There is no provision for agents and brokers. That Office would be responsible for financial examinations, minimum capital and risk-based capital requirements, investment limitations, and rehabilitation and liquidation of federally chartered insurers. Federally chartered insurers would participate in state guaranty funds; the proposal does not contemplate a national guaranty system.

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[22] There would be separate programs for property-casualty and life-health insurers.

The AIA proposal would exempt federally chartered insurers from rate regulation, including rate-filing requirements, by state or federal regulators. Forms would be exempt from prior approval. Federally chartered insurers would be required to participate in state residual markets. Trade practices / market conduct of federally chartered insurers would be subject to federal standards and regulation.[23] There would be no antitrust exemption for rating activities of federally chartered insurers, except for those related to residual market participation and state mandated participation in advisory or statistical organizations. The antitrust exemption would be continued for the development and dissemination of policy forms. State chartered insurers would retain the current exemption.

Schumer. Senator Schumer's bill has some provisions similar to the ABIA proposal and some similar to the AIA and ACLI proposals.[24] It would create an Office of the National Insurance Commissioner to regulate the solvency of federally chartered property-casualty and life-health-annuity insurers and authorize national agencies. Federally chartered insurers would have to participate in state guaranty funds that met minimum requirements; a national plan would be used for any states that did not. National insurers would be exempt from state rate regulation, except for required participation in state residual markets. The bill is silent on the issue of federal rate regulation. Market conduct and trade practices of federal insurers would be subject to federal standards. Federally chartered insurers would be exempt from federal antitrust law only for policy forms and residual markets.

LaFalce. Representative LaFalce's proposal (H.R. 3766) would establish an Office of National Insurers (within Treasury) to regulate all types of insurance sold by national insurers except health insurance.

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[23] The Federal Trade Commission would be prohibited from taking actions against insurers.

[24] The Schumer bill had not been introduced formally at the time of this writing pending resolution of the appropriate Senate committee.

Producers would be licensed by the states but subject to federal market conduct regulation when selling products of national insurers. The Office of National Insurers would regulate solvency of national insurers. National insurers would participate in qualifying state guaranty funds; national guaranty systems would be established for property-casualty and life insurers for non-qualifying states.

In contrast to the other bills, the LaFalce bill would not reduce or forgo prior approval regulation of rates and forms. Both national and state insurers would be subject to rate regulation by the states and would have to participate in state residual markets. National insurers would be subject to form regulation by the national regulator. National market conduct standards would apply to all insurers and would be enforceable by state regulators against state insurers. The antitrust exemption would be repealed for all insurers, except for historical data and residual markets.

V. Will Optional Federal Chartering Enhance Efficiency?

This section evaluates whether optional federal chartering would likely enhance the efficiency of insurance regulation. I consider seven main issues:

1. Whether federal chartering would curtail inefficient rate and form regulation;

2. Whether federal chartering would produce material scope and scale economies, beneficial streamlining and homogenization of regulatory requirements, and higher quality regulation;

3. Whether federal chartering would create beneficial regulatory competition;

4. Whether federal chartering would encourage fair, global competition;

5. The potential effects of federal chartering on data sharing arrangements and attendant effects on market competition and safety and soundness;

6. The likelihood and possible consequences of a federal guaranty system with optional federal chartering; and

7. Regulatory risk, litigation, and other transitional costs that would accompany optional federal chartering.

1. Will Federal Chartering Curtail Inefficient Rate and Form Regulation?

Federal regulation might substantially eliminate prior approval rate regulation, prior approval regulation of commercial insurance forms, and overly intrusive regulation of personal lines forms. The states have made progress in this area; additional progress is likely. But some states, including one or more of the largest, may retain such policies indefinitely. Some policyholders and consumer organizations continue to press for them, and some states' career regulatory staffs mistakenly believe that those regulations serve the public. Optional federal chartering might therefore provide the opportunity for a paradigm shift – a shift in regulatory focus that emphasizes competition and safety and soundness rather than regulatory micromanagement of insurers' product and pricing decisions.

One problem with this deregulation (or less regulation) scenario is that optional federal chartering may fail to eliminate a number of inefficient state practices. In particular, and as required in current proposals, federal chartered insurers very likely would have to participate in state residual markets, given state interests in ensuring the availability of mandatory coverages. Some states might still use residual markets to cap rates for high-risk policyholders and produce chronic cross-subsidies, even if optional federal chartering allowed insurers to charge voluntary market rates that are sufficient to produce normal returns on capital. Second, the Congress and federal regulators may not be immune from using insurance price regulation to redistribute wealth. The Congress, federal agencies, and the federal courts have authorized many forms of economically inefficient income redistribution. The federal crop insurance program, for example, involves significant taxpayer subsidies beyond what is necessary to overcome any failure in private markets. The temptation to redistribute wealth with insurance regulation will not necessarily be lower with optional federal chartering, even if such redistribution does not appear likely in the near future.

State regulation is largely unable to achieve subsidies across states. Federal regulation might be able to do so, especially if redistributive policies were mandated for federal and state insurers. For politically sensitive insurance lines, federal regulation could ultimately produce restrictions on rates and classification that would create pervasive cross-subsidies both within and across states, including possibly large subsidies from taxpayers, with detrimental effects on private sector risk management and resource allocation. Consumer groups already have proposed consumer protections as part of optional federal chartering that could have some of these effects.[25]

The federal courts could interpret the ABIA, Schumer, or LaFalce bills' provisions prohibiting unfair discrimination in ways that substantially impede cost-based underwriting and risk classification. The Seventh Circuit Court of Appeals, for example, has applied a disparate impact test to insurance industry practices related to the Fair Housing Act. Broader application of that approach under optional federal chartering, following substantial litigation, might require insurers to prove the business necessity of criteria and rating factors that readily meet state standards that rates not be unfairly discriminatory.

Federal regulatory policies in banking have been more aggressive than state insurance regulation in restricting competition and mandating disclosure under the guise of discouraging unfair discrimination. The Home Mortgage Disclosure Act of 1975 and later amendments, for example, 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 such proprietary data under state regulation. The Community Reinvestment Act of 1977 and later amendments impose significant costs on many banks, which must conduct business in regions where they have no comparative advantage in order to obtain approval of

[25] See Consumer Federation of America (2000).

affiliations and mergers.[26] Optional federal chartering could extend CRA type requirements to insurance, if not initially then later. Congressional hearings on sub-prime ("predatory") lending, strong pressure for significant restrictions on such lending, and related federal proposals for restricting credit life insurance terms (e.g., the prohibition of single premium products), magnify concern that federal insurance regulation will succumb to pressures that have produced inefficient controls on insurance rates in some states.

In short, support of federal chartering by many large property-casualty insurers appears to assume that would-be federal insurance regulators will eschew extensive price (or price-like) regulation. But the McCarran-Ferguson Act constitutes a barrier to entry for federal regulation of rates and rate classification. If that barrier is removed, the political pressures that contribute to overly intrusive regulation of rates and rate classification in some states could produce similar or worse outcomes with federal regulation.

2. Technical Efficiencies, Uniformity, and Quality of Regulation

Greater centralization of insurance regulation could achieve some economies of scale in the production of regulatory benefits.[27] If so, the same level of regulatory oversight/protection could be achieved at lower cost, or higher quality regulation could be achieved without a material increase in cost. Federal insurance regulation also might achieve some economies of scope with federal banking and securities regulation, even with functional regulation (e.g., through closer coordination or improved information sharing between federal banking, securities, and insurance regulators).

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[26] Benston (1997) provides a critique of the CRA and HMDA.

[27] See Grace and Phillips (2000) and Grace and Klein (2000) for attempts to provide empirical evidence related to possible cost savings.

Optional federal chartering might streamline and homogenize a variety of cumbersome regulations through de novo development of regulatory rules and procedures for federally chartered insurers in the areas of licensing, solvency oversight, rate and form filing (if any), and market conduct. Federal chartering would create the opportunity to modernize regulation, based on lessons learned in insurance and other sectors, which in turn would help encourage modernization by state regulators.

But there are at least four reasons to doubt that optional federal chartering would produce material scale and scope economies, if any:

(1) Significant aspects of property-casualty insurance regulation are local in nature, such as responding to consumer protection needs and oversight of contractual terms in relation to substantive state law. They need to be administered locally, significantly reducing possible scale and scope economies. Efficiently dealing with policyholder complaints, for example, generally will require regulatory staff in the states where the complaints arise, thus limiting opportunities for economies of scale. Even optional federal chartering proposals (such as the ABIA and Schumer bills) propose multiple regional offices for federal regulators.

(2) Potential economies of scale in relation to the current state system are diminished by existing coordination among state regulators and the likelihood of improved coordination over time given on-going regulatory reforms. A variety of state practices in solvency regulation illustrate that coordination, including the traditional system of partial deference to the domiciliary regulator, coordination of financial exams, and joint production of early warning systems (financial analysis systems for identifying weak insurers), including a system that focuses on large, multi-state insurers.

(3) The presence of multiple state regulators for a given insurer/function need not imply wasteful duplication. Even when there is material overlap, regional oversight of insurer conduct and safety and

soundness may help efficiently assimilate information in markets with hundreds of insurers, including those with licenses in most or even all states, where information related to the safety and soundness is diffusely spread among policyholders, agents, brokers, and competing insurers.

(4) Optional federal chartering would produce some and perhaps extensive overlap of state and federal regulation of solvency and market conduct. The LaFalce bill explicitly proposes dual regulation of market conduct and unfair trade practices. If legislation required federally regulated insurers to participate in state guaranty funds, state regulators would naturally monitor federally chartered insurers that conduct business in their states. Under the more likely outcome, at least over the longer run, that optional federal chartering would produce a single federal guaranty system for federally and state chartered insurers (see below), material overlap would certainly occur. Although some overlap in solvency regulation could be efficient, it is important to dispel any naive notion that optional federal chartering would permit a sharp demarcation of state and federal authority. The dividing line between federal and state authority for solvency, rates, forms, and market conduct will necessarily be blurry.

Regarding streamlining and homogenization of regulation, complete or nearly complete uniformity is undesirable and infeasible given demographic differences across states, and more important, differences in substantive state law (e.g., motor vehicle accident reparations law and workers' compensation law) that necessitate differences in property-casualty insurance contractual terms. Ongoing state reforms can also help streamline state regulatory practices and achieve a material degree of desirable uniformity. Finally, although many observers intuit or expect that the technical quality of federal regulation would exceed that in many states, without large scale and scope economies from optional chartering, any significant increase in quality would require greater expenditures. There is no compelling evidence that the quality of state regulation is too low, or that spending a lot more money to attract, train, and retain personnel with greater talents and skills would be cost effective.

3. Federal Chartering and Regulatory Competition

Optional federal chartering might produce competition between state and federal regulation that would lead to more efficient and less intrusive regulation. As long as insurers could switch charters and regulators at relatively low cost, a competitive chartering system could discipline potential inefficiencies of either state or federal regulators.[28] In the short run, optional federal chartering could provide strong motivation for more state regulators to modernize. In the longer run, the ability of federally chartered insurers to switch back to state regulation might discourage inefficient federal regulatory practices.

Dual chartering of banks appears to have produced some beneficial regulatory competition, including motivating regulators to consider the direct costs of oversight and associated fees paid by banks.[29] Would optional federal chartering produce robust regulatory competition and associated efficiency gains in property-casualty insurance regulation? Three factors make this result doubtful.[30] First, the history of federal/state interaction in

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[28] See Scott's (1977) treatise in the context of federal/state regulation of banks. Also see American Bankers Insurance Association (2001a).

[29] State banks have thrived under dual chartering. Although, on average, considerably smaller in size than federally chartered banks, about 70 percent of all banks are state chartered, and the proportion of banks with state charters grew in the 1990s.

[30] Note also that while insurer exit in the face of expropriation by regulation will generally be slow, the threat of exit is credible enough to provide some limits on inefficient regulatory behavior, reducing the potential benefits from state/federal regulatory competition. The ability of many medium-to-large corporations to circumvent some inefficient state regulations through the use

insurance regulation suggests that *potential* competition from federal regulators already provides an important source of discipline on state regulators, thus reducing the potential benefits from *actual* federal regulation. As long as the threat of federal regulation is sufficiently credible, additional gains from increased competition with federal regulation may be modest.

Second, conditions that have produced some degree of meaningful federal/state regulatory competition in banking may not be present in insurance. Specifically, the requisite mobility between charters that is necessary for robust federal/state competition might be missing. The costs to multi-state, federally chartered insurers of switching back to a state charter and returning to state regulation in multiple states could be much larger than the associated costs for banks, even relatively large ones, to switch to a state charter. Perhaps more important, because a significant portion of the costs of switching to a federal charter would be fixed (largely invariant to insurer size), relatively small insurers might find it economically infeasible to switch, locking them into state regulation and rules and regulations that their federally chartered competitors might escape. Thus, federal chartering could become dominant and entrenched for large, multi-state insurers; many small, regional insurers would need to remain with state regulation even if they were competitively disadvantaged.

Third, and as I elaborate below, dual chartering in banking exists in the context of federal deposit insurance coverage for both federally and state chartered banks. A federal guaranty system covering all insurers could be a precondition for effective regulatory competition on other dimensions. Any benefits from increased regulatory competition would then need to be

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of self-insurance, captives, and other alternative risk transfer programs also provides some discipline on state regulatory practices that otherwise would adversely affect those companies.

assessed in relation to any disadvantages of an inclusive federal guaranty program.

4. Financial Modernization and Globalization

U.S. insurers face substantially more competition and potential competition from foreign-owned entities and other sectors as a result of increased globalization, the convergence of risk management products, and the gradual erosion of regulatory barriers between securities, banking, and insurance in the United States with the enactment of the GLB Act. Inefficient state regulatory rules might harm some insurers' ability to compete in this new environment.

State regulation of rates and especially forms can directly impede an insurer's ability to introduce new products to compete with closely related products offered by companies beyond the pale of insurance regulation. Many life-annuity insurers that compete for savings dollars with banks and other institutions emphasize this problem. It also may be of import to property-casualty insurers that seek to develop innovative risk financing programs in the presence of competition from capital market instruments and banks.

State regulatory practices that increase costs or temporarily prevent insurers from earning normal returns in some markets might conceivably create a drag on insurers' earnings and capital accumulation that could impede their ability to innovate and respond nimbly to competitors that are not similarly constrained. If so, new insurers or insurers that were affected less by such policies may be competitively advantaged because they did not incur such costs, or can avoid doing so by targeting regions and products outside the scope of state regulation, or where state regulation is relatively efficient. This possible disadvantage is most likely for large, multi-state property-casualty insurers that specialize in commercial lines and have substantial infrastructure in many states.

A principal counter-argument is that functional regulation largely obviates these concerns. As long as "insurers" face similar regulatory constraints in specific markets going forward, whether controlled by insurance holding companies, bank holding companies, or securities firms, whether domestic or foreign, there should be no material advantage for any sector or region. State insurance regulation, for example, has not demonstrably chilled entry of foreign controlled insurers into the United States. Instead, one of the major developments of the past two decades has been the significant market penetration of foreign owned insurers either through entry or merger and acquisition.

A less obvious issue is that functional regulation requires determination of whether new products constitute insurance, banking services, or securities. As was true before GLB, those determinations could involve jurisdictional conflict between the insurance, banking, and securities sectors and regulators. Some insurer representatives may fear that federally regulated entities will have an inherent advantage in those battles (which are likely to be more prevalent for life-annuity insurers than for property-casualty insurers). But it is not clear that optional federal chartering would help much. Federal insurance regulators might have much less clout than regulators of the much larger banking and securities sectors. A related concern may be that the absence of a federal insurance regulator could make it more likely that functional regulation could eventually be replaced by "umbrella" regulation (where a single regulatory agency would oversee all activities – banking, securities, insurance, and so on – of a multi-product financial institution) and/or that insurers would be disadvantaged in any transition to umbrella regulation. Functional regulation, however, appears likely to continue indefinitely.

5. Federal Chartering, Information Sharing, and Market Competition

I noted above that the costs of switching to a federal charter would likely disadvantage smaller insurers compared to their larger competitors. That outcome could reduce competition in markets where smaller insurers currently compete vigorously with much larger companies and often play an important role in making coverage widely available. In addition, and consistent with the current proposals, optional federal chartering would likely be accompanied by elimination or a substantial reduction of the limited antitrust exemption for federally chartered insurers. The integrity and value of current systems of information sharing would be undermined, even if federally chartered insurers were required to participate in various state information sharing arrangements (as is contemplated by the AIA and Schumer bills). The results would include less competition, higher costs of ratemaking, and reduced safety and soundness, with disproportionate effects on small insurers.

To be sure, court decisions have eroded the scope of the antitrust exemption over time. The widespread shift to prospective loss cost systems (as opposed to advisory rates that include expense and profit loadings) has further reduced the benefits of the exemption. Moreover, federal chartering legislation conceivably might preserve many of the remaining benefits. Even so, changes in the McCarran-Ferguson Act's antitrust exemption that most likely would accompany federal chartering will not enhance the affordability and availability of coverage. Those changes could easily tend toward higher prices, less availability, and less stability.

6. Federal Guarantees with Optional Chartering

A federal guaranty system for federally and state-chartered insurers would likely be inevitable under optional chartering, and that outcome could undermine market discipline for safety and soundness. The ABIA proposal would create separate guaranty systems for national and state insurers. That approach would increase the volatility of state guaranty fund assessments, undermining the state funds' stability and reducing their effective capacity. The eventual result would likely be the creation of a single federal system.

Requiring national insurers to participate in the guaranty systems in most if not all states in lieu of creating a federal guaranty system, as is contemplated to various degrees by the remaining proposals, also would be unstable.[31] Bifurcation of solvency oversight/regulation and guarantees of insolvent insurers' obligations would sever the responsibility for reducing the risk and magnitude of insolvencies from the responsibility for paying the unfunded claims of insolvent insurers. Federally chartered and regulated insurers could logically question why they should bear risk associated with insolvencies of insurers with a different type of charter and solvency regulation and vice versa. In addition, the future insolvency of a federally chartered insurer or a number of state chartered insurers would likely create strong criticism of any remaining differences in guaranty coverage across states and of the alleged defects of funding with ex post assessments. In either case pressure would soon mount for merging the systems, and creation of a federal guaranty system patterned after deposit insurance would be likely (as is proposed in the ABIA bill).[32]

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[31] As noted earlier, the AIA and ACLI proposals both endorse state guaranty funds. Regarding the state system, the Executive Summary of the ACLI proposal states:

> ... it is essential that a single system be in place to preserve sufficient resources within a guaranty system to adequately protect policyholders. And, since time and again the existing insurance guaranty association mechanism has proven itself to be very effective and efficient in achieving its objectives of providing protection and benefits to policyholders, maintaining it within a federal regulatory scheme assures continued achievement of these goals.

[32] Such pressure might arise in conjunction with the Reliance Group insolvency and related problems, even though federal regulation and

A federal guaranty system covering both national and state insurers would face considerable pressure to expand protection of policyholders against loss from insurer insolvency and make taxpayers countrywide bear part of the risk. Such expansion in turn might materially undermine overall incentives for safety. The records of bank / savings and loan solvency regulation and deposit insurance are not laudable in this regard. Pre-funding of a federal guaranty system could also dilute insurer pressure for effective solvency regulation.

An eventual inclusion of state chartered insurers in a federal guaranty system would be accompanied by some federal monitoring/regulation of their solvency, increasing the amount of dual regulation. If expansion of federal guarantees undermined market discipline and increased insolvency risk, more regulatory constraints on operations of both national and state insurers would likely follow. The overall result of optional federal chartering could therefore be less reliance on market discipline and more reliance on regulation.

One counter-argument to this less than sanguine assessment is that Congress will have little appetite for creating a federal guaranty system that ultimately could undermine incentives for safety and soundness and stress the federal budget, even in the face of very strong media criticism of the "patchwork quilt" of state guarantees or vivid illustrations of individual hardships "caused" by limited guarantees that promote market discipline. Another counter-argument is that, even if a federal guaranty system is inevitable, the lessons learned from deposit insurance and the "too big to fail" doctrine, from the savings and loan crisis, and from bank insolvency problems and attendant legislation requiring prompt corrective action by regulators for insolvent depository institutions will prevent any significant

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guarantees would have been unlikely to prevent and might have led to worse problems.

expansion in the scope of guarantees and attendant curtailment of market discipline.

But would the Congress be able to resist the inevitable pressure for more extensive guarantees? When criticisms of limited protection under the current system are made, the McCarran-Ferguson Act again represents a substantial barrier to federal action. That barrier will disappear under optional federal chartering. The outcome could be more risk spreading and fewer incentives for risk reduction, which in turn would lead to more regulatory controls on risk taking. The result would be more rather than less regulation.

7. Regulatory Risk, Litigation, and Transitional Costs

A decentralized state regulatory system involves less regulatory risk than a centralized system (whether optional or mandatory). Decentralization allows insurers to diversify regulatory risk. The resulting risk reduction is especially important in view of uncertainty about how to design and practice efficient regulation and possible divergence between the incentives of regulators and the efficiency goal. Regulatory mistakes tend to be localized in the state system; cautious experimentation and learning are facilitated. With greater centralization, mistakes are amplified; contagion is automatic. The risk-reducing feature of state regulation has been stressed for decades. It cannot be persuasively dismissed as unimportant. It should be weighed carefully when evaluating the potential benefits and costs of creating a new, largely untested system of federal regulation.

A transition to optional federal chartering would also involve substantial litigation and other frictional costs. Extensive and protracted litigation will likely occur on two dimensions. First, the scope of federal pre-emption of state insurance law will be litigated.[33] Second, changes in the antitrust exemption will produce litigation concerning what cooperative practices are legal for federally chartered insurers, including efficient practices permitted under current law, such as making the conditions for the sale of one type of insurance conditional on purchasing other types of coverage. Well-crafted legislation might minimize the amount of litigation, but transition/litigation costs would likely reach into the billions of dollars.

[33] Litigation over the application of ERISA and the Risk Retention Act are suggestive, as is litigation concerning federal pre-emption of state regulation of banks (see Scott, 1980).

VI. Concluding Remarks

The case for regulatory modernization through substantial deregulation of property-casualty insurance rates and many policy forms is overwhelming. Would optional federal chartering serve the public interest by promoting economically efficient (de)regulation? Answering that question is necessarily subjective. The issues are complex; information on the potential benefits and costs of different regulatory schemes is soft and inherently scarce. Nor can it be assumed that actual legislation would achieve most of any potential efficiencies, and, if so, whether it would continue to do so over time.

Insurance company executives who support federal chartering have legitimate concerns about the adverse effects of regulation in some states on their companies' abilities to grow and to serve their customers and shareholders. They may hope to exert more effective influence on federal regulators/legislators for efficient regulation than they have been able to achieve in some states. Continued, inefficient regulatory interference with their firms' legitimate product and pricing decisions is understandingly irksome; their desires for a paradigm shift are understandable. But the stakes are large and transcend the interests of individual insurers or particular segments of the property-casualty insurance industry.

The possible benefits from optional federal chartering – a reduction in inefficient regulation of rates and forms, achievement of regulatory scale and scope economies, and promotion of desirable regulatory competition – are hypothetical. They are subject to real uncertainties and are probably modest at best. The potential risks and costs of optional federal chartering are comparatively large. They include modifications in insurance guaranty funds and data sharing arrangements that would undermine safety, soundness, and healthy competition. Optional federal chartering also could ultimately produce broader restrictions on insurance pricing and underwriting, which would increase cross-subsidies among policyholders, place taxpayers at risk, and inefficiently distort policyholders' incentives to reduce the risk of loss. Optional federal chartering entails a significant risk of adverse and unexpected consequences, no matter how carefully and narrowly initial legislation is crafted. The better and more prudent policy is to reject federal chartering and encourage and support further modernization of state regulation.

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Table 1
Selected State / NAIC Regulatory Modernization Initiatives

Initiative	Objectives	Status
Deregulation of rates and forms for large commercial risks	Eliminate unnecessary rate and form filing and approval requirements	Legislation enacted in approximately half of the states
General improvements in rate and form regulation (Improvements to State-Based Systems Working Group)	Streamline and homogenize state filing and review process, expand electronic filing, promote regulatory framework that recognizes competition	Worked on revised model laws related to prior approval and competitive rating; model commercial lines regulation bill approved by NAIC
Non-resident producer licensing (NARAB Working Group)	Meet GLB provisions dealing with reciprocity for non-resident producer licensing to prevent formation of NARAB	38 states have passed NAIC Producer Licensing Model Act; state laws are being reviewed for compliance with GLB's reciprocity provisions
National treatment of selected transactions (National Treatment and Coordination Working Group)	Coordinate licensing and approval of mergers and acquisitions for multi-state insurers; move toward national treatment of qualifying insurers in other areas	Early work has focused on expanding state participation in ALERT (Accelerated Licensure, Evaluation and Review Techniques) program
Consumer protection regulation for bank insurance sales (Functional Regulation Working Group)	Preserve and clarify functional regulation of insurance to correspond with the Safe Harbors in Section 104 GLB	Developed amendments for NAIC Unfair Trade Practices Act
Interstate compact for one-stop approval of life-annuity-disability-long term care forms (Interstate Compact Working Group)	Allow prompt approval and simultaneous role out of forms nationwide under uniform standards	Introduction and revision of draft proposal

Table 2
Regulation of Federally Chartered Property-Casualty Insurers under Current Proposals for Optional Federal Chartering

Feature	American Bankers Insurance Assn. (ABIA)	American Insurance Association (AIA)	Schumer Bill	LaFalce Bill (H.R. 3677)
Federal regulatory agency	Office of the National Insurance Commissioner (within Treasury)	Federal Insurance Chartering Office (within Treasury)	Same as ABIA	Office of National Insurers (within Treasury)
Scope	All insurance and annuity contracts except state insurers and residual markets; authorizes national insurance agencies	Property-casualty insurance; no provision for agents	Similar to ABIA	All insurance except health insurance; producers licensed by state but subject to federal market conduct regulation when selling products of national insurers
Solvency	Examinations, minimum capital requirements, risk-based capital requirements, investment limitations, rehabilitation, liquidation, prompt corrective action	Examinations, minimum capital and risk-based capital requirements, investment limitations, rehabilitation and liquidation	Similar to ABIA	Similar to ABIA

Feature	American Bankers Insurance Assn. (ABIA)	American Insurance Association (AIA)	Schumer Bill	LaFalce Bill (H.R. 3766)
Guaranty system	National Insurance Guaranty Corporation for national insurers and, at their option, state insurers; funded by risk-based assessments; generally patterned after federal deposit insurance	Must participate in state guaranty funds	Must participate in state guaranty funds provided that state's fund meets minimum requirements; national plan will be used if state does not meet standards	Same as Schumer Bill
Rates	No state or federal regulation of rates	Exempt from rate regulation, including rate filing requirements, at state and federal levels	Not subject to state regulation; silent on federal regulation	National and state insurers subject to state regulation
Forms	No prior approval; forms must be filed and meet federal standards or, at the insurer's option, state law in principal place of business	No prior approval by state or federal regulators	No prior approval by state or federal regulators	Prior approval of forms for national insurers by Office of National Insurers
Residual Markets	Must participate in state programs	Must participate in state programs	Must participate in state programs	Must participate in state programs
Trade practices / market conduct	Federal standards and regulation, including prohibition of unfair discrimination	Federal standards and regulation	Similar to ABIA bill	National standards apply to all insurers; enforceable against state insurers by state regulators

Feature	American Bankers Insurance Assn. (ABIA)	American Insurance Association (AIA)	Schumer Bill	LaFalce Bill (H.R. 3766)
Antitrust exemption	None for national insurers	None for national insurers, except for policy forms and residual markets; FTC Act would not apply to national insurers	None for national insurers, except for policy forms and residual markets	Repeals exemption for all insurers, except for historical data and residual markets

Appendix

Overview of State Insurance Regulation

The insurance business is heavily regulated in the United States and most other developed countries. Each state has a state insurance department (or commission) that implements state legislation governing the purchase and sale of insurance that is set forth in the state's state insurance code. In addition to specific mandates specified in the state's insurance code, the insurance department has the authority to establish rules and procedures to implement legislative directives. The state insurance commissioner is appointed by the governor in a significant majority of states and elected in the others.

When viewed broadly, insurance regulation includes the state insurance code, its implementation by the state insurance department, and other legislation related to insurance (such as compulsory insurance requirements) governing the purchase, sale or enforcement of insurance contracts. In addition to regulation, the courts have a significant effect on contractual relations between insurers and policyholders through interpretation and enforcement of contract provisions. The major regulated activities are summarized in Table A-1.

Insurance regulation is complex because of the scope of activities that are regulated and differences in regulation across states. However, most major activities are regulated in most or all states using the same broad type of regulation, such as solvency regulation and regulation of policy forms. Additional uniformity, cooperation, and coordination of state insurance regulation are achieved by the activities of the National Association of Insurance Commissioners (NAIC). The NAIC is a voluntary organization of all state insurance commissioners that holds regular meetings to discuss insurance regulatory issues and develop model laws. (The precursor organization to the NAIC was established in 1871.)

Some coordination of state solvency regulation has been achieved by having the state insurance department in which the state is domiciled (chartered) play a leading role in certain aspects of solvency oversight, such as conducting and preparing reports based on on-site financial examinations. The NAIC plays a major role in promoting uniform financial reporting and risk-based capital requirements across states. In addition, the NAIC oversees the coordination of financial examinations of insurance companies by state regulators. In the early 1990s the NAIC developed risk-based capital requirements. It also established a solvency regulation accreditation program in 1991 that specifies minimum standards for state solvency regulation. States that adopt specified model laws related to solvency regulation and meet minimum standards for solvency monitoring are accredited by the NAIC. States that are not accredited face some risk of increased monitoring or regulation of their home (i.e., domestic) insurers by other states' insurance departments and of being known for weak regulation. Most states have been accredited.

The Evolution and Scope of State Regulatory Authority

State regulation of insurance companies and agents originated in the early 19th century with restrictions and limitations on insurer operations contained in state charters that allowed insurers to conduct business. Bills to create a federal agency to regulate insurance were introduced but not enacted by the U.S. Congress in the1860s. In 1868 the U.S. Supreme Court in *Paul v. Virginia* (75 U.S. 168) held that insurance was not commerce and therefore not subject to laws affecting interstate commerce. States, rather then the federal government, had the power to regulate insurance. This decision was upheld for approximately 75 years in other cases that argued that insurance constituted interstate commerce.

During the 1870s numerous insurers became insolvent, in part due to major fires in Boston and Chicago. These events spurred the development of insurance rating bureaus, precursor organizations to modern rate advisory organizations. The rating bureaus established property insurance rates for most insurers, in principle to ensure adequate prices and reduce insolvency risk. Many states either permitted or encouraged bureau development; some states regulated their activities or set rates for use by all companies.

The U.S. Department of Justice began an investigation of a large rating bureau known as the South-Eastern Underwriters Association in 1942. The association was indicted for alleged violations of the Sherman Act, including restraining and monopolizing commerce, fixing prices and agents' commissions, attempting to force policyholders to buy from member insurers, denying non-member insurers access to reinsurance from member insurers, and refusing to transact with agents who represented non-member insurers. A federal district court dismissed the case in view of *Paul v. Virginia*. Upon appeal, the Supreme Court, in *United States v. South-Eastern Underwriters Association* (322 U.S. 533,1944), overturned *Paul v. Virginia* by a 4 to 3 vote with two justices not voting, holding that insurance is commerce, that it is interstate commerce when it takes place across state lines, that Congress could therefore regulate insurance, and that the Sherman Antitrust Act applied to insurance. The decision did not prohibit state regulation, but it held that state laws contrary to federal law were invalid.[34]

The SEUA decision called into question the permissible scope of state regulation and taxation of insurers and the legality of industry operating procedures, especially the use of rating bureaus. Insurers and state regulators sought federal legislation to clarify these issues, and the Congress enacted the McCarran-Ferguson Act in 1945 (15 U.S.C., 1945). The law states that the continued regulation and taxation of insurance by the states is

[34] Chief Justice Stone's dissent (joined by Justice Frankfurter) argued that the Congress never intended the antitrust laws to apply to insurance. Justice Jackson agreed that insurance was commerce but rejected the majority's use of the Sherman Act to "strike down the constitutional basis of state regulation."

in the public interest. In what is often called “reverse pre-emption,” the Act states 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. However, the Sherman, Clayton, and Federal Trade Commission Acts are “applicable to the business of insurance to the extent that such business is not regulated by state law.” The Sherman Act is applicable to “any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.”

The McCarran-Ferguson Act thus had two clear implications: First, states would continue to have primary authority for insurance regulation, although the federal government could enact legislation regulating insurance if state regulation were found to be deficient. Second, rating bureau activities would not be subject to antitrust law if they were regulated by the states and did not involve boycott, coercion, or intimidation.

Most states subsequently revised their regulatory systems to provide greater oversight of rating bureau activities, typically by making property-casualty insurance rates subject to regulatory prior approval and either requiring or strongly encouraging all insurers to use bureau rates.[35] In the late 1950s, pressure for increased rate competition and legal decisions led

[35] Many states have antitrust laws that apply to insurance. A second but slower response to the McCarran-Ferguson Act was the enactment by the states of legislation dealing with unfair trade practices by insurers in order to deter application of the FTC Act to insurance. In *Federal Trade Commission v. National Casualty Co.* (357 U.S. 560, 1957), the Supreme Court rejected FTC regulation of insurer advertising. In a much later case, *FTC v. Ticor Title Insurance Co.* (112 S.Ct. 2169, 1992), the Court permitted an FTC challenge to the fixing of rates for title services. Following FTC studies of the insurance industry in the late 1970s, in 1980 the Congress exempted the business of insurance from the FTC’s investigative and reporting powers (except those related to antitrust violations). FTC studies and reports on insurance were only permitted when requested by a majority of specified congressional committees.

many states to make it easier for insurers to charge non-bureau rates. The large direct writers (insurers with exclusive agents as opposed to independent agents and brokers, such as Allstate, Nationwide, and State Farm) generally obtained approval to charge lower rates commensurate with their lower operating expenses and targeting of lower risk policyholders, thereby producing significant benefits to many policyholders. The system of uniform bureau rating gradually became an historical relic. Beginning in the mid 1960s, a significant number of states ultimately eliminated prior approval regulation, replacing their prior approval laws with competitive rating laws. Modern insurance advisory organizations now commonly file prospective loss costs with state regulators, which can then be used by insurers in their own rate filings. Numerous court decisions have narrowed the scope of the McCarran-Ferguson Act's antitrust protection by narrowing the scope of activities regarded as the "business of insurance" and by broadened the meaning of "boycott."[36]

[36] See, for example, *Group Life & Health Insurance Co. v. Royal Drug Co.* (440 U.S. 205, 1979), *St. Paul Fire & Marine v. Barry* (438 U.S. 531, 1978), and *Hartford Fire v. California* (113 S.Ct. 2891, 1993). The Court also narrowed the meaning of insurance in two key cases involving extension of federal regulation to insurance-related activities. In *SEC v. VALIC of America* (359 U.S. 65, 1959), the Court held that that variable annuities were securities and not insurance and therefore were subject to federal securities laws, including SEC regulation. In *NationsBank v. VALIC* (115 S.Ct. 810), the Court held that the fixed annuities were part of the business of banking and not insurance, thereby upholding a decision by the Comptroller of the Currency permitting national banks to sell annuities. The Court's ruling facilitated substantial expansion in bank sales of annuities. See, for example, Kimball and Heaney (1995) for detailed discussion of these and related cases. Court decisions and federal legislation have extended federal influence in a number of areas besides this brief sampling. Examples include application of the Fair Housing Act to alleged insurance redlining, RICO suits against insurers, federal authorization of risk retention and risk purchasing groups, and the complex issue of preemption under ERISA.

Divergent Trends in State Regulation

The onset of competitive rating laws in the 1960s and their later expansion reflected several influences, including (1) the gradual erosion of bureau pricing and increased administrative costs associated with multiple rate filings by numerous insurers, (2) recognition that solvency regulation obviated rate regulation’s possible role in preventing insolvencies, (3) the hope that price competition would ameliorate growing insurance affordability problems in some states.[37] Rapid claim cost growth in the 1970s caused a number of other states to eschew competitive rating and increase the intensity and scope of rate regulation in an attempt to limit rate increases. This trend continued in the 1980s, culminating in the passage of Proposition 103 in California in 1988. By then several states were already well known for substantial constraints on automobile insurance rate increases in the face of rising claim costs, as well as for limitations on underwriting and rate classification that caused premiums to diverge from expected costs for many policyholders. The 1980s also saw widespread regulatory suppression of workers’ compensation rates in the presence of rapidly rising loss costs.[38] Residual markets, though ostensibly markets of last resort, mushroomed in size and often became a vehicle for imposing binding caps on rates.

Changes in the methods and administration of rate regulation accompanied restrictive and comprehensive controls with the goal of limiting rate increases in some states. Instead of the traditional focus on the actuarial soundness of rate filings, some states adopted public utility style rate of return regulation, including in some cases limits on the amounts and types of expenses that could be incorporated in rate filings. A few states restricted insurer exit in response to regulatory rate suppression, by requiring

[37] See, for example, Hanson, Dineen, and Johnson (1974).

[38] See, for example, my 1998 book with Patricia Danzon (Danzon and Harrington, 1998).

an insurer to exit all lines in the state if it exited a given regulated line, by permitting only gradual withdrawal, or by levying exit fees to fund future residual market deficits or guaranty fund assessments.[39]

Large catastrophe losses from hurricanes and earthquakes in the 1990s led to expanded state intervention in the pricing and underwriting of homeowners insurance, including constraints on non-renewals and insurer withdrawals. As discussed in the main body of this paper, however, there has been some trend towards deregulation or less invasive regulation of rates in other property-casualty lines. Loss trends for auto insurance improved substantially beginning in the early 1990s, which reduced public pressure for using rate regulation in an attempt to lower rates. Favorable cost trends also occurred in workers' compensation insurance. During the early 1990s many states modified their systems of voluntary and residual market rate regulation to permit higher rates and provide greater incentives for loss control to employers and workers' compensation insurers. Some states substantially deregulated workers' compensation insurance rates for the voluntary market. Those changes were followed by substantial reductions in the size of workers' compensation insurance residual markets. During 1998-2001, nearly half of the states eliminated prior approval requirements for rates and/or policy forms for large commercial policyholders, and a number of other states considered that change.

Federal/State Interaction

The Congress has exerted substantial pressure on state regulators to change regulatory practices by periodically threatening to adopt some form of federal regulation. This section highlights several episodes that illustrate

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[39] See Epstein (1999) for detailed discussion of lock-in provisions and their legality.

the interplay between proposed federal regulation and state responses. Table A-2 summarizes federal-state interaction since the 1940s.

Development of State Guaranty Funds. Property-casualty insurance company insolvencies received considerable attention in the late 1960s. Many of the insolvent insurers had specialized in non-standard auto liability insurance (i.e., liability coverage for high-risk and/or relatively low-income policyholders). These insolvencies produced criticism of state regulation and a congressional proposal for a federal guaranty system patterned after deposit insurance. State regulators responded in several ways. The National Association of Insurance Commissioners (NAIC) adopted model legislation for state guaranty funds during 1969-1970. The state guaranty fund system for property-casualty insurance expanded rapidly in the 1970s; guaranty fund growth was slower for life-health insurers. In both cases, most states eventually passed legislation that is identical or substantially similar to the model legislation. The NAIC also developed an early warning system for the detection of financially weak insurers by state regulators (the Insurance Regulatory Information System), which was implemented in 1974.

The 1960s insolvencies and a subsequent increase in property-casualty insurer failures in the mid 1970s also influenced Senator Edward Brooke (R-Mass.) to propose a system of dual federal / state regulation that would have allowed optional federal chartering and regulation of insurers with full preemption of state regulation.[40] It also would have created a federal guaranty fund analogous to deposit insurance.

Insurance Affordability and the Liability Insurance Crisis. Rapid growth in property-casualty insurance rates during the mid 1980s and early 1990s increased support for modifying or eliminating the limited antitrust exemption for the business of insurance. Real auto and workers'

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[40] S.3884, Federal Insurance Act, introduced October 1976.

compensation insurance rates grew rapidly in conjunction with rapid growth in claim costs. The hard liability insurance market in the mid 1980s produced sharp increases in commercial liability insurance rates and premiums following a period of declining premiums and worsening insurer operating margins during the early 1980s.

Some observers argued that the exemption facilitated collusion to increase prices, especially during the liability insurance crisis. Although those arguments were inconsistent with the evidence, the development of advisory rates and policy forms by the Insurance Services Office (ISO) and to a lesser extent the National Council on Compensation Insurance became controversial. Pressure mounted for modifying the exemption, and the attorneys general of nearly twenty states filed a federal antitrust suit against the ISO, the Reinsurance Association of America, and a number of other domestic and alien insurers and reinsurers, alleging illegal activity in the introduction of a new standard general liability insurance contract in the mid 1980s.[41]

State regulators responded in two main ways. First, in 1989 an NAIC committee proposed prohibiting the promulgation by rate service organizations of advisory rates that included expense and profit loadings. The ISO in effect complied voluntarily, instead disseminating only developed and trended loss costs. Second, a number of states switched to loss cost systems and/or prohibited the use of advisory rates or loss costs in rate filings by insurers with market shares above specified thresholds.

Representative Jack Brooks (D-Texas) and Senator Howard Metzenbaum (D-Ohio) eventually proposed bills to substantially eliminate the exemption. The Brooks bill would have amended the McCarran-Ferguson Act to eliminate the antitrust exemption except for specified safe

[41] The suit settled after the Supreme Court refused to dismiss the case, ruling inter alia in 1993 that some of the alleged activities would constitute a boycott if proved true.

harbors, including conduct involving historical loss data and loss development, standard policy forms, and risk pools that historically provided underwriting capacity.[42] Pressure for modifying the exemption waned as premium growth abated and the key advocates left the Congress.

Insolvency Problems in the Late 1980s and Early 1990s. The early 1990s saw another challenge to state regulation in response to increases in the frequency and severity of insurance company insolvencies and associated guaranty fund payments that began in the mid 1980s. The largest property-casualty insurer insolvency (Mission Insurance Group in 1987) until the insolvency or Reliance Insurance Group in 2001 ranked among the top 10 insurers in workers' compensation insurance premiums prior to its insolvency and required guaranty fund assessments of nearly $500 million. Several other property-casualty insolvencies required assessments of at least $250 million. Several relatively large life insurers failed in 1991, including two insurer groups that ranked in the top 25 in terms of assets (Executive Life and Mutual Benefit Life). Guaranty fund assessments for Executive Life totaled $2.1 billion, over five times greater than for any other life-health insurer insolvency.[43]

A 1990 report, *Failed Promises*, based on hearings held by Representative John Dingell of Michigan, contained a scathing indictment of alleged defects in state solvency regulation. The General Accounting Office also issued several reports that were highly critical of state solvency regulation. In 1993 Representative Dingle introduce a bill that would have created a dual system of state and federal solvency regulation.[44] Specifically, the bill would:

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[42] H.R.9, the Insurance Competitive Pricing Act of 1994, reported to the House in October 1994.

[43] Assessments for Mutual Benefit Life totaled just $81 million.

[44] H.R. 1290, the Federal Insurance Solvency Act of 1993.

1. Create a Federal Insurance Solvency Commission (FISC) to establish preemptive federal standards for state solvency regulation.

2. Allow insurers to become federally "certified" and subject to solvency regulation by the FISC rather than the states.

3. Make reinsurers subject to FISC regulation.

4. Create a pre-funded federal guaranty system for federally certified insurers.

5. Exempt highly capitalized, commercial lines insurers with federal certification from state regulation of rates, forms, and unfair trade and settlement practices.

6. Establish a uniform system for multi-state licensing of agents and brokers.

The Dingell bill was criticized on a variety of accounts, including the proposed federal guaranty system and bifurcation of solvency and rate regulation. Moreover, a variety of factors apart from possible regulatory failure contributed to insurer insolvencies during the late 1980s and early 1990s. Many property-casualty insurers that failed wrote large amounts of business liability insurance that produced much higher claim costs than the insurers originally reported on their financial statements. A large component of the increase in claim costs was probably unexpected in many cases. Some property-casualty insurer insolvencies were influenced by intense competition that characterized the soft market for business liability insurance during the early 1980s.

The increase in the frequency of life-health insurer insolvencies that began in the mid 1980s was due in part to small health insurers that experienced large claim costs in relation to premiums and the claim liabilities that they originally reported. The insolvency of several large life insurance companies in 1991 was more consequential and accounted for much of the increase in guaranty fund assessments. The large life insurer insolvencies primarily reflected reductions in the value of assets held, including Executive Life, which had invested heavily in high yield bonds. The more widespread problem was reduced real estate values, which, for example, precipitated the insolvency of Mutual Benefit Life.

The insolvencies of Executive Life, Mutual Benefit Life, and a few other insurers were preceded by substantial cash withdrawals by life insurance and annuity policyholders who had become concerned with the safety of their funds. No other large insurer failed in 1991, and asset values subsequently rebounded in many cases, which, along with the raising of new capital, significantly strengthened the capital of the industry.[45] Policyholder withdrawals of funds during 1990 and 1991 primarily occurred for weak companies, as opposed to reflecting irrational panic and contagion that adversely affected strong insurers.[46] The resulting flight to quality provided additional incentives for insurers to increase their capital and reduce risk.

State regulators took numerous actions to strengthen solvency regulation. Perhaps most important, the NAIC developed and implemented risk-based capital requirements, which followed that step in banking regulation. The NAIC also adopted its solvency regulation accreditation program, which led many states to change their solvency laws and regulation to comply with the standards promulgated by the NAIC. Support for federal

[45] Some evidence suggests that because of the rebound in high yield bond prices that occurred in 1991, Executive Life might have been solvent if it could have survived until year-end. The corporation that succeeded Mutual Benefit Life and that was supervised by New Jersey regulators was in good enough financial shape to be offered for sale to the private sector in 1997. Whether some regulators took action against some insurers prematurely or made statements that unduly frightened policyholders and contributed to the insolvency of others is subject to debate.

[46] See Fenn and Cole (1994).

intervention waned in conjunction with changes that were made in state regulation and as insolvency experience improved.

Table A-1
Overview of Regulated Activities

Activity	Description	Principal Types of Coverage and Prevalence Across States
Licensing of insurers and agents / brokers	Granting, renewal, and revocation of license to conduct business by state insurance departments	All types of coverage and states
Insurer solvency	Solvency monitoring by state insurance departments, capital and financial reporting requirements, investment regulations, holding company regulation, guaranty funds	All types of coverage and states
Rates	Prior approval of rate changes and regulation of rate differentials across policyholders by state insurance departments for the voluntary market	• Workers' compensation rates in about 80 percent of the states • Personal auto, homeowners and other business property-liability insurance rates in about half of the states • Individual and small group health insurance in some states • Credit life and health insurance in some states
Residual markets	Industry must supply coverage through residual market at a regulated rate to applicants who have difficulty obtaining it voluntarily, such as an assigned risk plan or joint underwriting association	• Personal automobile in all states • Workers' compensation in all states • Urban and coastal property insurance in some states • Individual health insurance in some states
Content of policy forms	Regulation of contract language (including provisions governing cancellation and non-renewal) and approval of forms by state insurance departments	Most types of coverage in all states (except, in about half the states, policies covering large commercial risks)
Contract interpretation and enforcement	State insurance department enforcement of legislation dealing with market conduct and unfair trade practices	Most types of coverage in all states
Insurer sales practices and information disclosure	Regulation of sales practices through state insurance department enforcement of market conduct / unfair trade practices legislation; required disclosure of price information; production and dissemination of information about prices and quality by regulators	Mainly for personal insurance in most states

Activity	Description	Principal Types of Coverage and Prevalence Across States
Compulsory purchase of coverage (or minimum requirements for self-insurance)	Compulsory insurance laws and their enforcement by the states	• Personal auto liability in almost all states • Automobile personal injury protection coverage in most no-fault states • Workers' compensation insurance • Miscellaneous type of business and professional liability insurance in most states

Table A-2

Federal-State Interaction in Insurance Regulation Since the Mid-20th Century

Period	Issue	Proposed Federal Actions	Major State Actions
1940s	Application of federal antitrust law to insurance	Enactment of McCarran-Ferguson Act in 1945 with limited antitrust exemption following SEUA decision	Broad adoption of prior approval regulation
Late 1960s - 1970s	Efficacy of state solvency regulation	Proposed federal regulation, including federal guaranty system	Creation of state guaranty funds; improved monitoring, including early warning system
1980s	Liability insurance crisis and cost surges in auto and workers' compensation insurance	Proposed modifications or elimination of limited antitrust exemption	Broad adoption of advisory loss cost systems instead of advisory rates
Late 1980s - early 1990s	Increased frequency and severity of property-casualty and life-health insurer insolvencies	Proposed optional federal chartering to include federal guaranty system and minimum standards for state regulation	Adoption of risk-based capital requirements and NAIC solvency regulation certification program
Late 1990s - present	Modernization of rate, form, and market conduct regulation	Major proposals for optional federal chartering (see Table 2)	Initiatives to comply with GLB requirements and modernize state regulation; deregulation of rates and/or form regulation for large commercial policyholders in many states (see Table 1)

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