

OPTIONAL FEDERAL CHARTERING OF INSURANCE COMPANIES; A COMPILATION AND OVERVIEW OF RECENT POLICY CONSIDERATION ARGUMENTS

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During June 2002, the House Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, held three days of hearings entitled “Insurance Regulation and Competition for the 21st Century.”¹ The hearings were called to assess the advisability and desirability of reform in the national marketing of insurance products. While the subcommittee did not have a specific purpose in mind for the hearings, it assumed that some regulatory reform is needed to allow regulated financial institutions to market products that are not called “insurance,” but, in effect, are insurance and not be subject to the 50-state review process.² This article presents many of the competing arguments specifically addressing Federal Insurance Chartering that were submitted in testimony to the subcommittee.³

Most, if not all, of those testifying on this topic agreed that reform of the current system is called for. The burden of complying with the individual regulatory requirements of each state is perceived as too great and in need of modification. Clearly then the issue is how to accomplish this goal.

The Case for Optional Federal Insurance Chartering

The proponents of federal chartering believe the current state-by-state regulatory system is unable to keep pace with the rapid changes taking place in the insurance industry. Advances in technology, convergences in the financial services industry, globalization of the insurance market and even the terrorist attack of September 11 drastically changed the operating environment for insurers. The inability of state regulators to keep up with these changes, in turn results in a competitive disadvantage, especially for insurers in direct competition with commercial banks, brokerage firms or mutual funds.

Comparisons to the banking system are irresistible for proponents of federal chartering as banks exist with both a federal and state chartering system; and proponents of federal chartering present the dual charter for banks as a model for insurance industry regulatory reform. The federal chartering proponents argue that the Gramm-Leach-Bliley Financial Modernization Act changed the rules of competition for insurers, banks, and securities firms and a federal charter for insurance entities would facilitate the level regulatory playing field that is essential for insurers competing in this new environment. For example, proponents allege that in many instances, a bank may introduce a new product immediately without any action by their regulator, and securities firms can typically bring new products to market within 90 days. Some insurers claim however, they at times have to wait more than a year to secure all the required state approvals necessary to offer a new product nationwide.

The costs of complying with the regulations in each state is also a factor proponents point to in support of the federal charter option. Companies state they are required to maintain complex corporate structures to accommodate the unique and diverse regulatory regimes of the various states. Furthermore, the proponents point out that the costs associated with filing and complying with each states’ rules are unnecessarily duplicative and consumers ultimately end up shouldering the burden for these increased administrative costs. Additionally, the proponents note, consumers have less choice of products due to required prior approval. In the current system, there is less competition due to entry, exit, price, and product approval barriers that have been erected in numerous states. A free market based regulatory framework, the proponents argue, would make product design and pricing more competitive which would in turn benefit consumers. The result, they assert, is that under the current system consumers pay more for less adequate risk protection than would be the case under a more dynamic regulatory framework.

The proponents admit, however, that the states are gradually pursuing a number of insurance reform initiatives. However, the proponents maintain that only Congress can bring consistent and lasting improvements to the

regulation of insurance because even when states adopt favorable regulatory modifications, a new legislature or regulator can easily erase this progress by overturning the changes.

The apparent solution for the many problems alleged by the proponents is optional federal chartering. Under the optional federal charting model, a uniform regulatory body would streamline the process of bringing new products to market on a nationwide basis. A centralized regulatory system would have the tools to deal with major complex issues with far-reaching financial implications, such as terrorism, natural catastrophes, fraud, and asbestos litigation. Under this proposed model, a state-based regulatory approach, appropriate for companies that operate on a single-state or regional basis, would still be available. However, national and international companies as well as their customers would be allowed to choose the regulatory approach that they find most suitable for their size and scope of operations, such as federal chartering. Proponents of the optional federal chartering model emphasize that the a federal charter is an “option,” companies that do a local business or that for other reasons would prefer to remain exclusively regulated by the states are perfectly free to do so.

In addition, under the optional federal chartering proposal, consumers who deal with national insurers may very well enjoy significant added protections and benefits over those afforded by the states. Consumers will be able to take advantage of uniform protections nationwide and the same availability of products and services in all 50 states. Consumers will also benefit from the direct attention of a federal regulator on consumer issues of national importance. Finally, consumers would be assured that an insurance product purchased in one state would travel with them intact to a new state.

Those in favor of federal chartering argue that federal expertise and oversight with respect to insurance is a critical and missing component in the support and maintenance of a strong national economy. Further, the change would have favorable international consequences. As the financial services marketplace becomes more global, the United States cannot claim that foreign markets need to be more open, while the domestic market is still so complicated with its hodgepodge of state regulations. Proponents believes that competitiveness in the international insurance market can only be achieved through a central federal regulatory body with a one stop set of regulations that ensure adequate consumer protections and solvency oversight. It is argued that consumers cannot be adequately protected if insurers are subjected to conflicting requirements at the international, federal, and state levels.

In sum, federal chartering proponents believe that all consumers would benefit from more product availability and mobility, uniform policies, increased competition and greater product choice if federal chartering was adopted for the insurance industry. Federal chartering proponents assert that a federal agency would provide more standardized, consistent and comprehensive regulation for larger insurers and insurance agencies.

The Case for State Regulation

The arguments against a federal chartering option also inevitably emphasize the consumer impacts. Those opposed to the federal chartering option believe that state regulation is more pro-consumer for a variety of reasons. They maintain that, from a consumer’s perspective, the state system of regulation has performed very well. The system has proven to be adaptable, accessible, and relatively efficient, with rare insolvencies and no taxpayer bailouts and that the proposals for federal and dual charters offer few advantages for consumers.

Insurance, opponents of federal chartering point out, is essentially a local product and consumers in different states have different needs. Opponents doubt the proponents’ claims that if federal chartering were to be adopted, consumers will be well served by a federal bureaucracy. Instead, they argue that a clear advantage to consumers in the state system is the accessibility of state regulators. Experience indicates that it is more difficult to contact and receive assistance with a regulatory dispute from a federal office.

Opponents of a dual system contend that the best qualities of a state system including responsiveness, diversity and innovation would be lost in a federal or national model of insurance regulation. A national regulatory model calls for a single set of rules applying equally across all states and all insurance markets. Opponents argue that it is inconceivable how such a system could function in connection with the diversity of states’ underlying laws and

differing consumer expectations regarding the role of insurance regulation. For example, state regulators are more responsive to market disturbances in individual states caused by local occurrences such as destructive storms than a federal agency would be. Additionally, state regulators, who are familiar with their state's judicial interpretations of governing laws, are in a better position to assess insurers' market conduct.

Moreover, opponents allege, a federal regulatory system would be unable to address the policy nuances of individual states' tort and contract laws. Both property and casualty insurance products and the state regulatory systems reflect the differences in state laws relating to tort liability-injury compensation rules, contract standards, motorist obligations, the role of government, and also, local variances in social and economic values. Citizens of each state often have different views about responsibility and compensation and insurance products are designed and priced differently in each state due to such differences. Opponents argue that federally licensed insurers would still have to tailor products to accommodate each state's tort laws.

In general, opponents argue against the desirability of federal intervention in the insurance marketplace for many reasons. Rather than simplifying the regulatory system, opponents assert that a federal or dual charter would instead unnecessarily add complexity to the current system by creating another regulatory layer. Opponents point out that there is no certainty that a federal regulator would be the "only" regulator for even the largest insurance companies. Furthermore, the consequences of a regulatory mishap would be far more widespread if a single national regulator makes a mistake unlike when a state regulator makes a mistake because then the damage is localized and can be more easily remedied.

At its best, opponents argue, state insurance regulation is adaptable to changing notions of public policy or to competitive pressures of the industry. Contrary to the proponents' arguments, a federal system would be slower, not quicker, to respond to issues of immediate importance. This would be particularly true in the case of company licensing, financial regulation, corporate governance, and rate and form filing efficiency. Such changes can be made at the state level without extensive statutory changes.

Instead of reducing costs to consumers, the state regulation supporters argue that a dual system will impact consumers with increased costs. This, the opponents assert, is because states currently derive significant income from premium taxes, which exceed the cost of regulation. A federal regulatory entity would have to be funded either directly from the federal budget, or from fees assessed to insurers. Consumers will have to pay for two systems because taxes and fees are passed on to them, unless the states give up premium tax revenue. Costs and bureaucracy will inevitably increase under a federal framework. Experience shows that federal regulation has a tradition of creating expensive and inefficient government institutions.

State regulation supporters contend that the proponents' reliance on the banking system as a model for dual regulatory systems is additionally misplaced. Banking, it is argued, is an entirely different business than insurance. Banking's ties to the nation's monetary system and the economy provide a compelling justification and historical basis for federal oversight. There is however no such justification for a federal role in insurance oversight.

Additionally, there is the assertion that optional federal chartering would not be an "option" at all. Opponents state that a federal charter may be optional for an insurer choosing it, but the negative impact of federally regulated insurers will not be optional for state chartered insurers, consumers, state government, and local taxpayers who are affected. They argue that an unlevel playing field will exist between those insurers who opt for federal regulation and those whose insurance activities continue to be regulated by the states. The separate and uncoordinated systems of regulation will mean no equality in the constraints competing insurers contend with as a result of regulatory oversight. Furthermore, separate and competing systems of rate and form regulation, underwriting requirements, market conduct regulation, insolvency requirements, and other critical aspects of insurance regulation will result in an unfair and anti-competitive market.

Ultimately, two separate insurance systems operating in each state will result. One would be the current department of insurance established and operated under state law and government supervision. State regulatory supporters maintain that this system will continue responding directly to state voters and taxpayers. The second would be a new federal regulator with the power to preempt state laws and authorities that conflict with federal laws governing

policyholders and claimants of federally chartered insurers. The dual system will likely result in litigation generated by the resulting market and regulatory confusion.

Moreover, opponents argue, dual regulation would produce an unfair environment for the thousands of smaller companies, and create regulatory competition that has often produced poor policy in financial institution regulation. Proposals for optional federal charters would alter the McCarran-Ferguson Act antitrust safe harbor provisions that currently allow data sharing. This would also weaken state data reporting mandates. An optional federal charter system that precludes, restricts, or even discourages the production of advisory loss costs and supplementary rating information could seriously undermine competition and place smaller and regional organizations at a disadvantage. It is argued that the inability of small companies and regional market firms to access needed data could significantly impair their ability to compete.

Finally, the opponents of federal chartering strongly contend that current efforts at market reform at the state level should be given time to work. For example, the new balance compelled by Gramm-Leach-Bliley continues to evolve. Additional changes such as adoption of the Uniform Certificate of Authority Application show progress in bringing more uniformity to the company licensing process. Currently, there is no major impetus, such as convergence of the financial services industry, to further change the balance between federal and state regulation. Change without need could destabilize a system that has historically worked so well. The opponents admit that the state process may take more effort, however, under the state system consumers in each state retain control over important aspects of insurance and claims procedures that affect their financial security in the communities where they live.

Conclusion

Even those that support the state regulatory system agree that there is room for improvement. Current regulatory systems in some states cause delays in introduction of new products and slow rate approvals; in other states, the market withdrawal process is both punitive and bureaucratic. Financial and market conduct examinations are often disjointed and inefficient, and suffer from a lack of coordination. Both opponents and proponents stress that these areas of state regulation must be updated, simplified, and greater uniformity must be achieved among the states.

Endnotes

1. Hearings were held on June 4, 11, and 18, 2002.
2. *See*, Opening comments of the Hon. Richard H. Baker, Tuesday June 4, 2002.
3. *See generally*, printed hearings of the 107th Congress, accessible on the House Committee on Financial Service's website at <http://financialservices.house.gov/hearings.asp?formmode=printed&congress=8>. In drafting this article the authors reviewed and summarized selected portions of the prepared testimony presented to the Subcommittee by: *Mr. Wayne White*, President & Chairman, Home Mutual Fire Insurance Company, on behalf of the National Association of Mutual Insurance Companies; *Mr. Steve Bartlett*, President, Financial Services Roundtable; *Ms. Ann W. Spragens*, Senior Vice President and General Counsel, The Alliance of American Insurers; *The Honorable Mark Young*, Vermont State Representative, on behalf of the National Conference of Insurance Legislators; *Mr. Michael D. Phillipus*, Vice President of Communications and External Affairs, Risk and Insurance Management Society; *Mr. Steven J. Harter*, President, National Association of Professional Insurance Agents; *Joseph J. Gasper*, President & Chief Operating Officer, Nationwide; Chairman, American Council of Life Insurers; *Tony Nicely*, Chairman, President & CEO, Geico Insurance Companies; Chairman, National Association of Independent Insurers; *Donald A. Young*, President, Health Insurance Association of America; *Robert P. Restrepo, Jr.*, President & CEO, Allmerica Property & Casualty Companies; Chairman-elect, American Insurance Association; *Paul Mattered*, Senior Vice President & Chief Public Affairs Officer, Liberty Mutual Group on behalf of Liberty International; *Franklin W. Nutter*, President, Reinsurance Association of America; *Terri Vaughan*, President, National Association of Insurance Commissioners; *Tom Ahart*, President, Independent Insurance Agents and Brokers of America; *Glenn J. Milesko*, President & CEO, Banc One Insurance Services Corporation on behalf of the American Bankers Insurance Association and the Financial

Services Coordinating Council; *John Van Osdall*, Chairman, Council of Insurance Agents and Brokers; *Scott A. Gilliam*, Director of Government Relations, Cincinnati Insurance Companies; *Hans Sternberg*, Chairman & CEO, Starmount Life Insurance Company; *Wayne E. McOwen*, Vice President of External Affairs, Guard Financial Group; American International Group, Inc. (statement for the record); American Land Title Association (statement for the record); General Accounting Office (GAO) (statement for the record); and, National Association of Insurance and Financial Advisors.