MODERNIZING PROPERTY/CASUALTY INSURANCE REGULATION

WHAT'S AT STAKE FOR AMERICA'S FARM MUTUAL INSURANCE COMPANIES?

THE NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES
The National Association of Mutual Insurance Companies (NAMIC) is a full-service national trade association with more than 1,300 member companies that underwrite 40 percent ($123 billion) of the property/casualty insurance premium written in the United States. NAMIC's membership includes five of the 10 largest property/casualty carriers, every size regional and national property/casualty insurer and hundreds of farm mutual insurance companies. NAMIC benefits member companies through government relations, public affairs, education, arbitration services, professional liability insurance and employee benefit programs.

PREFACE

We are at the beginning of a long and vigorous debate over how the property/casualty insurance industry will be regulated in the future and whether a new federal charter should be established.

NAMIC recently released a public policy paper that addresses the future of insurance regulation. The paper, *Regulation of Property/Casualty Insurance: The Road to Reform*, concludes that a reformed system of state insurance regulation is superior to an unproven new system of federal regulation crafted in a problematic political environment.

Many of NAMIC's farm mutual members may wonder what this debate has to do with them. Issues like "speed to market" for new products and "uniformity" in regulation among states are generally not the concerns of farm mutuals. As a result, farm mutual managers and directors may assume that the proposed solutions for these large company problems will not affect them. In NAMIC's view, this is not a safe assumption.

This paper builds upon the research and conclusions of the public policy paper, but it is specifically targeted to the needs and concerns of the farm mutual insurance company. We encourage you to read the longer paper for the complete public policy arguments for reformed state regulation and against a new federal regulatory charter.

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A Brief History of Farm Mutual Insurance Companies and Their Regulation
America's farm mutual insurance companies are one of the great business success stories of the nineteenth and twentieth centuries. This year we celebrate the 250th anniversary of the founding of the Philadelphia Contributionship, the first successful mutual insurance company in America. A century after the founding of the Contributionship, mutual insurance had spread to cities and towns far beyond its roots in Philadelphia and on the East Coast. Most rural families, however, were still not served by an insurance company.[1]

The late nineteenth century was a time of great growth and expansion for America, with millions of people moving westward to take advantage of the availability of land. In the last few decades of the 1800s, more land was brought under cultivation than in the entire previous history of the United States. The huge increase in rural wealth, from $4 billion in 1850 to $16 billion in 1890, created a great need for fire insurance that would protect farm property.

Insurance for rural risks was not readily available to farmers of this period. Insurance was traditionally an urban institution, and the companies that wrote town business were not interested in writing farm risks. When stock companies did agree to write farm risks, the premiums were so high that most farmers could not afford the insurance.

Over time, however, farming communities sprang up to serve the needs of local farmers and mutual insurance once again proved its adaptability as farmers sought solutions to their growing need to protect their property. These companies became known as farm mutuals, and hundreds of them were organized between 1850 and 1900. Many of these early companies survived, and more than 700 of them are active NAMIC members today.

Traditionally, farm mutuals have been lightly regulated by state insurance departments. Insurance policymakers in most states have appropriately considered the conventionally strong balance sheets and surplus levels, the accessibility to the public in the rural counties that they serve, and the long tradition of service in their markets in determining that farm mutuals require less regulation than do other insurance companies

Most public policy issues related to farm mutuals have centered on questions of taxation rather than regulatory oversight. With NAMIC's help, the federal government has recognized the special role of farm mutuals and has allowed certain tax advantages to companies and their policyholders. Today's issue is small company tax exemption legislation that would amend the Internal Revenue Code, expanding the tax exemption for small farm mutual insurance companies, and indexing it for inflation in the future. Going back to the early part of the twentieth century, policy discussions of whether farm mutuals should pay any income tax, the repeal of insurance premium tax for mutual companies in the Revenue Act of 1921, and battles to defeat anti-mutual tax proposals in the 1960s and 70s are examples of tax policy that have touched farm mutuals.

[1] A Century of Commitment 1895-1995, The History of the National Association of Mutual Insurance Companies, Harold W. Walters (1994)

Why Must We Debate Insurance Regulation Now?
Several trends have brought the modernization of insurance regulation to the national stage. In addition, some have observed that we are beginning a new era of post-Enron/Arthur Andersen re-examination of business, regulation and government. Policymakers' view of appropriate regulatory reforms for insurance will be colored by this expensive debacle and related regulatory failure.

The following trends are driving insurance regulatory modernization and the consideration of a new federal charter.

First is the convergence of financial services — banking, insurance and securities — that was recognized and approved in the Gramm-Leach-Bliley Financial Services Modernization Act of 1999 (GLBA). While few companies have taken advantage of the law's new structure and created a "financial services holding company," the law did fuel the perception that insurance is part of one large financial services industry and no longer a stand-alone unit. As a result, when Congress examines regulation of the global businesses that comprise financial services, insurance stands out as the only business regulated primarily at the state level. As such, it is the only financial services industry outside the oversight of a federal regulatory system that is accountable to Congress.

Second, there has been measurable cross-pollination of banking and insurance. With an established stake in the insurance business, banks are now viewed as legitimate players in insurance regulatory policy. As an industry, banks are very comfortable with consistent, uniform and centralized *federal* regulation. As opponents of the insurance industry on many policy issues over the years, they have been frustrated by the "state to state" combat required to make wholesale change in insurance law and regulation. As a result, banks have become engaged in the insurance regulatory debate. Their primary insurance lobbying organization, the American Bankers Insurance Association (ABIA), was established to promote a policymaking agenda that centers on creating a centralized federal insurance regulator consistent with the type of regulation banks are accustomed to.

Third, large insurance companies – particularly large life insurance companies who face competition from banks on products like annuities – are legitimately frustrated by state insurance regulation that is often slow, inconsistent and arbitrary. NAMIC and others in the insurance regulatory community are aggressively promoting solutions to these problems.

- "Slow" is being addressed by initiatives known as "Speed to Market," which would permit open competition in the design of insurance products and prices. Regulatory pre-approval would no longer be required for most products and rates.
- "Inconsistent" has to do with the balkanized insurance regulatory system that has different requirements in every state jurisdiction. Certain national standards in financial and market regulation as well as improvements in the company licensing process are the proposed fixes for this problem.
- "Arbitrary" is a word often used to describe the insurance regulatory approach to market conduct by insurance companies. Today, market conduct examinations

> are often conducted without any evidence that a company has treated policyholders illegally or unfairly. Companies end up paying large fines for technical violations. Reforms in this area would include the creation of a more rational "market surveillance" system that operates under the premise that most insurance companies are in business to treat their customers fairly.

Most insurance regulators and state policymakers have recognized these challenges. Two positive forces are 1) the reform-minded leadership now in place at the National Association of Insurance Commissioners (NAIC) and National Conference of Insurance Legislators (NCOIL), and 2) the newly formed National Conference of State Legislatures (NCSL) Task Force to Streamline and Simplify Insurance Regulation.

However, recognizing the need for change and making the changes are two different matters. NAMIC has a strategy for accomplishing the needed reforms in state regulation and its Regulatory Affairs Department is devoting substantial resources to getting these needed reforms accomplished.

What's At Stake for the Farm Mutual Companies?
Any wholesale re-evaluation of insurance undertaken to create "optimum" regulation for the industry will almost certainly create regulatory and business changes for farm mutual insurance companies.

More Regulation: Whether Needed or Not
In most states, farm mutuals operate under a legal code that is separate from property/casualty insurers. While regulation varies from state-to-state, farm mutuals have fewer regulatory requirements than do their property/casualty insurance company brethren.

Farm mutuals are generally required to file an annual statement with the state department of insurance, pay an annual filing fee, and are subject to examination by the department. Traditionally, few states have regularly examined farm mutuals, though on-site exams have taken place with greater frequency in the past few years.

Contrast this with non-farm mutual property/casualty insurance companies. Examinations by insurance department officials occur routinely, and insurance departments perform on-site examinations as they deem necessary. All companies are required to file quarterly and annual financial reports in all states where they conduct business. Further, all companies are required to file an annual statement audited by an independent accounting firm and have their claims reserves certified by an independent actuary.

Though it would be unnecessary and even harmful to subject farm mutuals to regulation similar to property/casualty insurance companies, it is likely that this would be one outcome of a new federal/state insurance regulatory system.

The following scenarios consider various factors that could affect farm mutuals in the post-regulatory reform world:

A New "Optional" Federal Regulator

Several bills now in Congress – and supported by the American Insurance Association (AIA), American Council of Life Insurance (ACLI) and the ABIA – would establish a new federal regulator for insurance. These organizations submit that the attractiveness of their "optional" federal charter is that it is purely voluntary – companies that choose to remain in the state system can do so with no changes to their business or regulation.

NAMIC maintains that even if the optional federal charter were accomplished for the 200 largest property/casualty insurance companies that do business in all 51 jurisdictions, it would leave thousands of other smaller insurers – including farm mutuals – locked into a complex, multi-layered, unreformed system of regulation.

Regulation of state chartered banks in the United States is a corollary for how farm mutuals may be treated if a new federal insurance regulator is created.

State chartered banks must comply with regulation by their primary state regulator, but at least one and often two additional federal regulators are also charged with oversight of their business. As the backstop for insolvent banks and thrifts, the Federal Deposit Insurance Corporation (FDIC) regulates all state chartered banks for solvency. In addition, many state chartered banks are regulated indirectly by the Federal Reserve's oversight of their bank holding companies.

Even prior to the FDIC's more active regulatory oversight of state chartered banks prompted by the S&L scandal of the 1980s, state chartered banks have always been affected by federal regulation as a result of business competition and charter inconsistencies with federally chartered banks.

A recent example familiar to the insurance industry was the decision by the Office of the Comptroller of the Currency (OCC) – the national bank regulator – to allow national banks to sell insurance. The U.S. Supreme Court[2] upheld this aggressive interpretation of the National Bank Act, and state legislatures and regulators were forced to respond on behalf of state chartered banks adversely affected by the new powers given to their competitors.

This charter competition is driven by a bank's ability to "flip" charters when it is determined that the other charter offers greater benefits, and recognizes the reality that banks with different charters compete for the same business in the marketplace. A similar charter competition may exist under a dual system of insurance regulation, though it is as doubtful that farm mutuals would elect federal regulation as it is that federal regulators would understand and effectively oversee the business of farm mutuals.

[2] Barnett Bank of Marion County, N.A. v. Nelson (1996).

A Federal Safety Net or Guaranty Fund
Another potential complication for farm mutual insurance companies is the creation of a separate and competing federal guaranty system of insurers operating under a federal charter, such as those proposed in Congress by Senator Charles Schumer (D-NY)[3] and Rep. John Lafalce (D-NY). These proposals would have the effect of weakening the state guaranty fund system by depleting its capacity from $4.8 billion to less than $3 billion, and reducing its overall risk pools.

Also under the Schumer bill, every state's guaranty fund would have to meet minimum standards or be disqualified by the federal government. If a fund is disqualified, it appears both the state and federally licensed companies in that state would be compelled to pay into the federal guaranty fund. The new layer of federal involvement would not be the result of the state regulated insurer "electing" to become part of the federal guaranty fund. In fact, this situation may present dire consequences for the small company in the federal guaranty fund when a large insolvency occurs.

Many farm mutuals do not participate in the guaranty fund system because they issue assessable policies. Considering the practical difficulty of assessing policyholders in today's insurance marketplace, the elimination of assessable policies and required participation of farm mutuals in the guaranty fund may be an outcome of insurance regulatory reforms. In addition to altering the farm mutual financial profile, this change would require "assessable" farm mutual insurance companies to issue new policies to all customers.

The Bottom Line
Legislation to create a federal or dual charter would likely add regulatory layers to the current system of insurance regulation for farm mutual insurance companies. This would produce an unfair environment for the thousands of smaller companies, and create state v. federal regulatory competition that often produces poor policymaking in financial institution regulation.

In addition, though advocates of a federal charter insist that the new structure would only affect those companies who elect to participate, it is impossible to completely segregate federal charters from state charters under the misguided concept of charter "choice." The introduction of a new system of insurance regulation would increase regulatory scrutiny of farm mutuals and produce a corresponding increase in the cost of regulatory compliance. This is in spite of the fact that farm mutuals do not need the extra regulatory attention, and they cannot afford the time and cost of new, unnecessary regulatory compliance burdens.

Where Do We Go From Here?
As noted above, there are powerful forces at work that will cause insurance regulation to be re-examined, and federal regulation to be considered. NAMIC believes that state regulation can be reformed and that we are now in our window of opportunity in which to accomplish this. We believe a reformed state regulatory system should be a high priority

[3] The National Insurance Chartering and Supervision Act.

of farm mutual companies, both to stave off federal regulation and to improve the existing regulatory scheme.

Policymakers, the insurance industry and other constituent groups must now decide: how do we address new realities of insurance regulation in a way that will continue to protect consumers and maintain the industry's strong competitive tradition? The following are NAMIC's public policy arguments for a reformed and preserved state system and against a new federal regulator:

There are two primary reasons to regulate the private sector:

- protection against market failure, and
- public interest, such as gathering consumer information.

A third purpose, social regulation, which requires businesses to rectify societal problems, is not a legitimate reason to regulate, but it is often imposed on business and increasingly so at the federal level. Data reporting and mandatory community reinvestment are two examples of social regulation that would have negative implications for farm mutual insurance companies.

From a consumer's perspective, the state system of regulation has performed admirably throughout its history. State insurance regulation has proven to be adaptable, accessible, and relatively efficient, with rare insolvencies and no taxpayer bailouts.

However, state regulation can be slow to act and is inconsistent from state-to-state. Furthermore, most states still have unnecessary rate regulation regimes that often result in fewer choices and higher rates for consumers.

One advantage that state governments possess is their ability to adapt to the unique issues faced by each state. State regulators and legislators are in the best position to recognize and respond to marketplace concerns ranging from risks related to weather to consumer product preferences. And consumers and other participants have easy access to regulators at the state capital.

With the ability to respond to unique local issues, the individual states serve as a launching pad for reform. The idea that each may serve as a "laboratory" for experimentation [4] of democracy remains true today, and state-based insurance regulation provides a system which, at its best, encourages innovation in insurance coverage.

Of the three purposes for regulation mentioned above, federal regulation is no better than state regulation in addressing market failures or consumer interests. Federal action has, however, been actively used for enacting social regulation, providing one of the most compelling arguments for opposing it.

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[4] New York State Ice Company v. Liebman, 285 US 262 (1932).

More importantly, proposals for federal and dual charters offer precious few advantages for consumers, and consumer interests are rarely cited as reasons for moving away from the state system.

Industry proponents of federal regulation may design their idea of "a perfect system," but they can neither anticipate nor prevent the imposition of unwelcome and harmful social regulation as part of the new regulatory structure.

Legislation to create a federal or dual charter would not reduce insurance regulation, but would add regulatory layers and complexity to the current system. While better coordination between state regulators must be achieved, it is by no means certain a new federal regulator would be the "single" regulator for even the largest property/casualty insurance companies. Dual regulation would produce an unfair environment for the thousands of smaller companies, and would create regulatory competition that often produces poor policy in financial institution regulation. In effect, dual regulation would result in more – and more complex – regulation with fewer advantages.

Another issue faced by a federal insurance regulatory system is whether or how to address the inconsistencies created by the various state tort law systems. Since each state has its own unique tort laws, and since those laws significantly affect insurance, federally licensed insurers would still have to tailor their products to accommodate each state's tort laws. Eliminating these differences is critical to achieving national uniformity, but failing to address this challenge will significantly impede hopes of gaining efficiencies through a federal system.

Proponents of federal chartering say the cost of operating the new federal insurance agency will fall on companies and agents who will pay fees for the regulatory oversight, but neither bill proposed so far provides any estimate of what those costs will be. These decisions are left to the personnel in the new agency. This begs the question*: Will a federal charter reduce regulatory costs that are indirectly paid by consumers and/or taxpayers, and will it bring about less bureaucracy for companies choosing this option?*

Federal regulation may bring us closest to uniformity in regulation, but when the single national regulator makes a mistake, it will have significant economy-wide consequences.[5] When a state regulator makes a mistake today, the damage is localized and can be more easily "fixed."

While federal regulation would result in a degree of uniformity, it is not the panacea it initially appears to be. First, the federal government will have to promulgate a large body of regulation and find a way to address the differences in state tort laws that have existed throughout our nation's history. Next, it will require a considerable amount of time to interpret these regulations on the agency level. It will take even more time to determine the validity of these interpretations in the federal court system, with no guarantee that the various federal districts will agree on final interpretations. *How long will this process*

[5] The S&L debacle, for example.

take, how much uniformity can it produce and how much reform can the states accomplish in the meantime?

While state regulation has certain intrinsic advantages over federal regulation, the current system of state regulation is far from perfect, and changes must be made to create a reformed, rationalized and consistent system that will benefit both consumers and the industry.

- States should eliminate the approval process for pricing insurance products. Insurers must have the ability and opportunity to price their products based on their own market research and strategic plan. Combined with market pricing, regulators must eliminate burdensome and unproductive form approval processes that impede the delivery of products to consumers.

- States must adopt a new market surveillance program that operates with the underlying premise that insurance companies are in business to treat their policyholders fairly, and only companies that violate that trust should be pursued and punished.

- The financial examination function now conducted by most states desperately needs to reduce costs and provide additional training so oversight can focus on financial analysis and risk assessment.

- The company licensing process, beyond adopting a uniform application form, must eliminate state-specific licensing requirements and develop an electronic process that allows insurers to seek licensure or changes in corporate governance with a few keystrokes.

Engaging Congress as the vehicle for reform – even in what is intended as a limited pre-emptive role – is not in the best interests of the insurance industry or the consumers it serves. As discussed in this paper, the political process of creating a new federal framework is problematic in and of itself. The end product of even the most thoughtful proposal submitted to federal lawmakers will most surely produce results far more intrusive than intended. Prospects for the administration of a federal system raise more questions than answers (costs, overlap, state/federal relations, etc.).

Several recent developments should be acknowledged as meaningful, positive signs of a developing consensus for reform among crucial state participants. Individual regulators have an important role to play in recommending standards for reform and raising the profile of those issues in their states. In the final analysis, however, state legislative action must be the focus of any modernization initiatives.

The work of the new task force created by the National Conference of State Legislatures (NCSL) is especially notable. The NCSL's Executive Committee Task Force to Streamline and Simplify Insurance Regulation will develop a set of recommendations to streamline state insurance regulation and will ask state legislators to consider them. For

NCSL to depart from its traditional advisory function to make specific state proposals is an extraordinary step. They have a commendable track record of success when they have done this on other issues in the past.

Industry, consumers, regulators, governors and legislators must work together to eliminate the reasons often cited to justify creating a new federal system. States can achieve the optimum insurance regulatory system by engaging state legislatures across the country in an all-out effort to reform state regulation and protect consumers, create uniformity, ensure competitive markets and promise more choices for the insurance buyer.