REGULATION OF PROPERTY/CASUALTY INSURANCE: THE ROAD TO REFORM

A NAMIC PUBLIC POLICY PAPER

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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

Just as public policy does not operate in a vacuum, it should not be created in one. In making public policy recommendations, NAMIC believes consideration should be given to the social, political and economic environment in which we operate. Good public policy – which is, by definition, policy that is in the *public* good – must consider these environmental factors.

In producing this public policy paper, NAMIC's objective has been to go beyond the parochial view of what is the best regulation for a particular type of insurance company, and instead consider what is the best insurance regulation for all constituents, including consumers, taxpayers, insurance companies, agents and others affected by the insurance underwriting process. Our conclusion, which was reached through years of member involvement and research, is that a reformed system of state insurance regulation is the best structure.

While our process began with an open mind and a blank sheet of paper, we've elected to begin this paper with the conclusion reached in our public policy process, and to reveal the reasoning behind the conclusion as the paper develops. While we greatly respect and value the other participants in the debate who hold different views – particularly the American Insurance Association (AIA), which also represents large commercial property/casualty insurance companies – NAMIC believes that our case for reformed state regulation ultimately will prove to be the best policy for all parties affected by insurance regulation.

That said, several stakeholders have engaged Congress on the issue of federal insurance regulation, and some members of Congress have shown great interest in at least considering whether they should craft legislation on insurance regulation. In this paper, NAMIC provides perspective for that debate.

OVERVIEW OF THE EXECUTIVE SUMMARY

Using a public policy process that has involved hundreds of member companies, outside consultants and thousands of staff hours, NAMIC has concluded that a reformed system of state regulation is superior to an unproven new system of federal regulation crafted in a problematic political environment. This paper establishes that:

- *Market failure and the public interest are the two legitimate reasons to regulate.*

- *Social regulation, which involves using business to solve societal problems, is not a legitimate reason to regulate and often generates unintended negative consequences.*

- *State regulation of insurance is adaptable, innovative and close to the people but reforms are needed.*

- *Proposals for federal or dual regulation of insurance present several problems, including likely social regulation for the industry; the creation of inefficient layered regulation; presentation of new conflicts with existing state tort law, the likelihood of increased regulatory cost and enlarged bureaucracy; concern about the "Big Mistake" as a consequence of federal regulation and the reality of rulemaking and litigation in a federal environment.*

The paper concludes that the necessary reforms to state regulation are better achieved through state legislative action, that state legislatures are assuming more responsibility for setting fundamental public policies and that a consensus is emerging in favor of competitive markets. NAMIC reasons that continuation of market-based reforms will eliminate the political impetus for a dual federal regulatory charter.

EXECUTIVE SUMMARY

The business of insurance has changed dramatically since 1945 when Congress passed the McCarran-Ferguson Act[1] giving insurers a limited exemption against federal antitrust laws and granting the states supremacy over the regulation of insurance. State, national and international boundaries mean much less today than they did 57 years ago. Industry boundaries also mean much less as the enactment of the Gramm-Leach-Bliley Financial Services Modernization Act[2] (GLBA) in November 1999 served to eliminate many of the traditional barriers between banks, securities firms and insurance companies.

Regulation of insurance has yet to match the pace of these changes. Today, an insurer wishing to conduct business in all 51 insurance jurisdictions must still obtain separate licenses in each and then navigate multiple and diverse regulatory structures. In contrast,

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[1] 15 U.S.C. Chapters 20.
[2] P.L. 106-102.

a bank wishing to do business nationwide can obtain one single license from the federal government.

Policymakers, the insurance industry and other constituent groups must now address the following issue: 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?

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 business to address society's issues, is not an accepted reason to regulate, but it is often imposed in the form of regulation and increasingly at the federal level.

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

One advantage possessed by state governments is its ability to adapt to the unique issues faced by each state. State regulators and legislators are in the best position to consider and respond to marketplace concerns ranging from risks related to weather to consumer 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 launch pad for reform. The idea that each may serve as a "laboratory" for experimentation [3] 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.

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

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

Industry proponents of federal regulation may design their idea of "a perfect system," but they can neither anticipate nor prevent the imposition of disastrous social regulation in exchange for the new regulatory structure.

Legislation to create a federal or dual charter would add regulatory layers and complexity to the current system of insurance regulation. While better coordination between state regulators must be accomplished, it is by no means certain that 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 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.

One of the most complex and challenging issues 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 various 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 hamper hopes for 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 has significant economy-wide consequences.[4] When a state regulator makes a mistake, the damage is localized and can be more easily "fixed." Insurance is inherently local and geographic because risk is local and geographic.

While federal regulation will 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 that have existed in state tort laws for our nation's entire 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 take, how much uniformity can it produce and how much reform can the states accomplish in the meantime?*

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[4] A case in point is the savings &loan debacle.

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 industry.

- States should eliminate the approval process for pricing insurance products. Insurers must have the responsibility 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 delivery of products to consumers.

- A new market surveillance program must be adopted by the states that operates with the underlying premise that most 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 that oversight can focus on financial analysis and risk assessment.

- The company licensing process, beyond adopting the uniform application form, must eliminate state-specific licensing requirements and develop an electronic process that will allow 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 what was intended. Prospects for the administration of a federal system raise more questions than answers (costs, overlap, state/federal relations, etc.).

Several developments should be acknowledged as meaningful, positive signs of the existence of a 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 important market reform issues in their states. In the final analysis, however, state legislative action should be the focus of modernization initiatives.

There is an emerging consensus that insurance regulation should not impede marketplace competition. In all, eleven (11) states have acted to modernize commercial or personal lines rate laws since 2003 to promote competition.

Also notable is a subtle shift of power in the states with respect to who makes fundamental insurance public policy. Legislators now embrace the reality that they set public policy and that regulators are the administrators.

Industry, consumers, regulators, governors and legislators must work in collaboration to eliminate the reasons stated by Congress to create a new federal system. States can evolve into 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 choices for the insurance buyer.

THE CURRENT SITUATION

House and Senate Consideration of Federal Insurance Regulatory Reform Proposals

In 2000, the United States Congress' House Energy and Commerce Committee's Subcommittee on Finance and Hazardous Waste, chaired by Ohio Representative Michael Oxley (R-OH), began a series of hearings on regulatory modernization that were continued when Congressman Oxley became chairman of the newly-created House Financial Services Committee the following year. Committee members expressed a preference for preserving the state system, but clearly held out the possibility that federal prodding might be necessary to realize key changes.

Four years later, Chairman Oxley outlined what he termed a "roadmap" for reform to the National Association of Insurance Commissioners (NAIC). He articulated a number of legislative goals intended to increase competition and efficiency for insurers while providing more choices and protections for consumers via the existing structure of state regulation. This vision took form later in the year with release of an August 19, 2004 discussion draft of the State Regulatory Modernization and Transparency (SMART) Act. The draft includes a provision that would, over time, preempt state laws that regulate prices for commercial and personal lines insurance products. As of this writing, the SMART Act is in the process of being revised and has yet to be introduced as a bill in the 109th Congress.

On the other side of the Capitol, the Senate Banking Committee held a hearing entitled "Examination and Oversight of the Condition and Regulation of the Insurance Industry" on September 22, 2004. At the hearing, several senators expressed an interest in optional federal charter legislation. In the 109th Congress, Chairman Richard Shelby (R-AL) indicated his intention to hold hearings on insurance regulation and other banking committee senators are considering the introduction of optional federal charter legislation. As of this writing, no such legislation has been introduced. These are the latest in a series of developments that indicate a continued federal interest in the future of insurance regulation.

The Positions of National Trade Associations on Insurance Regulatory Reform.

Three national insurance trade associations – the American Council of Life Insurers (ACLI), the American Bankers Insurance Association (ABIA) and the American Insurance Association (AIA) – announced their support for a federal regulatory alternative, or a federal charter. In fact, a Senate bill introduced in late 2001 but never acted on was based largely on an early version of the ABIA proposal. Insurance agent groups, represented by the Independent Insurance Agents of America (IIAA) and the National Association of Professional Insurance Agents (PIA), have supported the SMART Act approach to impose certain mandates designed to achieve greater uniformity of state insurance regulation.

National groups representing state policymakers, responding to activity in Washington, also favor continued exclusive state regulation. The National Association of Insurance Commissioners (NAIC) has been working since early 1999 to enact provisions of its *Statement of Intent*[5] and has specifically opposed adoption of a SMART bill and undoubtedly would oppose an alternative federal insurance charter. The National Governor's Association (NGA), the National Conference of Insurance Legislators (NCOIL), the National Conference of State Legislatures (NCSL) and the American Legislative Exchange Council (ALEC) each have adopted policy positions in opposition to any move toward federal regulation or an alternative federal charter system. Meanwhile, individual state legislatures have been reforming their laws including rate modernization and credit based insurance scoring.

At the same time, the industry's underwriting results have declined in the past few years due, in part, to an intensely competitive pricing environment and certain catastrophic losses. The nation's 3,319 property/casualty insurers have been able to rely on gains made in their investment portfolios to sustain their operations and show modest net income.[6]

WHY REGULATE?

The United States boasts the best free-market economy in the world. Historically, American businesses and individual transactions have been subject to only a few simple rules of law: they include contract law and a general rule of peace. As long as businesses and individuals do not use force or commit fraud on other economic actors, we generally prefer to let free markets determine outcomes.

In spite of this free enterprise tradition, a countervailing public policy practice also has evolved, establishing regulatory agencies to place economic checks on certain industries or to create federal agencies to protect an individual's civil rights or work, health or safety interests. The first regulatory agency was the Interstate Commerce Commission, which began in 1887 to set rates for the railroads. Next came the Federal Reserve System (1913), followed by the Federal Trade Commission (1914), the Federal Radio Commission (1927) and the Federal Power Commission (1930).

The collapse of the stock market in 1929 and its subsequent impact on the country's monetary policies led to creation of the Federal Home Loan Bank Board (1932) and the Federal Deposit Insurance Corporation (1933). At the same time, Congress also began to create regulatory agencies that had, as their primary mission, the protection of consumer interests. The first agency of this type was the Federal Food & Drug Administration.

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[5] The NAIC document is known as the "Statement of Intent: The Future of Insurance Regulation" and can be accessed at http://www.naic.org/GLBA/statement_of_intent.htm

[6] Latest statistics compiled by A.M. Best and reported in the Insurance Information Institute's *2001 Fact Book* show that insurers' 1999 net after-tax income fell 28.9 percent from 1998, mainly due to a 38.3 percent surge in underwriting losses, a 27.8 percent drop in realized capital gains, and a 2.5 percent decline in investment income. As a result, the industry's surplus rose only 0.3 percent, the smallest gain since 1984.

The 1960s and 1970s witnessed a proliferation of new federal regulatory agencies, and new social regulatory programs tended to cross many sectors of the economy (rather than individual industries) and affect industrial processes, product designs, and by-products (rather than entry, investment, and pricing decisions).[7]

Ronald Reagan campaigned for president promising to halt regulatory excesses. He succeeded, with the help of Congress, in not enacting a single new regulatory law in 1981. Since then, there have been other efforts to minimize regulatory oversight, but despite this, the federal bureaucracy has continued to grow. Today, some 55 federal agencies, staffed by 130,000 individuals now develop, implement and enforce a myriad of regulations, including an estimated 2,000 new rules each year.[8]

What is the economic effect on American businesses of this regulatory glut? Professor Thomas Hopkins of the Rochester Institute of Technology estimates that the business community collectively spends close to $800 billion each year to comply with federal regulations, and this does not include the indirect effects on labor and productivity.[9] The Center for the Study of American Business says the loss in productivity as a result of complying with federal regulations approaches $1.5 trillion in economic activity annually, or the equivalent of an economy the size of Germany.[10] State regulation is not much better. The Insurance Information Institute, for example, estimates that insurers collectively spend upwards of $1 billion annually on compliance programs in the states.[11]

Why do policymakers impose regulatory edicts on certain industries? The answer, if one looks hard enough, invariably would fall into one of three major categories: market failure, consumer information gathering and social regulation.

Market Failure

The United States generally accepts the notion that a more or less free market within the rule of law is the best consumer protection devices available.

But, what if a given market is not "free"? In that case, the federal government has imposed economic regulation on prices and conduct as a means to protect consumers from the exercise of excessive market power.

The classic case is the granting of exclusive geographical monopolies to utility companies. The argument is that there is room for only one seller in that particular market as it would be expensive to duplicate power lines, water mains, or natural gas pipelines.

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[7] See the first chapter, "The Role of Economic Analysis in Regulatory Reform," in the Office of Management and Budget's *Report to Congress on the Costs and Benefits of Federal Regulations* (September 30, 1997). Available at http://www.whitehouse.gov/ombinforeg/chap1.html.

[8] For facts and figures on the federal regulatory system, go to www.regulatory.org.

[9] Professor Hopkins' original work appeared in the December 1998 issue of *Policy Sciences*. The complete report can be accessed at http://www.kluweronline.com/issn/0032-2687.

[10] The Center for the Study of American Business is part of the Weidenbaum Center on the Economy, Government and Public Policy at Washington University in St. Louis, MO. Available at http://csab.wustl.edu.

[11] See the Insurance Information Institute's *2001 Fact Book.*

In exchange for being a "natural monopoly," utilities agree to have their prices regulated by some outside public body.[12] The consumer has few substitutes for electricity and water, and the monopoly utility, if unchecked, could have *carte blanche* with its pricing.

Another example is the railroad industry in the late 19th and early 20th century. Farmers in particular, led by The Grange in the Plains states, objected that they had only one railroad outlet available. They simply had to get their crops to market. The railroad knew this and priced—high—accordingly. This eventually led to the Interstate Commerce Commission.

The "market failure" reason for regulation tends to become outdated over time due to changing technologies. Utility companies in many states are now subject to competition. It can be argued that the ICC ultimately harmed railroads to the extent that its actions gave impetus to competing airline and truck transportation industries.

"Market failure" regulation, while it may seem a good idea at the time, can easily become "regulatory failure" if the regulatory agencies either cannot or will not adapt to changing economic circumstances. We have seen unprecedented change in the insurance industry in recent years (convergence, privacy, terrorism, catastrophe, superfund, securitization, etc.) and should ask whether regulatory failure would have been a real possibility with a federal insurance authority.

Public Interest

Sometimes, federal policymakers have reasoned that it is more efficient to gather consumer information through a public body. The classic example is the U.S. Food and Drug Administration (FDA), which is charged with ensuring the "safety and efficacy" of new and existing medicines. The FDA is supposed to be a one-stop clearinghouse that oversees the testing of new medicines, thereby giving medical doctors and patients an independent assurance that the drugs are effective and not dangerous. It is argued—perhaps correctly—that this is cheaper and builds more confidence than any private firm like Underwriters Laboratory attempting to perform the same function.

Some economists, however, argue that even the widely respected FDA often bungles its function. They argue that the FDA's bureaucratic imperative is to make sure that no unsafe medicine makes it to market. As a result, drugs that may turn out to be safe and efficacious are withheld from the market, or withheld far too long. FDA regulation follows the criminal law maxim of "better to let 10 guilty men go free than to convict one innocent man" except that with the FDA, it translates to "better to reject 10 good drugs than to let one bad drug get on the market". This can be unusually hard on the sick person who might have benefited from any of those 10 drugs.

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[12] Even the case of utilities is not immutable. The movement today is for utilities to give up their monopolies in exchange for competition on the generating side. The widely publicized flop of California's deregulation effort does not mean the concept is wrong. California's plan was the worst imaginable.

Social Regulation

The social upheavals of the 1960s and 1970s coincided with the shift in regulatory focus from the purely "public interest" approach to a "social regulation" milieu that imposed new regulatory controls "to achieve social goals that are not fully valued in the market."[13]

It is important to clarify the common misunderstanding that social regulation protects consumers from improper practices such as redlining. Such practices are more properly characterized as a "market failure" and should be regulated as such. Social regulation imposes costs on the private sector in cases where public officials are unwilling to impose them directly on the public through taxes and government fees. Estimated costs of social regulation are on the order of one-third of the budget of the federal government.[14]

The end result of social regulation is that it corrupts markets and shifts unjustified costs to business. It is purely political. Its goal is not to prohibit illegal conduct, nor is it intended to strengthen competition. Rather, it is a way for government to mandate socially engineered outcomes with no impact on budgets or tax levels. However, the costs of these endeavors fall on companies, and ultimately on consumers. Furthermore, social regulation generates many unintended consequences as a result of its hidden costs and the fact that it rewards non-market based behavior and competencies.

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[13] Joseph V. Kennedy, "A Better Way to Regulate: What Government Can Learn From the Market," *Policy Review*, October & November 2001.

[14] See, Clyde Wayne Crews Jr., "Ten Thousand Commandments: A Policymaker's Snapshot of the Federal Regulatory State." This report, produced annually by the Competitive Enterprise Institute, is available on their Web site, www.cei.org.

THE CURRENT SYSTEM OF STATE INSURANCE REGULATION

As an association of companies representing 43 percent of the U.S. property/casualty insurance market, NAMIC has a tendency to view issues of regulation from the perspective of the insurance company. However, NAMIC believes that the overall public interest must be served in the positions that it advocates for members, and that good public policy in insurance regulation must consider the consumer's interest.

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

However, state regulation does present problems for the companies it regulates, particularly larger companies that do business on a national scale and must comply with inconsistent regulation across 51 different jurisdictions. State regulation can be slow to act, and most states have unnecessary rate regulation that often results in fewer choices and higher rates for consumers.

The debate about the optimum balance between state and federal power and responsibilities that began before the constitution's ratification has continued throughout our history and continues today in the debate between federal and state regulation of insurance. Consider this statement from the Federalist papers:

> "The proposed constitution, so far from implying an abolition from the State governments, makes them constituent parts of the national sovereignty … and leaves in their possession certain exclusive and very important portions of the sovereign power. This fully corresponds, in every rational import of the terms, with the idea of a federal government."[15]

Prior to arriving at this conclusion, Alexander Hamilton addressed some of the advantages that would arise from the existence of numerous states. In one particularly illuminating passage, he quotes French writer Baron De Montesquieu: "Should abuses creep into one part, they are reformed by those that remain sound."[16] The point made here is that the states were viewed as retaining critical authority because they would add substantially to the quality of government and would serve as a check on mistakes and abuses.

The states were also retained because the founding fathers did not trust concentrated power. Consider this passage in a letter written by Thomas Jefferson:

> "I consider the foundation of the Constitution as laid on this ground: That 'all powers not delegated to the United States, by the Constitution, nor prohibited by it to the States, are reserved to the States or to the people' (Tenth Amendment). To take a single step beyond the boundaries thus specifically drawn around the

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[15] Federalist 9, Alexander Hamilton, November 21, 1787.
[16] Ibid.

> powers of Congress is to take possession of a boundless field of power, no longer susceptible to any definition."[17]

Adaptable to Local Markets

One of the advantages possessed by state governments is adaptability to the unique issues faced by each state. State regulators and legislators are in the best position to consider and respond to marketplace concerns ranging from the weather to consumer preferences.

For example, as a result of Florida's exposure to hurricanes in 1995, the Florida Department of Insurance gave a two to five percent discount on homeowner's policies to those who installed specifically designed shutters and glass for hurricanes. [18] The result? Florida residents were given a break if they modified their homes to protect them against their state's severe weather problems. While insurers had to give a discount, it was given for an activity that would reduce an insurer's exposure to risk.

While it is true a federal regulator could adopt a similar solution for Florida, the addition of responsibility for the well-being of 50 other jurisdictions adds a degree of political complexity to this task. In addressing a particular state's problems, a single regulator would be subject to lobbying from others who want or need their specific issues addressed as well. This could lead to tensions that would alter the shape of the final remedy.

For instance, had there been a national regulator in 1995, one of three things would likely have happened:

1. The discount for Florida residents would also have been available to policyholders across the country, even in areas where there is no risk of hurricanes,[19]
2. Florida residents would have received their discounts in return for somebody else getting something else – regardless of the merit of that something else,[20] or
3. The give and take nature of the issue would have mired consideration of Florida's problems in such a political quagmire that inaction would have killed a sensible response.

In the ongoing effort to balance responsibilities between state and federal regulators, state regulators have the advantage of being able to focus exclusively on the impact that a

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[17] Thomas Jefferson in a letter to George Washington, February 15, 1791.

[18] Liberty, footnote 7, page 8.

[19] At first this might seem harmless, but consider the impact on insurers who are forced to give a 2 to 5 percent discount for the mitigation of a non-existent risk. Window installation companies in areas that have no risk of hurricanes would have been able to tell potential customers that they could get a 2 to 5 percent reduction in their homeowners policies for installing new "weather resistant windows that are so strong that they can stand up to hurricanes". People would pay more than they should for windows, insurers are forced to give a meaningless discount, and the only winner is the window installation company.

[20] In other words, somebody agrees to not object, or withdraw objections, to the Florida discount in return for something they want. Regardless of the merit of their request, this poses a difficult choice for a conscientious regulator.

particular decision will have on their fellow citizens, rather than being concerned about pressure from other states.

Opportunities for Innovation

With the ability to respond to unique local issues, individual states serve as a launch pad for reform. The idea that each may serve as a "laboratory" for experimentation [21] of democracy remains true today, and state-based insurance regulation provides a system which, at its best, can encourage innovation in insurance coverage.

True innovation occurred when the 1969 Illinois legislature decided to deviate from the prior approval law that was put in place following passage of McCarran-Ferguson in 1945. Illinois lawmakers only intended to experiment for two years with a file and use competitive rating law. At the end of the trial period, legislators could not agree to changes or renewal of the law. In the process of passing the initial competitive rating language, however, the original prior approval language was repealed, leaving Illinois with no property liability rating law except for workers' compensation. Property/casualty rates in Illinois remain unregulated today.[22]

In the words of former Illinois Insurance Director Phillip R. O'Connor and his colleague, Eugene P. Esposito, veterans of insurance regulatory developments across the country,

> "Not only has Illinois proven the absence of rate regulation does not cause the roof to fall in, but also the absence of a rate law can be a major contributor to the creation of one of the healthiest and most vibrant insurance markets in the country." [23]

O'Connor and Esposito cite several vital signs that indicate the Illinois experiment is working well:

- Stable rates for consumers, ranking roughly in the middle of all states in average personal expenditures.
- Illinois market attracts the largest share of all private passenger auto and homeowner insurers in the nation.
- Low residual markets indicate affordability and availability.[24]

These positive signs are all the more remarkable when you consider that Illinois includes the third largest urban area in the United States, and two-thirds of the state's residents live in the Chicago area.[25]

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[21] *New York State Ice Company v. Liebman*, 285 US 262 (1932).
[22] For a discussion of Illinois' competitive rating environment, see Phillip R. O'Connor and Eugene P. Esposito, *Modernizing Insurance Regulation: Tacking to the Winds of Change*, April 26, 2001.
[23] Ibid.
[24] Ibid.
[25] For census information on Chicago and the state of Illinois, see http://www.commerce.state.il.us/census/2000profiles/.

Close to the People
It is beyond debate that state regulators, themselves citizens of the states they serve, are closer to the people affected by their regulation. They have regulatory authority over problems that they, their friends, and their families must face on a daily basis. Further, as a function of size and geographic proximity, state governments are more accessible to residents of their state. Greater accessibility means more interaction and more responsiveness to the people and their problems. Two recent regulatory actions lend support to this argument.

In Texas, then-Insurance Commissioner Jose Montemayor issued a set of recommendations[26] for how mold claims should be covered in homeowners' policies. Mold has evolved as an issue in Texas over the past two years as insurance companies began handling record numbers of mold claims. The issue caught the public's attention in June 2001 when a Texas District Court judge upheld a $32.1 million lawsuit brought by an Austin-area couple who claimed their insurer acted in bad faith in its handling of water and mold damage claims to the couple's 22-room mansion.

Commissioner Montemayor responded by holding three public hearings in the state where hundreds of consumers and some industry representatives offered their views on how to handle the mold issue. In the end, while the commissioner chose not to exclude mold coverage, he did limit the amount of coverage in the most popular homeowners' policy and gave consumers the option of purchasing additional coverage for an extra premium. In January 2002, Commissioner Montemayor appointed a task force of experts to advise him on how insurers should respond to water and mold damage claims going forward.[27]

By contrast, consider the State Children's Health Insurance Program (S-CHIP), established as part of the federal Balanced Budget Act of 1997[28] to provide health insurance to children of families whose incomes were too high to qualify for Medicaid but who still could not afford or did not have access to health insurance.

Proponents projected that 11 million uninsured children could take advantage of the $40 billion program, which was to be funded over 10 years with monies from a new 15-cent tax on cigarettes. The federal Health Care Financing Administration (HCFA) was charged with overseeing the program, drafting the program rules, and dispensing grants to the states to run the programs.

How has S-CHIP worked? Not as well as expected.

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[26] The new Texas mold rules can be found at http://www.tdi.state.tx.us/commish/multi/co-01-1105.html.
[27] See Texas Department of Insurance news release dated January 11, 2002. http://www.tdi.state.tx.us/commish/nr01112b.html.
[28] See Subtitle J, of the Balanced Budget Act of 1997 (P.L. 105-33) for a description of the State Children's Health Insurance Program.

One Urban Institute study found that while 88 percent of low-income respondents were aware of S-CHIP, less than one-fourth of them ever inquired about the program.[29] A second Urban Institute study found respondents less interested in health coverage and more concerned about finding a way to pay for dental care for their children.[30]

The National Governors Association (NGA) estimates that 3.3 million children were enrolled in S-CHIP in the first three years of its operation, well below initial expectations.[31] The NGA passed a resolution in which the governors said concern about continued funding for the program, combined with federal regulatory barriers, prevented them from developing innovative programs to reach more children.[32] As an example, the governors cited the option of enrolling legal immigrant pregnant women and children in Medicaid and S-CHIP.

Comparing the Texas response to mold with the federal response to children's health care needs helps to demonstrate the advantages of governments that are closer to the people. In Texas, Commissioner Montemayor was able to conduct three public hearings in which he obtained perspectives from Texas residents about a Texas problem. In the S-CHIP example, the governors clearly understood the needs of the children in their states, but were unable to influence the structure of S-CHIP program.

This is not because members of Congress do not care about the health needs of children; they are just not capable of responding to the varying needs of people on a state-by-state basis. Put another way, what you do for one, you must do for all. The result is that, on the federal level, there is often one programmatic solution for the entire nation. Congress acts on national problems that have enough attention and impact that a national consensus is possible.

This reality requires the federal government to treat insurance as a program rather than a business that offers financial protection from risk. This is particularly problematic when that risk varies by state and region. Florida has hurricanes, California has earthquakes, Texas has mold, and the list goes on. How do you achieve national consensus on the risk for Texas homeowners mold?

State regulators are closer to the people, are residents of the states they serve, have a specialized knowledge of the problems their states face, and are protected by their state's borders from the pressures of competing regional concerns. Of course, state-by-state innovation must be balanced with the uniform regulatory practices that many within the industry, including NAMIC, seek. NAMIC believes that "uniformity is beneficial and

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[29] Genevieve Kenney, Jennifer Haley and Lisa Dubay, "How Familiar Are Low-Income Parents with Medicaid and SCHIP?" Urban Institute, "Assessing the New Federalism Series," B-34, July 2, 2001. Paper available at http://newfederalism.urban.org/html/series_b/b34/b34.html.

[30] Ruth Almeida, Ian Hill and Genevieve Kenney, "Does SCHIP Spell Better Dental Care Access for Children? An Early Look at New Initiatives," Urban Institute, "Assessing the New Federalism Series," OP-50, July 2001. Paper available at http://newfederalism.urban.org/html/occa50.html.

[31] The National Governors Association's statement on S-CHIP can be found at http://www.nga.org/nga/IobbyIssues/1,1169,D_1309,00.html.

[32] Ibid.

achievable where state needs are similar and unnecessary regulatory differences significantly impede effective competition."[33]

This definition encourages, rather than precludes the best efforts of policymakers to resolve issues that have unique origins in their state. Regulation of the industry in Washington, D.C. will effectively shift the emphasis away from the states, leaving significant matters of public policy unaddressed at a level where the best solutions may be found.

[33] "Accepting the Challenge: Redefining State Regulation Now," National Association of Mutual Insurance Companies, April 18, 2000. Available at http:www.namic.org/perspective/default.htm.

FEDERAL AND DUAL REGULATION ALTERNATIVES

Of the three purposes for regulation mentioned earlier in this paper, federal regulation is no better than state regulation in addressing market failures or consumer interests. Federal regulation, however, has been more actively employed for enacting social regulation, and now presents one of the most compelling arguments for opposing it.

More importantly, proposals for federal and dual charters offer precious few advantages for consumers, and consumer interests are rarely cited as reasons for a change 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 disastrous social regulation in exchange for the new regulatory structure.

While the word "federal" inspires confidence among many citizens –witness the creation of the new federal Transportation Security Administration – it is by no means clear that federal regulation of insurance would be "better" in any rational sense of the term.

As an illustration of how federal regulation of financial institutions can go wrong, the Savings and Loan (S&L) scandal of the 1980s is instructive. The S&L scandal is without question the largest collapse of financial institutions ever seen in this country due to regulatory incompetence. (The banking collapse of the early 1930s was larger in relative terms, but that was due to overall horrific economic conditions and disastrously tight monetary policy by the Federal Reserve Board). The S&L scandal cost taxpayers at least $300 billion and perhaps as much as $500 billion. The true figure will likely never be known.

While the S&L scandal was exacerbated by poor oversight by a handful of state regulators, there is no question that the majority of the blame belongs with regulators and policymakers at the federal level. Since some hold up federal regulation of insurance as a panacea, it is useful to examine how federal regulatory oversight failed to prevent the meltdown of an entire class of financial institutions barely a decade ago.

In hindsight, it is easy to see what caused the S&L breakdown. Up until the 1980s, S&Ls were home loan institutions. They lent long for fixed rate mortgages and borrowed short from their depositors.

The S&Ls received considerable protection from the Federal Reserve's Regulation Q.[34] It limited the rates of interest that commercial banks could pay on short-term deposits. S&Ls were protected by regulators (the Federal Reserve) by price controls on what their chief competitors could pay for deposits.

Several events began happening virtually simultaneously in the early 1980s to change that equation. The marketplace—as it sooner or later eventually does—spotted an opportunity to create a profitable new product called money market funds. Investors

[34] 2000 CFR Title 12, Volume 3, Prohibition Against the Payment of Interest on Demand Deposits.

flocked to them. Why accept abysmally low interest rates in banks and S&Ls in exchange for federal deposit insurance if you could get a higher interest rate investing in what amounts to short term (but not federally insured) paper of America's largest and most highly rated companies? After all, if companies like General Motors or General Electric became insolvent next week, the entire country would probably be in dire economic straits anyway.

The Federal Reserve relaxed Regulation Q so banks could compete with the new money market competitors. With their portfolios full of fixed rate long-term mortgages, the S&Ls were obviously disadvantaged in this new competition for funds.

They sought the authority to expand their portfolios to lend on (i.e., higher yielding, riskier) properties more like traditional commercial banks. They obtained their authority, principally in the Garn-St. Germain Depository Institutions Act of 1982[35] plus an increase from $50,000 to $100,000 in their federal deposit insurance guarantee from Federal Savings and Loan Insurance Corporation (FSLIC).

Now, S&L executives, who had neither training nor experience as commercial lenders, were being asked to behave like them. In addition, they wouldn't be gambling with their own (their depositors') money. Place a risky loan, and if it pans out, your institution wins. Place a risky loan and it fails, the taxpayers (FSLIC) lose. Economists call this a "perverse incentive." Insurers call it "moral hazard."

S&Ls began to pile up huge losses. Regulators, principally the FSLIC and the Federal Home Loan Bank Board, compounded the problem by refusing to order corrective action. Instead, they kept insolvent S&Ls in business (racking up even larger losses) far beyond the time when they had become walking corpses by allowing them to carry as an asset something called "regulatory good will." No one ever figured out what "regulatory good will" was except that permission from the regulators to keep operating went far beyond the time when doors should have been shut and depositors paid off.[36]

When the doors were finally closed on the S&Ls, it was at a cost of hundreds of billions of taxpayer dollars. It also was an appalling illustration of federal regulatory incompetence played out on a grand scale.

Should the insurance industry be regulated at the federal level? Recommendations for good public policy must include an assessment of the environment in which the policy is considered. The following six social, political and economic factors must be taken into account in any consideration of dual or federal regulation of the insurance industry:

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[35] 12 U.S.C. § 371a.

[36] For an excellent analysis of the lessons to be learned from the S&L debacle, see Catherine England's monograph, "Lessons from the Savings and Loan Debacle: The Case for Further Financial Deregulation," published in the *Cato Review of Business & Government*. Available at http://www.cato.org/pubs/regulation/regv15n3/reg15n3-england.html.

The Political Environment

One of the strongest arguments for rejecting a federal role in insurance regulation is the likelihood that an act of Congress originally drafted for relatively narrow reasons could result in expansive new demands on the property/casualty industry.

The *National Underwriter*, in a January 28, 2002 editorial, sounded this alarm:

> "If Congress takes up federal chartering, there's no telling where it might lead. As the industry painfully learned when it put forth a federal terrorism reinsurance proposal, once Congress gets its hands on a plan, the final product does not necessarily look anything like the original or represent something the industry would support."[37]

Nonetheless, a federal solution seems worth the risk to some in the industry frustrated by a system that requires approvals of products and prices subject to different laws and by multiple regulators. As has been often and loudly stated, the product approval process is especially challenging for the life industry because of direct competition with banks in certain financial services. Unique local laws and conditions do not usually dictate the regulation of life products, making them better suited to a single point of filing for approval.

Since the terms of homeowner, automobile and business insurance policy contracts often vary by jurisdiction, property/casualty advocates of federal regulatory reform see federal regulation as a vehicle to eliminate the prior approval of product pricing. NAMIC concurs with the judgment that prior approval is a policy that has outgrown its post-McCarran origins. Companies should be able to ask a price based on what their market research indicates the value will be to consumers and to change that price if they determine a different rate is more appropriate. It has been frequently demonstrated that market pricing benefits the consumer.

But pursuit of this objective through the Congress is a tactic fraught with great risk and uncertainty. Government is driven by politics, quite a different motivator than profit, or lower prices or better service. These pressures damage competitive markets. While this occurs at both the state and the federal levels, federal regulation is highly susceptible to political and special interest pressures. Anything that creates an ability to succeed in the industry by any means other than the market place criteria of providing better quality and value is inherently risky and ultimately ineffective.

Price regulation (or price suppression, as is usually the result) is a dearly protected power of state insurance regulators, indicative of its political attractiveness as a governing power. There will be significant difficulties in persuading the federal government that they too should ignore the temptation of dictating the prices that insurance companies may charge in the name of consumer protection i.e. good politics.

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[37] "Federal Chartering Proposals Put Chaos Theory to the Test," *National Underwriter*, January 28, 2002.

Assuming rate modernization could be achieved in Congress, the political accommodations necessary to pass such a complex and controversial measure will produce consequences that will fundamentally change the business of insurance.

This reservation is well founded. Congress has regularly debated federal initiatives bearing the label "insurance." Their historical approach to the subject should be considered. It was succinctly captured in a critique of legislation that would have created a federal reinsurance program for housing in high risk areas: "Unlike private insurance, government insurance is more concerned with "helping people" and providing money than it is with balancing the books. Because the government does not have the same financial pressures that private companies have, the pricing of government insurance is often influenced more by political considerations than it is by economic ones."[38]

For example, in the face of complaints from farmers that "the insurance is too expensive for the coverage they get,"[39] the U.S. House approved reductions in premiums for federally subsidized crop insurance in 1999. Notably absent from this discussion was any actuarial justification for the premium that they had been charging, or for the reduction.

This is not surprising if one considers the program through the eyes of federal policymakers. In 1982, federal outlays for crop insurance subsidies were $13.3 billion while the tax burden on farmers totaled $13.4 billion.[40] All the money set aside for federal subsidies did not reach the recipient. Some was spent to ensure tax compliance costs, tax enforcement costs, administrative costs, subsidy compliance costs, and so on.

To take another example, the Federal Emergency Management Agency (FEMA) has managed federal flood insurance since 1968. They recently noticed that they were paying flood claims every year to the same people. The rules were finally changed so that people will no longer be able to collect benefits for the same bad judgment year in and year out.[41]

Viewed from this perspective, it is clear that neither crop nor flood "insurance" is really insurance at all. As authorized by Congress and administered by federal agencies, these are public programs designed to satisfy political constituencies. Policy decisions will be made with these concerns in mind, not on market conditions or the principles of risk sharing essential to the property/casualty industry.

This "political programmatic" orientation provides fertile soil for the pleas of interest groups that lobby Congress. One recent federal regulatory proposal would have imposed Community Reinvestment Act requirements and anti-redlining language.[42]

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[38] Jeffrey Yousey, "Flirting with Disaster," Competitive Enterprise Institute, February 1, 1998.
[39] Washington in Brief, *Washington Post*, September 30, 1999.
[40] James L. Payne, "Where Have All the Dollars Gone?" *Reason Magazine*, February 1994.
[41] FEMA Website, www.fema.gov.
[42] LaFalce "Dear Colleague" letter January 18, 2002, available at http://www.house.gov/banking_democrats_pr_020118a.htm.

The Gramm-Leach-Bliley Financial Services Modernization Act (GLBA) was complex legislation designed to achieve a straightforward outcome, convergence of the financial service industries. Even with that objective in mind, well-organized, narrow interests were successful in seeing several of their "pet" causes debated as amendments in committee or on the floor of Congress.

Luis Gutierrez (D-IL), Maxine Waters (D-CA), Bernard Sanders (I-VT) and Michael Capuano (D-MA) offered an amendment during the House Banking Committee markup of GLBA (then known as HR 10) that would have put in place new community reinvestment requirements for insurance.

Proposed expansion of the Community Reinvestment Act (CRA) to the insurance industry is yet more evidence of how the federal focus on programs attracts special interest issues in a way that is harmful to the industry and to consumers. CRA requires banks that receive deposits in a certain geographic area to lend money to people who live in that area. CRA was intended to serve as a remedial tool to prevent banks from discriminating against people in low-income areas.

NAMIC conducted an extensive review of this issue and determined that the CRA was not applicable to insurance.[43] Unlike banks, insurance companies are chartered to provide insurance, not credit. Insurers provide protection from risk and base their premiums on the risk factors associated with the policyholder. A CRA-like transaction would violate an insurer's fiduciary duty to policyholders, as well as violating many of the rules established by the states to ensure their solvency. Also, banks enjoy substantial federal benefits that insurers do not.[44] Insurance companies do not unfairly discriminate. In order to discriminate unfairly, insurers would have to set premiums based on factors such as race that do not impact on risk. Insurers are prohibited from doing this by state laws and they undergo regular examinations to ensure their compliance with these laws.[45]

However, these facts have not blunted the enthusiasm held by some special interest groups for imposing CRA requirements on insurers. This should be a matter of grave concern for those who advocate federal regulation.

Fortunately, the CRA amendment was not approved in the committee markup of GLBA, and the Rules Committee did not allow for consideration of any of these types of amendments on the House floor. This was a result of intense lobbying by NAMIC and others in the industry.

Recent evidence of how insurance acts as a magnet for extraneous special interest initiatives can be found in the original attempt by Congress to enact a terrorism backstop in the wake of the September 11 attacks.

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[43] *Should the Community Reinvestment Act Apply to Insurance Companies? A Public Policy View,* NAMIC, 1998.
[44] Ibid. Such as federal deposit insurance and access to Federal Reserve's discount window and payment services.
[45] Ibid.

Despite the unity of the insurance industry in late 2001, pronouncements that the backstop legislation was a “must pass” item and the fact that the House of Representatives completed a bill, the Senate was unable to bring a drafted bill to the floor for consideration. Combined with jurisdictional disputes, opposition by the trial bar lobby over limited tort protections that would only apply in the event of another terrorist attack proved to be a substantial roadblock to passage. It was only with the full support of the White House that the Terrorism Risk Insurance Act was passed in 2002, looking nothing like what the insurance industry said it needed.

The prospect of social regulation as administered at the national level raises valid concerns. Mandating political and social objectives is philosophically questionable, but when applied to the regulation of the insurance industry, it is highly suspect.

Inefficient Layered Regulation

In the United States, hundreds of insurance companies elect to do business in a single state and therefore enjoy regulation by a single state regulator. Multi-state writers must comply with regulation in the various states where they do business, but some deference is given to the domestic regulator and coordination and information sharing takes place between the home state and other states. While this system of coordination needs further improvement, it is being enhanced through reforms of the state system being advocated by NAMIC and other organizations.

Advocates maintain that a benefit of a federal regulatory system would be oversight by a single regulator. Even if it can be accomplished for the 200 largest property/casualty insurance companies that do business in all 51 jurisdictions, it would leave thousands of other property/casualty insurers locked into a complex multilateral system of regulation.

Regulation of state chartered banks in the United States is a corollary for how smaller companies may be treated if a new federal insurance regulator is created. State chartered banks must comply with the 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 in 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 known to all insurance companies was the decision by the Office of the Comptroller of the Currency (OCC) – the national bank regulator – that allowed national banks to sell insurance. The U.S. Supreme Court[46] upheld this aggressive interpretation

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

of the National Bank Act, and state legislatures and regulators were forced to respond on behalf of state chartered banks adversely affected by these new powers being 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.

Another potential complication for state regulated insurance companies in a "dual" charter system is the guaranty fund issue. In Senator Schumer's Senate bill[47], 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 that 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 fund when a large insolvency must be handled.

Legislation to create a federal or dual charter would add regulatory layers to the current system of insurance regulation. While better coordination between state regulators must be accomplished, it is by no means certain that a new federal regulator would be the "single" regulator even for the largest property/casualty insurance companies. Dual regulation would produce an unfair environment for the thousands of smaller companies, and create regulatory competition that often produces poor policymaking in financial institution regulation. Finally, though advocates of a federal charter insist that the new structure would only affect those companies who elect to participate, it is impossible to segregate any federal charter from a state charter under the misguided concept of charter "choice." Dual regulation will be the *de facto* – if not the *de jure* – structure.

Conflicts with Existing Laws.
Perhaps one of the most complex and challenging issues that would confront a uniform 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 various laws impact 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 hamper hopes for gaining efficiencies through national uniformity.

Yet, creating a uniform body of tort law presents significant problems of its own. First, there is the question of Congressional authority. Some believe that state tort laws may be protected by the 10th Amendment to the U.S. Constitution, which reserves to the states all powers not expressly granted to the federal government. Even if the 10th Amendment bar is overcome, there is still the likelihood that Congressional authority to preempt state laws may be inadequate and must be established. Finally, should the courts find that

[47] See the National Insurance Chartering and Supervision Act.

Congress has the legal authority to adopt a uniform body of laws, they must address the practical political problem of determining what substantive tort laws to adopt.

As Liberty Mutual Insurance Company has observed:

> "[t]he fundamental basis of all insurance transactions is the contractual promise to pay in the event of an insured contingency. Our system of contract law is deeply developed, and with respect to insurance policies is based on more than a century of policy interpretations by state courts. Our tort system, which governs many of the types of contingencies at the heart of insurance claims, particularly those covered by liability insurance, is also deeply based in state law."[48]

Assuming that preemption is not barred by the 10th Amendment, defining the existence and scope of Congressional authority will be a lengthy and complicated undertaking. Generally, Congressional preemption authority is based on the theory that Congress is regulating interstate commerce. In order to qualify, the activity must either be in the stream of, or significantly impact on, interstate commerce.[49] In 1944, the U.S. Supreme Court ruled that the business of insurance was in the stream of interstate commerce.[50] However, in a later decision, they held that state tort laws do not necessarily constitute the regulation of insurance.[51]

Congress might be able to override state tort laws, but a determination must be made on a case-by-case basis. In making each determination, the courts must consider the law's relationship to interstate commerce in light of the fact that the law in question is only effective within that state's borders, making any such connection increasingly tenuous.

At best, after years of litigation and appeals, the result will be a patchwork of laws that decreases uniformity. For instance, it might be successfully argued that Congress may mandate the use of seatbelts to protect a lane of interstate commerce. However, in some states, the failure of the plaintiff to wear a seat belt may be considered in assessing damages, in other states, the reverse is true. It is hard to imagine how this very fine point of law would fall under Congressional commerce clause authority.

Another complicating factor is that questions on commerce clause authority do not end with preemption. Congress must also be thoughtful about the limits of their authority in creating uniform laws. Consider that the U. S. Supreme Court struck down a federal criminal law prohibiting the possession of a firearm in a school zone because they found no relationship between the act of possessing a firearm in a school zone and interstate

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[48] "The Case for State Regulation: A Proposal for Government, Industry and Consumers," Liberty Mutual, March 2001, p. 7.

[49] *United States v. Lopez*, 514 U.S. 549, 115 S. Ct. 1624 (1995).

[50] *U.S. v. Southeast Underwriters Association*, 322 U.S. 533, 64 S. Ct. 1162 (1944).

[51] *Union Labor Life Insurance Co. v. Pireno*, 458 U.S. 119, 102 S. Ct. 3002, 3009 (1982) In determining whether a law regulates insurance, a court must consider: "*first*, whether the practice has the effect of transferring or spreading a policyholder's risk; *second*, whether the practice is an integral part of the policy relationship between the insurer and the insured; and *third*, whether the practice is limited to entities within the insurance industry."

commerce.[52] While this addresses a criminal statute, it is relevant because it goes beyond preemption by limiting Congress' authority to impose a law on the states. Also, consider a ruling from the 4th U.S. Circuit Court of Appeals that struck down a private cause of action against anyone who commits a crime of violence based on the victim's gender. Again, the court found no relationship between the offense and interstate commerce.[53]

Could Congress "federalize" the law of defamation, professional malpractice, premises liability, state corporation law, products liability law, etc. under its powers to regulate commerce at it affects insurance risk?

Even if Congress had carte blanche to preempt state tort laws, how would they proceed? Would they choose one state's tort laws and preempt all others in its favor? If they did that, how would members of Congress justify that to their constituents? Would they preempt all state laws and create an entirely new body of tort law? If so, how would they justify overturning 51 carefully developed bodies of law? Or, would they preempt on an as-needed basis? If they take that approach, how will they ever credibly offer uniformity as an advantage of federal licensing?

This is a critical debate that goes to the heart of our legal structure. One of the appealing aspects of our government is that the states have autonomy to create laws that appeal to their residents. Consider that New York State has banned the use of cell phones while driving, while, in Oregon, it is illegal for local governments to regulate the use of cell phones by drivers.[54] This kind of legal diversity is central to our culture, politically as well as legally. Its elimination should not be treated lightly.

Increased Cost and Enlarged Bureaucracy

Both federal chartering proposals 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 provides an estimate of what those costs will be. These decisions are left to the personnel in the new agency. This begs an obvious 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?

Finding an answer to that question is not simple. There is no easy way to compare the current costs of state regulatory regimes with a yet-to-be-created federal agency. But, since the chartering proposals are patterned after existing bank regulatory agencies, one can speculate on what those federal costs might become.

For instance, the Office of Thrift Supervision (OTS), in addition to its Washington, D.C. headquarters, has offices in Atlanta, Chicago, Dallas, Jersey City and San Francisco. The OTS employs 1,254 individuals, who oversee about 1,100 thrifts with more than 10,000

[52] *United States v. Lopez*, 514 U.S. 549, 115 S.Ct. 1624 (1995).

[53] *Brzonkala v. Virginia Polytechnic Institute and State University*, 169 F.3d 820 (1999).

[54] CompuServe Interactive Services, "A New Year Brings All New Silly Laws," January 20, 2002.

operating branches and total assets of more than $800 billion. The thrifts paid $131.3 million in assessments and exam, application and security filing fees in 2000.[55]

While the new federal agency would not initially incur the same costs as the OTS, with time, the new insurance regulator would likely rival the thrift's structure of having a central headquarters in Washington, D.C., regional offices and hundreds of employees. If, as the federal proposals claim, federally chartered companies will be required to continue to pay state premium taxes in addition to federal fees, perhaps the more appropriate question to ask is: where's the savings?

Some companies apparently believe the savings would come from only dealing with a single regulator instead of multiple state regulators, despite having to pay federal fees and state premium taxes. But, will that argument apply to banks forming new insurance companies under an optional federal charter? Who will have the competitive advantage then?

It has been well established that with the federal bureaucracy, there comes federal paperwork. What everyone may not know is just how daunting a problem that paperwork has become.

In spite of legislation like the Paperwork Reduction Act in 1995[56] to curb the paper flow, the federal Office of Management and Budget estimates that businesses spend an estimated 7.2 billion hours every year in meeting federal paperwork requirements at an estimated cost of $190 billion annually. The Small Business Administration (SBA) estimates that the costs to small businesses are a staggering $5,100 per employee.[57]

Despite these frightening statistics, some insurance companies may still view an operational federal charter as less of a regulatory paperwork burden than they now face in complying with multiple state laws and regulations. But, does that really outweigh the kind of day-to-day interaction that companies have with regulators and lawmakers?

An insurance company domiciled in a state today, regardless of its size, generally has some greater opportunity for meaningful engagement with its regulators and state legislators when it comes to interacting with them on certain laws or regulations, but will those same companies have similar opportunities at the federal level? What would it take to replicate that same level of access on the federal level?

Companies today can actively participate in deliberations at the quarterly NAIC meetings or before state administrative hearings and often can change the direction of a proposed model act or regulation. Under the more formal federal regulatory system, companies must respond to proposed rules in writing and do not have the same opportunities to intervene in that process to effect a more positive outcome. Again, this suggests a major

[55] For information about the Office of Thrift Supervision, visit their Web site at http://www.ots.treas.gov/.
[56] P.L. 104-13.
[57] See http://www.senate.gov/~voinovich/pressreleases/pr-010730a.htm.

commitment on the part of companies that will not be possible for all of them, and will add an even greater compliance burden for those with the financial resources.

Avoiding the "Big Mistake"

Federal regulation can bring us closest to uniformity in regulation, but when the single national regulator makes a mistake, it has significant economy-wide consequences.[58] For example, there is no doubt that the United States requires a single national currency, but with that comes a Federal Reserve Board to regulate that currency. Every mistake in monetary policy can lead to an economy-wide recession. When a state regulator makes a mistake, the damage is localized and can be "fixed" more easily.

California's celebrated passage in 1988 of Proposition 103, mandating a 20 percent rollback in automobile premiums and a prior approval system for rates after two generations of competitive pricing, is an example of a serious policy mistake driven by politics that has been mitigated by other state actions.[59]

Proponents of Proposition 103 represent it as the ideal system of insurance regulation.[60] Auto insurance rates have fallen and complaint volume at the California Department of Insurance is low. But California, with its massive population and multiple urban areas, will always be a high potential loss state. Simply slashing prices one-fifth without employing methods to lower the cost of inevitable losses could only result in insurer instability as company losses outpaced their ability to recoup expenses.

Fortunately, California's Supreme Court acted two months before Proposition 103 was passed to overrule adverse prior decisions that had led to dramatic increases in auto claim-related lawsuits during the 1980s. In addition, new laws were enacted to mandate seat belt use and reduce fraud by permitting its prosecution as a felony. Also, voters approved a bar on uninsured pain and suffering damages, commonly known as No Pay/No Play.

Therefore, it was this series of explicit public policy choices to reduce costs, not the institution of prior approval or slashed rates that have allowed prices to go down without driving California insurers out of the market.[61]

New Jersey has represented a case in contrast. For many years, The Garden State administered one of the toughest regulatory climates in the country with policies such as

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

[59] O'Connor and Esposito offer an excellent summary of the California situation in "Tacking to the Winds of Change."

[60] J. Robert Hunter, "Why Not The Best? The Most Effective Auto Insurance Regulation in the Nation," Consumer Federation of America, June 2001. Paper available at: http://consumerfed.org/whynotthebest.pdf.

[61] It has even been suggested that prices in California could be lower still were it not for a restrictive rate law that makes adjustments uncertain, keeping them unnaturally high. For an analysis, see Ken Cooley's paper at: http://www.namic.org/topnews/080/kkk.htm.

strict prior approval, mandatory coverage requirements, an excess profits law, territorial rate caps and barriers to exit.

Pricing relief was generally not available in New Jersey. Prior approval was so strict that the rate approval process took a year. In 1999 and 2000, 29 of 32 rate filings were rejected; and the three approvals were for only a portion of the requested adjustment.[62]

The situation was made worse in 1998 when state legislators, responding to the razor-close gubernatorial race the previous year in which auto insurance was a significant issue, enacted the Automobile Insurance Cost Reduction Act (AICRA). AICRA required mandatory 15 percent rate decreases and reforms aimed at reducing costs to insurers, although none of the reforms were projected to reduce costs by 15 percent as well.

What were the consequences of these purposeful public policy choices?

For one, insurance consumers in New Jersey paid the highest auto premiums in the country while their choices continue to dwindle.[63] More than 20 insurers left New Jersey during the 1990s.[64]

In the early part of the decade, New Jersey had 47 percent fewer companies selling insurance than Illinois, 34 percent fewer than New York and 31 percent fewer than Pennsylvania."[65] .

At one point it was forecast that one out of every five auto insurance buyers in New Jersey would have been placed with a new carrier, creating confusion for some and even higher rates. Under this scenario, some consumers may simply decide not to carry auto insurance at all. That will mean more uninsured motorists and higher costs for drivers involved in accidents with them. Certainly even the most politically motivated policymaker would not approve of these.

In 2003, the New Jersey legislature responded to the crisis. Policymakers approved substantial insurance regulatory reform, which included a more expedited rate approval process and modification of its somewhat antiquated laws pertaining to notion of "excess profits" (by extending the period over which profits are calculated.) Specific to the auto insurance market, this recent reform initiative will phase out the existing "take all comers" law requiring auto writers to accept all applicants.

Even with these changes in place, New Jersey is still considered a less than hospitable insurance environment and continues to experience difficulty attracting new companies due to the continuation of its dense regulatory structure that does little to attract new

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[62] John D. Worrall ,"Private Passenger Auto Insurance in New Jersey: A Three Decade Advertisement for Reform," in J. David Cummins, ed., *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency* (AEI-Brookings Joint Center for Regulatory Studies, 2002), p.81.
[63] NAIC, State Averages Expenditures & Premiums for Personal Automobile Insurance, as cited in Worrall.
[64] Ibid.
[65] Ibid.

writers, burdens existing writers with undue regulatory and administrative costs, limits consumer options, and creates regulatory barriers to exiting the state.

Today, companies that cannot afford to do business in New Jersey have 50 other jurisdictions available to them. Consider, however, the consequences for the country if a strict regulatory model like that of New Jersey (or California without the cost reduction policies) were imposed on the entire nation either through Congress or by an activist U.S. Insurance Commissioner. Where, then are the alternative insurance markets?

Some government actions start out laudably, but generate consequences totally unforeseen, sometimes many years later. One notable set of unforeseen consequences originates in the federal government's role during World War II in promoting health insurance as the only insurance product predominantly linked to the workplace.[66]

The U.S. War Labor Board had imposed wage and price controls as a wartime measure. Builders of escort vessels couldn't raise wages to attract more workers to build the needed convoy escorts. Their application for an exception denied, ship builders asked the War Labor Board if they could raise *compensation* without raising *wages.* The War Labor Board agreed, concluding that as long as "you don't raise cash incomes, we won't consider it income."

Thus, the modern employment-linked health insurance system was born. Employers bought comprehensive health insurance for their employees as a means of attracting the necessary labor force.

Fewer than 20 million Americans had any kind of health insurance in 1942. What was available was limited to some type of hospitalization plan with no coverage for physician bills, prescription drugs, or major medical expenses. After the war, employment-linked health insurance exploded. By 1954, over 100 million Americans were receiving health insurance from their employers.

The result of this seemingly innocuous federal tax decision during World War II is the "health insurance crisis," a staple of contemporary American political debate.

Employees with employment-linked health insurance today are under the mistaken illusion that health insurance is "free" because they don't write a check for it.[67] Economists will tell you that when a good is perceived as "free", it will be over-demanded.

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[66] For a discussion of federal government health insurance policy, see Styring, W. and Jonas, D., *Health Care 2020: Why Employment Based Health Insurance is in Trouble* (Hudson Institute Press, 1999). For more information about this book, visit http://www.hudson.org.

[67] In fact, every econometric study of the incidence of the cost of health insurance says it is "back shifted" to the employee. That is, in the absence of employer-provided health insurance costing X, the employee's cash income would rise by X.

Seniors accustomed to "free" health insurance during their working lives can be somewhat forgiven for wanting "free" health insurance in their retirement years. Thus, we get Medicare and nursing home Medicaid paid for by the "government" and demands to expand Medicare by including prescription drug coverage. Demand for something paid for by someone else is insatiable.

The ripple has spread to state governments, where debates over patient bills of rights and mandated insurer coverages are routine in state legislatures.

The Reality of Rulemaking, Litigation and Federal Uniformity

As previously noted, one of the primary justifications for federal regulation is the need for uniformity. This argument has a certain political appeal – pass one law and everything is uniform. However, this political perception does not reflect the truth about federal uniformity.

A new federal regulatory structure would begin with the promulgation of regulations, resulting in one body of rules requiring industry's attention. This is where the truth behind the political perception ends. This new body of rules will inevitably give rise to questions about the meaning of various regulations, requiring regulatory interpretation. Many of the interpretations will be litigated, and eventually undergo review in one of 12 federal courts of appeal. Not surprisingly, decisions coming from 12 separate federal districts vary. It is common to have substantially different, and sometimes completely contrary, interpretations of the same federal law. The only way variances in interpretations can be resolved is through the U.S. Supreme Court. Generally, while the Supreme Court is more likely to accept a case that involves what lawyers call a "split in the districts," this is not a foregone conclusion. The Supreme Court agrees to hear only a fraction of the requests it receives every year, and accepting cases is left completely to its discretion.

Then, consider that the federal government is a massive organization with many regulatory functions and agencies. Internal inconsistencies between laws and bodies of regulation promulgated by these various agencies are inevitable. Many of these inconsistencies can only be resolved by litigation, which is subject to the varying interpretations of the 12 separate federal circuits. Think of the uncertainty associated with different federal circuit interpretations in ERISA law or Title VII employment law.

While federal regulation will result in a degree of uniformity, it is not the panacea that 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 that have existed in state tort laws for the entire history of our nation. Next, it will require a considerable amount of time to interpret these regulations on the agency level. It will take even more time to attempt 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. This raises the questions: *How long will these processes take, how much uniformity can it produce and how much reform can the states accomplish in the meantime?*

REFORMED STATE REGULATION

As the previous sections of this paper show, state regulation has certain intrinsic advantages over federal regulation, and the path to obtaining federal regulation would be a treacherous political journey. However, 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 consumers and industry.

So, how can state insurance regulation work more effectively in the future? The answer depends on prompt policy maker response to four major issues:

1. Rate regulation,
2. Market surveillance,
3. Solvency monitoring, and
4. Company licensing.

Rate Regulation

If the property/casualty insurance business were described to a group of economists without identifying the industry, the economists would no doubt all answer "No" when asked the question, "Should government regulate prices in this business?" There's plenty of actual and potential competition there. The market will take care of protecting the consumer. Why involve government?

On the surface and in terms of pure economic theory, there is only a weak case for *any* regulation of the property/casualty insurance industry. Is there market failure and the possibility of predatory pricing? Hardly. There are more than 3,000 companies in the business. This would certainly not indicate a high level of industry concentration.

It is sometimes argued that, in a given state, in a particular market for a type of insurance, there may be insufficient competition. Rate regulation is justified in these cases, it is argued.

This might be true if it were not for the state of Illinois. As discussed earlier, Illinois deregulated auto insurance rates in the early 1970s, and motorists there today continue to enjoy auto insurance rates that are lower than nearly half the states. Market determination of auto insurance rates in this real world example did not cause rapacious pricing.[68]

States should eliminate the approval process for pricing insurance products. Insurers must have the responsibility and opportunity to price their products based on their own market research and strategic plan. Combined with market pricing, regulators must

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[68] As O'Connor and Esposito observe, Illinois legislators are evidently pleased with this public policy. No bill to re-establish prior approval of rates has ever received a majority vote in either chamber of the Illinois legislature.

eliminate burdensome and unproductive approval processes that impede delivery of products to consumers.

In prior approval states, prices are controlled by insurance regulators, in theory, to keep insurance affordable and available to consumers. But in states such as South Carolina and New Jersey, government-established prices have not reflected the potential cost of losses, thereby increasing the financial vulnerability of insurers and decreasing the choices available to the public. [69]

The consequences to consumers of these public policies have been almost entirely negative. Residual markets increase as insurers reduce voluntary market sales, fewer insurers are willing to enter the market, services to policyholders are reduced and incentives for policyholders to control losses decrease, and companies will effect an outright withdrawal from a market. The end result is that policies designed to serve consumers have precisely the opposite impact. Experience has shown competition to be the most effective regulator of insurance rates.

As a result of reform legislation enacted in 1997, South Carolina has now experienced notable success with modernizing its rating laws. During the first half of the 1990s, an average of 59 insurers did business in South Carolina while other southeastern states averaged 197 insurers. After the 1997 reforms, South Carolinians benefited from the choices provided by almost twice as many insurers and by a dramatic drop in the size of the residual market. [70]

One must be cognizant of how markets really work. Potential competition is as effective as actual competition in regulating business behavior, provided that there are no artificial barriers to entry.

Consider this example. From the 1940s through the early 1980s, the Gillette Safety Razor Company controlled over 95 percent of the U.S. market for razors and razor blades. Yet if one examines Gillette's rate of return on capital, it was quite ordinary. In other words, Gillette had an effective monopoly, but they did not behave as a monopolist! Moreover, Gillette innovated. They evolved from the old safety razor, sponsorship of the Friday night fights and the single edged razor blade to the double-edged disposable razor. Gillette innovated (something not easy to do in the static shaving business) and did not behave as a monopolist.

Why this strange behavior? At any time, Gillette could have raised its prices and made a fortune.

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[69] See Worrall, cited at footnote 65.

[70] Martin F. Grace, Robert W. Klein, Richard D. Phillips, "Auto Insurance Reform: Salvation in South Carolina," April 2001. The paper can be accessed at http://rmictr.gsu.edu/Papers/SC_Auto_Salvation_4-15-01.pdf.

The reason is that the shaving business is not hard to enter. If Gillette had behaved as a monopolist, their lush profits would have meant that they soon would not have been a monopolist. Their abnormally high profits would have been a signal to potential competitors to "come on in."

Now, consider what happens when a government entity imposes barriers to entry into a market.

In the days when "broadcasting" meant over-the-air TV, the three major networks had rates of return on capital roughly double that of the rest of U.S. business. The Federal Communications Commission (FCC) limited the number of local TV stations. To survive, each station had to be affiliated with a major network. Because of the limited number of local stations, there was room for only three major networks. They could charge quasi-monopoly prices.

The property/casualty insurance industry is more like the Gillette example than the broadcasting example. Rate regulation is not necessary, provided regulators do not artificially restrict competition.

Progress on rate reform is steady. Sixteen states (Arkansas, Colorado, Georgia, Indiana, Kansas, Kentucky, Maine, Massachusetts, Nebraska, New Hampshire, Oklahoma, Pennsylvania, Rhode Island, South Dakota, Virginia and Washington) have approved laws to exempt large commercial policyholders (ECPs) from rate regulatory review and approval. In addition, six others (Florida, Illinois, Missouri, Nevada, South Carolina and Wyoming) either already acted or have recently taken action to exempt certain classes or commercial lines from rate regulation as well.

These initial rate reform efforts targeting large commercial risks represent significant regulatory improvements, but they also reflect fundamental changes that have helped to expand growing consensus and fuel momentum about the need for more comprehensive insurance rate modernization. They are, in fact, seen as integrally important developments that literally opened the door for debate about extending rate reform to personal lines insurance.

Several states have recently taken action to extend rate modernization to the personal lines segment of the industry. At least five (Louisiana, Rhode Island, South Carolina, Connecticut and Texas) have emulated the basic concept behind the NCOIL Property Casualty Flex-Rating Regulatory Improvement Model Act, by extending rate modernization to personal lines through a percentage band or "flex rating" system enabling insurers to change rates by a certain percentage before regulatory review and approval is required.

Moreover, Nebraska, New Hampshire, Oklahoma and South Dakota have recently extended rate reform to personal lines by eliminating prior approval requirements and replacing them with relatively more favorable file and use or use and file requirements. In addition, Massachusetts and New Jersey, both of which are problematic auto insurance states, have recently taken actions aimed at improving performance of, and reducing reliance on, their respective residual market mechanisms and encouraging auto writers to enter their state markets.

Seventeen states have adopted some form of rate modernization since 2003. Among these are two of the most challenging markets, New Jersey and Texas. Also encouraging is that 22 states have established no filing requirements for large commercial risks in certain lines, and 15 states currently rely on the relatively more flexible use and file system to regulate certain lines. In addition, six more states (Louisiana, New York, Oregon, Rhode Island, Connecticut and South Carolina) have established some form of flex rating system for certain lines.

Of the 38 states that still use prior approval laws to regulate either commercial, personal, workers' compensation or other specific lines of coverage certain lines, over half of these states either apply prior approval only after a finding that a noncompetitive market exists or to very select lines of coverage such as title, surety, fidelity, inland marine, medical malpractice, mortgage guaranty and professional liability.

After removing these particular states from the tally, only 15 states still rely on prior approval laws to regulate either commercial or personal lines insurance rates. Unfortunately, three of the largest markets--New York, Florida and California—continue to require prior approval of personal lines. These states represent the clear focal point for further rate modernization advocacy efforts.

Market Surveillance

A new market surveillance program must be adopted by the states operating under the premise that most insurance companies are in business to treat their policyholders fairly and only companies that violate that trust should be pursued and punished.

Today, market conduct examinations are often initiated without any tangible evidence that the company in question has treated its policyholders unfairly. The result is that the company ends up paying government (regulators) thousands of dollars in examination costs without any substantive problems being detected. Consumer interests are not served when company financial resources are unnecessarily diverted.

This adjustment in regulatory philosophy relies on analysis of existing and available market data to reveal performance deviations rather than largely open-ended market conduct examinations. An emphasis on "market analysis" could include looking more closely at a company's *valid* consumer complaints, the company's market share relative to the rest of the marketplace, and other, non-proprietary information gathered by regulators. With this approach, regulators can focus their own limited resources on companies that fall outside a predetermined set of standards developed from data analysis.

The market analysis approach also could rely on a series of regularly scheduled compliance reviews, where regulators would send surveys to insurers to check on their compliance with new laws or regulations. This should only occur after an appropriate amount of time has passed that allows companies to come into compliance.

Regulators recently adopted a set of “best practices” for market conduct exams that were based on a set of recommendations offered by NAMIC and the other national property/casualty trade associations. States need to implement these practices to bring more uniformity and consistency to the current examination process. This can lead to more coordination among regulators in examining certain companies and should help to reduce the unnecessary duplication of exams that often takes place today.

The new process must be proportional so that insurers are given the opportunity to explain any market inconsistencies before being subjected to more severe actions like a market conduct examination or an administrative penalty. This process can be as informal as an exchange of letters between the regulator and the company or as formal as a set of department interrogatories sent to the insurer. The key is that insurers know the process ahead of time and that regulators consistently apply it.

If an administrative penalty is warranted, regulators should follow remediation principles found in other business areas, where a penalty is only imposed when the market problem is not corrected within a defined time frame. This encourages insurers to fix market problems in a timely fashion, and ultimately benefits consumers.

Certain functions now performed as part of routine market conduct examinations can more efficiently be handled through regularly scheduled compliance reviews. Perhaps “minimum standards” can be developed for such practices as documenting underwriting and claims files that can replace the need for on-site market conduct exams.

Many of these concepts have been captured in a model bill approved by both NCOIL and the NAIC. At this writing, only a handful of states have introduced legislation based on the model because resolution of several key issues is necessary. Chief among those matters that require resolution are the responsibility of the domestic regulator for the market conduct oversight of its domestic industry, the rights, if any, of insurers when a state regulator decides to conduct a market conduct examination, and stronger confidentiality protections for any information turned over to a regulator in the course of a market conduct investigation.

Considering that it was recently believed unlikely for a market conduct model of any sort to be completed, much less run through processes at NCOIL and the NAIC, its existence is a significant step forward. Industry and policy makers must still come to agreement on these matters to achieve reform of the market conduct system.

Solvency Monitoring

The core focus of state insurance regulation is solvency monitoring, and state regulators have an array of tools to be used for this monitoring on either a periodic basis or special basis to help insure a financially sound insurance market.

The financial examination, typically administered by the states on a cycle of three to five years, and sometimes including participation of other states' examiners, per NAIC protocol, is supplemented by a number of solvency measuring and reporting tools: Risk-based capital (known as "RBC" and similar to that used in banking); continuing computation, based on insurers' annual and quarterly financial reporting, of IRIS and FAST ratios that seek to identify weakening companies; actuarial opinions on the adequacy of reserves; "Jumpstart" reports; and the annual statutory audit of insurers' financial statements, performed consistent with the NAIC's Model Audit Rule.

Underlying these several means of assessing insurers' claims-paying ability is the "Codification of Statutory Accounting Principles," a compendium of accounting guidance reached through extensive joint effort and debate of industry and regulators. The "Codification" is the core content of the NAIC's *Accounting Practices and Procedures Manual*, which is the authority for insurers' regulatory accounting and reporting and, thereby, the basis for financial information used in all solvency monitoring.

Insurers have legitimate concern with solvency monitoring on at least two dimensions: 1) its stringency and consequences for doing business and 2) efficiency—also to be read as cost—of regulatory requirements. These dimensions are, similarly, of concern to policyholders, who want carriers of solid financial status but who do not want to pay premiums that reflect inefficient conduct of regulation.

NAMIC and six other national insurance trade associations recently produced a white paper,[71] excepted in this section, that identified three primary recommendations to facilitate discussion of the examination system by all stakeholders. Three fundamental recommendations were identified for regulator-industry dialogue toward improvement of the NAIC/state financial examination process—with special emphasis on efficiency. Those recommendations include:

- ***Controlling expenses, especially with respect to use of contracted CPA firms and other consultants***. Whether with such firms or with state examiners, costs must be managed by insisting on full planning before commencement of examinations, rather than on site.
- ***Reconsideration of protocols for zone examinations***. Participation of zone examiners often generates a disproportionate amount of total examination costs and should be minimized. Zone examiners are often less accountable and less knowledgeable than domestic examiners. When zone examiners *do* participate,

[71] "A Call for Change," Statutory Financial Examination Process white paper jointly produced by the Alliance of American Insurers, American Council of Life Insurers, American Insurance Association, National Alliance of Life Companies, National Association of Independent Insurers, the National Association of Mutual Insurance Companies, and the Reinsurance Association of America.

feedback from domestic examiners on performance of zone examiners to their respective states is also highly appropriate.

- ***Integrating audit work from annual CPA audits***. Efficiency dictates that examiners not duplicate work already done and available from independent auditors who perform annual audits. Examiners should use auditors' work papers for basic matters and concentrate instead on those compliance items that most concern them. Perhaps most productive of efficiency in state financial examinations of insurers is use of risk-focused examinations. Although requiring skills beyond the "ticking and tying" done by some examiners, such focus enables economy of labor by identifying areas where risks affecting material assets and liabilities may exist and directing further examination efforts thereto.

Of signal concern to non-public insurers is the extent to which state regulators may choose—for supposed use in financial examinations or elsewhere—to transplant content, particularly that related to internal accounting control, from the federal Sarbanes-Oxley Act to state regulation. The Act results from failures among public corporations; i. e., those in the public capital markets and regulated by the SEC and directs its requirements to public companies.

At this writing, regulators appear intent on a symmetry that would bring Sarbanes-Oxley content requiring extensive documentation and attestation on internal control into state solvency regulation. Whether for purposes of NAIC/state financial examinations or any other use, the additional weight of such content is unwarranted and of unreasonable cost.

With respect to solvency monitoring and its conduct by regulators, "more" often does not constitute reform but rather an incremental and unproductive burden on insurers. Reform or improvement has different meaning from respective perspectives of insurers and regulators, but it is reasonable to say that the extent of regulators' powers and means, if used skillfully and with some changes to increase efficiency, will provide adequate protections for policyholders.

Company Licensing

Federal chartering proponents often argue that to successfully compete in today's global marketplace, they need the ability to operate successfully in every insurance jurisdiction. This means obtaining a single, national license instead of navigating the uncertainty that resides in the 51 state insurance jurisdictions.

The Uniform Certificate of Authority Application (UCAA) is now used in every state and the District of Columbia and an "electronic application" is now in use. However, that represents only part of the company licensing reforms that are needed. States must modify and/or eliminate state-specific filing requirements that are inconsistent with the UCAA process.

For example, why should the application of a Fortune 500 company be held up because a state law requires a financial exam to be less than three years old, but the company's home state only examines its companies every five years?

Beyond the UCAA, regulators must answer several questions about the information that accompanies licensing applications. Some of the information, like a state's capital and surplus requirements or its investment requirements, may be difficult to make more uniform because of the threat it poses to a state's solvency accreditation. However, other requirements are not so sacrosanct.

Ultimately, what will make company licensing a viable state regulatory reform is an electronic process that allows companies to submit multiple applications to a central repository and allows the companies to update their information with a few keystrokes.

Concerns about the security and confidentiality of proprietary company information submitted to a licensing database must be addressed. As well, the role of NAIC staff in the licensing process must be resolved and whether companies must pay the NAIC a transmission fee to use a licensing database.

ACHIEVING REFORM THROUGH THE STATES

The urgency NAMIC expressed in 2002 remains unchanged: advocates of state-based reform must continue to move with dispatch to eliminate the reasons for federal regulation now being presented on Capitol Hill.

There is ample opportunity for the other side to make its case. Proponents of federal regulation are spending tens of thousands of dollars and CEO time to lobby Congress. Chairs of key House committees have renewed their interest in state reform efforts. Results of the 2006 mid-term elections could also tip the balance of national power toward federal regulation.

It is easy to be distracted by action in Washington. But beyond their present mode of pushing states to make changes, 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 industry or the consumers it serves.

As this paper argues, 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 undoubtedly produce results far more intrusive than what was intended. Prospects for administration of a federal system raise more questions than answers. Pursuit of any federal solution to the problems of state regulation will inevitably invite additional mandates that could serve to undermine the principles of risk sharing on which this industry is based.

What has changed since NAMIC first issued this paper is the policy direction of insurance regulation. There is an emerging consensus that insurance regulation should not impede marketplace competition. States like New Jersey and Louisiana have watched their markets shrink and have actually done something about it. In all, eleven (11) states have acted to modernize commercial or personal lines rate laws since 2003 to promote competition.

The consensus for competition is even reflected in the preemption of state rating laws found in the initial draft of the congressional SMART Act.

Also notable is a subtle shift of power in the states with respect to who makes fundamental insurance public policy. Legislators now embrace the reality that they set public policy and that regulators are the administrators. In addition to the states that have modernized their rating systems in the last two years, other examples are:

- The National Conference of Insurance Legislators (NCOIL) created model legislation on commercial and personal lines rate modernization, portions of which are now law in 24 states.

- The National Conference of State Legislatures (NCSL) has adopted a set of principles that call for states to “consider systems of product regulation that rely increasingly on competitive forces to determine Property/Casualty insurance rates …" and to "consider market-based systems that would allow competitive forces to shape the development and price of products sold by commercial insurers and would enable insurers to respond with greater innovation and flexibility to the evermore demanding needs of American business."

- NCOIL took the lead in creating a market conduct model bill that has since been endorsed by the National Association of Insurance Commissioners (NAIC), a rather stunning reversal of form.

Very important, too, was the work of NCOIL to approve model legislation on credit-based insurance scoring. The NCOIL model is now law in 19 states. While not commonly thought of as "reform" it is tangible evidence that states are taking responsibility for their regulatory environments—and not a moment too soon.

That said, the initial discussion draft of the S.M.A.R.T. Act is a creative proposal important to NAMIC member companies for two primary reasons:

- Rejection of the concept of a federal insurance regulator is in line with our long-held belief that state insurance regulation can best be accomplished in the state capitols. Since property-casualty insurance addresses issues that can vary significantly from one state to another, maintaining and improving the system's state-based foundation is the correct public policy response for this segment of the industry.

- Identification of the regulatory impediments to a competitive industry that can best serve consumers. As such, it is a valuable tool in the pursuit of reform in the states.

NAMIC was pleased with recognition in the initial draft that the primary barrier to fundamental reform of the property-casualty industry is price regulation. And the Act's call for more coordinated, "for cause" market conduct examinations is timely given the recent NCOIL model seeking a uniform standard for market surveillance.

It is difficult to accomplish what the authors of S.M.A.R.T. have in mind—creating national insurance standards without a national standard maker. There are many references to the National Association of Insurance Commissioners (NAIC) and its processes in the initial draft of the bill. NAMIC believes that reliance on a voluntary organization with mostly appointed commissioners, unduly drawn-out deliberations, little accountability or due process is a significant concern.

Even in its initial draft, S.M.A.R.T. has done industry and regulators a tremendous service by outlining an agenda for reform that will satisfy Capitol Hill. Since 2000, NAMIC has called for collaboration between the NAIC, the National Conference of Insurance Legislators (NCOIL) and the National Conference of State Legislators (NCSL) to study and enact state reforms. Today, that collaboration exists, at least on paper. Now is the time to demonstrate its effectiveness. NAMIC strongly suggests that regulators focus their time on working with their respective state legislators to enact reforms in the areas identified by the S.M.A.R.T. Act.

The property/casualty industry must not treat the question of federal insurance regulation as a *fait accompli*. It is far from that. On an issue so complex and filled with so much room for political error as this one, members of Congress and Senators will require agreement from the private sector that this is the correct outcome (and as we learned from the terrorism backstop debate, agreement is not always enough) before taking action.

Nor should industry blindly accept the calculation that Congress will not act in the near future. Clearly, there is interest that, given the right set of circumstances, could give rise to action at some point. If proponents of state regulatory reform are not effective advocates for their position, or new substantive benchmarks of state progress are too long in coming, the potential exists for federal proponents to gain enough momentum that indeed the question will become " when," not "if." But that time is not here. Not yet.

The old adage remains true: "politics abhors a vacuum." And a vacuum in insurance regulatory reform will certainly be filled at the federal level if the states don't fill it first.

Industry, consumers, regulators, governors and legislators must work in collaboration to eliminate the reasons why Congress would need to act. The road to reform runs through state capitals, not Washington, D.C.

State regulation can become the optimal insurance regulatory structure if reforms are made by state legislatures engaged in an all-out effort to enact measures to protect consumers, create uniformity, ensure competitive markets and promise choices for the insurance buyer.