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A Reexamination of Federal Regulation of the Insurance Industry

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Abstract: The Optional Federal Chartering (OFC) proposal introduced in the last session of Congress may have been the right bill for the introduction of federal regulation of the insurance industry at the turn of the 20th century. However, the current OFC proposal shows its 19th century roots as it merely copies the banking industry's dual chartering provision and various aspects of state insurance regulatory law. This paper critiques the issue of federal regulation, not necessarily from the perspective of whether federal regulation dominates state regulation, but as to whether the federal or state regulation is structured sufficiently to minimize market failures or to minimize the effect of regulatory failures.

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I. Introduction

The United States is in the midst of a financial crisis brought about by both the presence and absence of risk regulation. Mortgage companies were encouraged to write higher risk loans, in part, because of future expectations of increased property values and government pressure. At the same time the use of derivative contracts spread the risk of default of these riskier mortgages worldwide, boosting demand for all, but at the margin, especially high risk mortgages. This, by itself, was not the sole cause of the crisis but it also coincided with the securitization of all types of consumer and commercial risk which, too, spread worldwide. Further, rating agencies made critical rating decisions on these securities that understated their real risk. As a result, purchasers lined up to buy these supposed low risk securities only to subsequently discover the ratings were based upon either a bad model or assumptions that housing properties would always rise.[1] Regulators at one point mandated lower risk requirements for home purchases to promote housing purchases and at the same time were unable to regulate systemic risk caused by the growth of these securities.

The insurance sector has, so far, escaped serious problems resulting from the financial crisis. Life insurers' bond and equity portfolios are now valued lower and there have been rating downgrades in the life business. This has an effect on the value of future promises to pay life

[1] See Baily et al (2008) and Congleton (2009) for a review of the origins of the financial crisis.

insurance proceeds and annuity payments but, except for a small number of companies, the crisis has not spread to insurers. Property–casualty (p-c) insurers as a group are also relatively immune from the crisis as most p-c contracts are short term in nature and are less likely to become insolvent due to changes in their investment portfolio's value.

So a question that needs to be addressed is whether we need a new system of regulation for insurers. One can argue that the current state based system did an excellent job of protecting insurers' consumers and, to some extent, their stockholders, especially when superficially compared to the federal banking regulators. Insurance is thought to be a conservative business and thus, it may be the nature of insurers rather than their regulators which made the industry less vulnerable. However, one can also argue that the current state based system failed by allowing excessive risk taking by AIG. While a great portion of AIG was made up of insurance operations, it was its unregulated Financial Products group which destroyed so much value and, ultimately, required a large federal capital infusion. An argument might be made that if the federal government (and the taxpayer) will be responsible for bailing out "insurers," might their not be a strong case for federal oversight of the industry?

Federal regulation of insurance has been proposed since the time of the National Bank Act but never seemed to obtain sufficient Congressional support. Proposals came in the 1860s, early 1900s, 1950s, 1970s, 1990s and most recently in the last decade (Grace and Klein, 2009). Almost every wave of proposed regulatory reform resulted from the reaction to some sort of crisis. In the 1900s, for example, there were management scandals in some of the largest life insurers. In the 1950s, there was a concern that the industry was becoming concentrated and states were not able to regulate these now larger insurers. In fact, Congress held hearings on whether to repeal the McCarran-Ferguson Act which set up the current system of state regulation in 1945. The Act's state based system of regulation was thought insufficient compared to a federal regulator which could keep large interstate companies from obtaining market power (Knowlton, 1960). In the 1970s, with the rise of the consumer advocacy movement, it was felt that the federal government could do a better job of regulating market conduct.[2] In the early 1990s, the industry had experienced a large number of highly visible insolvencies and Congress expressed concern the states were no longer up to the task of regulating insurers.[3] The recent push to offer federal regulation as an option was not brought about by a public regulatory failure (unlike the impetus of the previous reform efforts) but because the private costs of duplicative regulation were being born by large interstate insurers, especially life insurers. While not all insurers support the proposed federal intervention into insurance markets in the form of an optional federal charter (OFC), the proposal came from the industry, rather than from the government.

This most recent reform effort focused specifically on two factors: elimination of duplicate compliance costs and providing an option to charter with the federal government. Ideally, the large national companies subject to multiple, and potentially conflicting, regulatory jurisdictions and rules would choose a federal charter and be subject to one set of rules nationwide. Smaller companies operating in only a few states might stay with the local state

[2] See Grace and Klein (2009) for more on these reform efforts. In addition, see generally Day (1970) for a background on the history of insurance regulation in the United States.

[3] See U.S. House of Representatives "Dingle Report" (1990) for a summation of the critique against the states' oversight of solvency regulation.

regulatory system. The argument was that no firm is forced to choose a different system. Thus, each insurer could choose the system which made the most economic sense.

A. Overview of the proposed Optional Federal Charter approach

In 2007, the National Insurance Act was introduced by Senator Sununu (R-NH) and Senator Tim Johnson (D-SD).[4] This bill would create the Office of National Insurance, which is headed by an administrator who would oversee the regulation of federally chartered insurers for solvency and market conduct activities. This office would be similar in scope and authority to the Office of the Comptroller of the Currency, which oversees National Banks. The Office of National Insurance would have jurisdiction over federally chartered insurers or producers (agents) and would offer charters to insurers operating as life companies or property-casualty companies. This regulatory authority would include both market conduct and product regulation. The federal regulator would be the solvency regulator for federally chartered companies, but the federal government would not be the source of funds for claims in excess of a failed companies assets. Instead, the individual state solvency guaranty funds would be the source of payments to the claimants of the bankrupt federally chartered insurer.[5] In addition, price regulation for most lines of insurance would be prohibited for federally chartered insurers.[6]

B. Roots in 19th century banking regulation

[4]The National Insurance Act, S. 40, Introduced May 24, 2007.

[5] § 1504 of the National Insurance Act of 2007.

[6] § 1215 of the National Insurance Act of 2007.

The proposed National Insurance Act looks quite similar to the National Banking Act of 1864 (NBA) which established the dual banking system we have today.[7] The major additions are 'tacked on" to the same structure as the NBA uses, such as the use of state guaranty funds and traditional market conduct regulations taken from state insurance regulatory statutes. In fact, the National Insurance Act requires the federal regulator to incorporate a set of currently existing model rules and laws into its rules. This bill is not a fresh start on how to think about insurance regulation, but a proposal to make insurers and, to some extent, consumers comfortable with a system which looks familiar.

The motivation behind the National Banking Act was complex and was based, in part, on the need for a method to finance the Civil War as well as the desire to establish a true national system of banks.[8] Arguably the motivations for the federal regulation of insurance are quite different. The OFC proposal is promoted as being beneficial because it will reduce the cost of regulation by removing multiple regulators from the review of the same activity. One industry sponsored study on the life industry suggested that annual savings to insurers and customers could be in the neighborhood of $5 billion (Pottier, 2007). [9]

While there may be significant benefits from reducing compliance costs, the resulting proposal looks old fashioned. This by itself is not a powerful critique, given the notion that one

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[7] U.S. Code Title XII Chapter 2.

[8] See e.g. Comptroller of the Currency (2003).

[9] If the property-casualty industry has a similarly size cost savings, this would amount to a non-trial amount of expenditures on unneeded regulation. One thing in this debate that has been overlooked is the size of this amount of savings on a present value basis. If we assume that the property-casualty industry has a similar cost and a conservative discount rate of 2-4 percent, this amounts to a total costs savings in the range of $250 - $500 billion. The question which is not clear is whether there was any offsetting consumer benefit to this type of multiple jurisdictional regulation.

should employ structures that have stood the test of time. However, there does not seem to be much evidence that significant thought was put into analyzing whether this was the right structure, especially given that banks and insurers are quite different financial institutions. Further, given the unprecedented changes in the financial markets in the past year, it is not entirely fair to criticize the authors and promoters of the NIA as missing the fundamental changes in the market.

The Bush Administration's Treasury Department provided another and potentially innovative approach to the regulation of financial services. In its *Blueprint* (Treasury, 2008), the Department engaged in a fundamental review of the system of financial regulation in the United States. In a change from a regulatory structure with numerous regulators with overlapping jurisdictions and little incentive to cooperate for the benefit of social welfare, the *Blueprint* proposed three regulators: a systemic risk regulator, a market conduct regulator, and a solvency regulator. These regulators would have jurisdiction across financial industry sectors. This innovation in regulatory thinking went beyond the industrial regulatory models that have developed over the last 100 years and create opportunities for regulatory arbitrage.[10] However, insurance was not dealt with the same way the other financial service industries were. The *Blueprint* proposed a federal regulation system for insurers like that in the National Insurance Act as an intermediate step to integration with other financial service regulation.

In February of 2009, it was announced that a new bill would be introduced in the 111th Congress which would allow for federal regulation of insurance. Representatives Melissa Bean

[10] For example, monoline insurers were set up to offer bond insurance under state law. However, collateralized debt obligations were essentially the same thing and had no real substantive regulator.

(D-IL) and Ed Royce, (R-CA) said they would introduce a bill which may be titled the National Insurance Consumer Protection and Regulatory Modernization Act (NICPRMA). While all the details of legislation have not been fully disclosed, some important ideas have been. Prices will be set by companies free from regulation as long as they are actuarially sound. Like the NIA, solvency regulation will be conducted at the federal level with participation in state guaranty funds. Further, insurance holding companies will be subject to federal regulation through holding company regulations as well as through a federal systemic risk regulator, which will be set up in separate legislation.[11] What is interesting is that the federal risk regulator could take an insurance holding company under its jurisdiction if it thought the holding company's operations increased systemic risk. In fact, this federal systemic risk regulator sounds like the regulatory role proposed in the Treasury *Blueprint.*

The NIA was arguably a good approach prior to the crisis of 2008, but it does not deal with the problems facing financial markets today. The National Insurance Consumer Protection and Regulatory Modernization Act sounds promising because it adds a potentially important innovation to the prudential regulation of risk, but it still does not address the issue of modernizing the regulation of insurance.

II. The Federal Role & Regulatory Modernization

[11] The bill has not yet been introduced so any facts about the bill come from conjecture from press summaries like this one. Postal, "Sponsors of U.S. Insurance Regulator Bill List Details," *National Underwriter*, viewed on February 13, 2009 at http://www.propertyandcasualtyinsurancenews.com/cms/nupc/Breaking%20News/2009/02/12-USCOMMISIONER-dp.

There is a role for the federal government in insurance regulation. Where it can succeed is in the area of removing the costs of conflicting state laws and reducing the effect of systemic risk on all financial markets. Reduction of compliance costs is the rationale behind the 2007 NIA as well as the proposed 2009 Legislation. The NICPRMA's addition to this mix is introducing the role of a systemic risk regulator with the authority to mandate that certain insurers be federally chartered companies.[12] However, with exception of the addition of the systemic risk regulator, there is little modern thinking about how insurance regulation should proceed.

A recent paper by Grace and Scott (2009) examined part of the issue from an administrative law perspective which shows how little discussion there was of how a federal insurance regulator should be organized. For example, there are a number of regulatory models available in the United States. There is the multi-commissioner administrative body like the SEC. This is in direct contrast to the single administrator overseeing the Office of the Comptroller of the Currency. There is also an independent (from the executive branch) administrative agency like the Federal Reserve Board of Governors. Again, this contrasts directly with the administrator of the Office of the Comptroller of the Currency. The fact that the National Insurance Act of 2007 and its projected 2009 version merely copy the structure of the banking system calls the question as to why the national banking system is structured this way today. The Treasury *Blueprint* as well as others (see e.g. Brown (2008)) discusses other options and what is interesting is that these options were not conditioned on the current financial crisis.

[12] Essentially, there is a double option on the table now. From the description in the press, insurers could opt to become federally chartered, but the Federal government could opt to regulate a state chartered company if part of a holding company that might create a systemic risk.

The *Blueprint's* approach is to use a three pronged regulatory approach with a systemic risk regulator, a solvency regulator, and a market conduct regulator that would oversee *all* financial services including securities and commodities trading. This is a major innovation in financial regulation in the United States. The OFC bills, in contrast, are not innovative from the point of view of what is regulated and how it is accomplished as the approach in both bills (with the exception of a systemic risk regulator) is to shift traditional regulatory powers from the states to the federal government.

Other methods of regulation of the insurance industry are also possible. Some insurers have joined unofficial self regulatory organizations like the Insurance Marketplace Standards Association (IMSA) to increase their ability to understand their customers and to be more likely to provide policies which more closely meet the needs of their customers. These types of standards are different from state based rules that are often decades old and have not suffered an across the board reexamination, except after some sort of regulatory failure. However, from a practical point of view, Congress is not likely to delegate monitoring powers to private entities for some time. The approach of organizations like IMSA, though, can assist in the development of modern approaches to market conduct regulation.

In sum, there has been no real systematic discussion of modernization of the regulatory approach over the last decade outside of allowing for greater integration of financial services through enactment of the Gramm-Leach-Bliley Act of 1999 (GLB). Other than allowing banks and insurers to be owned by a common parent, GLB did not really change the content of insurance regulation except it mandated that the states attempt to resolve interstate differences in agency licensing. Other important substantive aspects of insurance regulation have not been reexamined. For example, solvency regulation as practiced by the states and the NAIC has not been scrutinized since Congress made them do so in the late 1980s and early 1990s. In contrast, bank regulators have adopted aspects of the Basel accords, but insurance regulators have not. Many insurers are complying with Basel II by developing their own capital models and the tests which support the models. They are not required to do so by law but are doing it to be responsible stewards of capital. To be fair, there has been an attempt to standardize certain product approval processes through the use of the new Interstate Insurance Product Regulation Commission. However, the commission has taken time to get started and was commenced, at least in part, to stave off an OFC type of regulation. This history of insurance regulation suggests that state insurance regulation is reactive. Regulation only changes because of a crisis or outside pressure from Congress. It is interesting that Congress (and not the states) also proposed the SMART Act that would have pre-empted the states' ability to regulate and transferred it to the Federal government. This proposed Act started a conversation about regulation, but it did not get to fundamentals - just what level of regulation was appropriate for insurance regulation. The OFC bills have structured this debate in such as way as to eliminate discussion of reform. Given that many aspects of regulation are important, more reforms should be on the table.

III. Why Regulate Insurance?

Economists describe the role of government as rectifying market failures.[13] In the insurance industry, there are potential market failures due, in essence, to imperfect information. Customers cannot, for example, observe the behavior of insurance company management. For a

[13] See Skipper and Klein (2000) for a more thorough treatment of how economists think about the regulation of insurance.

life insurance consumer, this might be important because of the long time between when a contract is purchased and when a payout might occur. Also, there is no effective way to discipline the insurer's management. For example, a life insurance consumer cannot "punish" a "bad" company by exchanging his long term policy for one with another insurer. Thus, the argument is that government can monitor a firm's solvency position and take actions to prohibit subsequent insurer actions which reduce the value of life insurance contracts.

A second potential market failure is related to the insurance contract itself. An insurance contract is a complicated financial agreement, so the government could reduce informational uncertainties by making the contract more standardized or approving contract language to reduce errors and misunderstanding in the contracting process.[14]

A third informational problem might arise from an insurer's strategy and marketing structure. Because insurers have different marketing (direct versus independent agents) approaches and different levels of capital backing the company, shopping for the right policy is costly to consumers because they do not have the information to make accurate judgments about the services and the quality of services provided by insurers. Arguably, the government could guarantee a level of service after a claim or set prices so that a consumer would know that the contract is priced fairly. In addition, prices could be set to keep insurers from using their market power to exploit consumers through higher prices. This last rationale is often made for price regulation of insurance. This argument is made even though most personal lines insurance markets (which are the most likely to be regulated) are competitive markets in terms of numbers

[14] This standardization is common in personal lines products (like homeowners and auto), but it does not always solve all problems as there are new problems with contract interpretation that are costly to resolve. The Katrina wind/water litigation is just an example of this problem.

of competitors which, in turn, reduces the likelihood of any one of them being able to influence prices (Tennyson, 2007).

These types of arguments form the standard historical arguments for insurance regulation. A further rationale, with a more immediate application for banking regulation, is the market failure caused by the externality that one bank failure may lead to other failures due to a loss of consumer confidence in the financial system. Banks have solvency regulation to protect depositors and to protect the banking system from contagion risk. Historically, insurers did not present a real contagion risk to the financial system, but this may no longer be true. Financial companies are now interconnected in a way without historical precedent. Holding companies have evolved containing many different types of regulated and unregulated firms. A bank with an insurer as part of its operations can extend the contagion risk to its insurance operations. Alternatively, an insurer with a large and unregulated derivative trading business which suffers large losses can trigger questions about the overall soundness of the insurance operations. In addition, counter parties to trades by such an unregulated entity can cause significant harm so as to disrupt the banking system. The focus of regulation, at least, in insurance has been on the individual company and not the group or holding company. This needs to change, at some level, to allow for the proper accounting of systemic risk.[15] A state regulator cannot realistically regulate an insurer for its possible systemic affects on national and international markets especially in situations where the insurer within the state is a separately organized corporation from the corporation which might induce a systemic risk issue.

[15] Prior to the introduction of the NICPRMA and the creation of a systemic risk regulator, I thought legislation that granted the Federal Reserve the right to assess systemic risk through the use of normal administrative agency powers of investigation would be sufficient for any firm that might create systemic risk. New legislation which sets up a formal systemic risk regulator will likely spell out these powers and their scope in more detail.

Each of these supposed market failures is an underlying rationale for regulation of insurance or banking. However, not all of these examples are true in well functioning insurance markets. One of the problems state insurance markets have had over the last one hundred or so years is that state regulations have caused insurance markets to fail. The mischief caused by poor regulatory policy is not minimized by the OFC bills.

Ideally the states were supposed to be laboratories for experiments in regulation and that over time good ideas would rise to the top. This has not always been the case, as bad ideas seem to be recurring, especially in the areas of price regulation. The proposed federal laws do not necessarily deal with true regulatory reform (except at the possible elimination of price and form regulation). There are other potential regulatory failures involving other aspects of regulation which the current federalization proposals do not address.

For example, the current proposals do not pre-empt states' compulsory insurance requirements for automobile or workers compensation. Workers compensation and personal automobile coverage are required in almost every state. However, not everyone can afford the insurance.[16] For the case of auto insurance, the state steps in with a residual (or involuntary) market, which subsidizes the price for those who cannot afford insurance. For homeowners insurance, we have a similar problem. Homeowners insurance is "almost" compulsory if one financed the purchase of a home with a mortgage. Mortgage banks require the home be insured while the mortgage is in force. Home owners insurance is generally not so expensive that it affects people's ability to buy it, even though it is made compulsory by mortgage lenders. The

[16] The Insurance Information Institute (2009) states that 13.7 percent of drivers are uninsured and by using figures from the Insurance Research Council, they project that the economic downturn and increases in unemployment will cause this number to rise to about 16.1 percent in 2010.

general exception to this rule is for homes in hurricane and/or flood zones. States have set up various facilities to subsidize homeowner's insurance though special windstorm pools or, in some cases, state owned insurers. Further, we have a federal program to subside flood risks. Some forty years ago, the Federal government set up a flood insurance program to deal with flood risk because private insurers would not. By refusing to deal with the problem of risk subsidization, we have embedded a time bomb that could destroy free markets by reducing the availability of private market insurance in the future. These distributional and affordability issues for higher risk customers have not been addressed in any of the proposals for federal regulation. Nor have the incentives to reduce moral hazard in these markets been considered by the states. This is quite important, as these mandatory market participation programs still remain with the state under the both the NIA and NICPRMA.

IV. Problems with Current Approach to Federal Regulation

A. Risk regulation

The problem with federal regulation is not that it is regulation that was previously undertaken by the state and is now undertaken by the federal government, but it has to do with the value of regulation itself. An overlooked aspect of regulation is the role it might play in the regulation of risk taking itself. Regulation can encourage excessive risk taking which can occur if risk is not allowed to be priced properly. Examples of improper pricing abound, especially in the automobile industry (see Cummins, 2000) but can also be seen in the Florida homeowner insurance market. While the federal legislation contemplates actuarial fair prices, there is nothing that necessarily prohibits intervention to restrict proper underwriting criteria.[17] For example, some states restrict the use of territorial rating for auto insurance (Kaminski, 2006) or the use of genetic underwriting (Rothstein, 2004); some states do not allow underwriting differentials in life insurance against those who travel to dangerous parts of the world[18] and some states prohibit discrimination in life insurance against those subject to spousal battery (NAIC Model Laws, 2008). Further, some states have imposed restrictions on the use of credit information in pricing of insurance.[19] These are just a few examples of restrictions on underwriting that have arisen in the past few years. Without discussing the merits of any rationale behind the underwriting prohibitions, they all do the same thing. Underwriting restrictions lower the cost of insurance for high risk customers and raise the price of insurance for low risk customers. Over time, this can cause major disruptions in insurance markets. Again, the perfect examples of regulation induced market failures are the automobile insurance markets with strict price regulation and the Florida and other states' coastal homeowners markets. Nothing in the federal legislation would prohibit the government from adding to this list of socialized risks through underwriting restrictions even if the risk differential was real (in the sense it was supported by data using scientifically acceptable methods). The failure to promote accurate risk pricing will cause a market failure and result in higher prices in the future. This has been demonstrated time and again, yet people, legislatures and governors still propose to do it.

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[17] By proper underwriting criteria, I mean those criteria that are statistically shown (using standard acceptable methods) to be related to risk.

[18] See e.g. New Jersey, Assembly Bill 1586, enacted March 26, 2008.

[19] See e.g., *Insurance Institute of Michigan, et al. v. Commissioner*, No. 262385, 2008 WL 190394 (Mich. Ct. App., Aug. 21, 2008)

A simple example is all that is needed to show how this works. If the state of Florida kept homeowners insurance prices low in coastal areas, it lowers the price of living in coastal areas without changing the actual risk of hurricane losses. More buildings are built and more people move into the area, increasing the size of a potential loss. In contrast, if people were given the price signal that this was a higher risk area, they would not have the same incentive to build or move to the higher risk area. The potential loss would then be lower, everything else held constant. If a hurricane does occur in an environment where price controls exist, we have concentrated our risks in a risky area and losses will be higher and they will have to be paid by people living in the high risk area. If risk was priced properly to begin with, the losses resulting from a hurricane would likely be lower. Risk pricing is an effective method to reduce long run costs to society. Nothing in the OFC proposals reinforce the proper use of risk pricing, as the government could easily make it impermissible to use reasonable risk factors in underwriting.

B. Federal-state interactions under an OFC are problematic

A second problem with the current proposed structures has to do with the potential interaction of solvency monitoring and the solvency guaranty funds. Again, this goes to the role the government plays in regulating risk. A proposed federal regulator needs to have the authority and the mandate to minimize the costs of market failures. This includes the marketing and contract issues mentioned above, but it also includes the costs of solvency monitoring and resolution. Recent research shows the cost of insurance solvency regulation is three to five times that of bank resolution (see Willenborg (2000) and Grace, Klein and Phillips (2008)).[20] The

[20] This cost differential could be for a number of reasons specific to insurance. However, it is quite large and might be reduced if there were incentives to do so. Grace, Klein and Phillips (2008) demonstrate a number of problems inherent in the current state based system that likely adds to the cost of resolution.

difference between the insurance system and the banking system is that, for insurers, there are 50 plus states and territories each with their own guaranty funds. The Federal government has the FDIC, which has solvency monitoring responsibility as well as the authority to resolve and liquidate failed banks. The FDIC has economies of scale in knowledge and ability to resolve troubled banks while the states do not. Special laws were developed for the insurance industry since there is no state bankruptcy law. Further, since insurer insolvencies are relatively infrequent and there are no specialized state insurance bankruptcy courts, there are high fixed costs of insurance solvency resolution. In addition, since these state insurance bankruptcy laws are not uniform, we observe a variety of practices across the states. This makes insurance solvency resolution costly because there is no opportunity to obtain scale economies. The proposed federal optional federal regulatory system has no effect on this system of solvency resolution.

Further, there are some potential games that could arise under the current proposals. For example, state guaranty funds would protect against losses that arise from insolvent insurers not being able to fully pay claims. This could allow states to act strategically against federal insurers while, perhaps, benefitting state insurers. First, states could allow their domestic companies leeway in setting reserves. By allowing the states' domestics to operate at lower level of capitalization, they can essentially employ the state's guaranty fund as part of the firm's capital structure. Thus, the domestic companies can price their products lower than federally chartered companies because presumably they will be properly monitored for solvency purposes. In doing so, risks are transferred to the states' insurers, but in the event of a failure of the state insurer, the guaranty fund will also assess the federally chartered companies' customers. Everyone thus pays for the state's policy prescriptions. This, in effect, shifts risks to larger interstate companies. Prevention of this behavior would require a great deal of monitoring of state regulatory practices.

This could be addressed, in part, with the requirement that guaranty funds become pre-loss funds and that they charge insurers a risk based premium. This would make states reluctant to interfere with proper reserve setting if the guaranty fund could then raise the insurer's solvency insurance premium. All states except New York assess after a loss. However, New York's pre-loss assessment is still subject to political risk as the legislature could expropriate this fund for other reasons than insurance insolvency protection.[21] Further New York's pre-assessment fund is not based on risk, but market share.

A third problem is that given the existence of the state guaranty funds, states can be strategic with risk shifting for residual markets. Under the NIA, federally chartered companies are still subject to compulsory insurance requirements in the state for lines like personal automobile insurance or workers compensation. Before we examine the effect of a NIA on compulsory insurance markets, it is important to describe what happens under current conditions.

Because of the compulsory nature of the insurance, states may feel obligated to keep rates "reasonable" even for the highest risk customer. The result is a voluntary market with price based on the actuarial risk of the insured and an involuntary market where the insured is charged less than his actuarial risk. If the state has price regulation in the voluntary market and it is severe, then insurers will choose only to take on the lowest risk customers because the other

[21] For example, in 2005, the NY state legislature took money from the property-liability guaranty fund to put it in the workers compensation guaranty fund, which was underfunded. Further, it had borrowed money in the past and transferred it to the motor vehicle liability security fund. See e.g. *Insurance Journal* viewed on February 12, 2009 at http://www.insurancejournal.com/news/east/2005/02/16/51544.htm .

(higher risk) customers would not be profitable. As the voluntary market shrinks, the involuntary market grows.

Further, involuntary market customers are assigned to insurers based on the all of the insurers' market shares in the state. While the price for involuntary coverage is higher than in the voluntary market (as a paean to the fact that the insureds are higher risk), it is generally still not always enough to cover the actuarially fair costs. This often results in the involuntary market being operated at a deficit. This deficit is then passed to the voluntary market in the next year in the form of higher prices. However, due to price regulation, it may not be possible to pass on the entire amount of the deficit to the customers in the voluntary market resulting in firms leaving the market and putting stress on the remaining companies. This is essentially what happens in states where price regulation is so binding that firms can not earn reasonable profits over a number of years.[22]

Now, if we add the effects of an optional federal charter provision, we see a similar ability of states to shift risk costs. Again, suppose the domestic insurance market is price regulated. Under the OFC legislation, the state's price regulation would not apply to the federally chartered insurers, but under the current proposals the federally chartered company is required to participate in the mandatory coverage – residual (involuntary) market mechanisms the state sets up. So, if the state keeps the price of auto insurance low for domestic insurers through domestic-only price regulation, the domestic insurers will not take on the higher risk customers. Certain high risk customers will not be able to afford insurance in the voluntary

[22]The deleterious effects of these types of regulatory policies were documented in a series of case studies of various states including New Jersey, Massachusetts, and South Carolina (see Cummins, 2000). In each case, the state had to deregulate to regain a normal, well functioning automobile insurance market.

market even from federally chartered insurers. Thus, they will be placed in the residual market and assigned to insurers based on the insurer's market share.

The result will be that federally chartered companies will also have to bear the higher risk insureds at a price that is less than the actuarial fair costs. Further, a deficit in this market will be passed on to the voluntary market in terms of higher costs in the following year. If the deficit increases the costs to the voluntary market insurers who are federally regulated, they will not be able to compete with the state insurers unless they lower their prices. Thus the combination of price regulation of the domestic firms and the existence of the residual market may cause federally chartered insurers to pay for the privilege of operating in a state in terms of lower profits. The saving grace here is that this is not a long-run sustainable proposition. As the federally chartered insurers decide to leave such a state or if the residual market increases dramatically, low risk insureds will end up having to pay higher and higher insurance costs. This will put political pressure on the state to change its regulatory policies.

C. The role of the state and federal governments in the future of insurance regulation.

If the criterion for a state based insurance regulatory system to be successful is that states must regulate to minimize compliance costs, then the current state regulation of insurance is doomed to failure. One of the major rationales for federal regulation is reduction of costs of trying to satisfy multiple states' regulators. The NAIC has stated that it is trying to reduce these types of costs through model legislation and interstate compacts. Its good intentions notwithstanding, it is not capable of getting the states to operate quickly and efficiently together. Even Congress cannot obtain compliance from the states. In the Gramm-Leach Bliley Act of

1999, Congress mandated that the states set up a nationwide licensing system for agents. After ten years, not all of the states participate in this system to reduce multistate licensing costs.[23]

In 2007, for example, the NAIC proposed the Military Sales Model Practices Regulation as a result of a law enacted by Congress in 2006. This regulation is designed to protect young soldiers, sailors, marines, and airmen from aggressive sales tactics directed at military personnel. As of late last year, only 18 states have enacted it. Presumably, this was an important issue for Congress, yet it has not been adopted by a majority of states in its first two years. Depending on universal action among the states to enact laws that prompt action is just not feasible. Grace and Scott (2009) document a number of other examples of this type which suggest that joint actions by the states are never going to be able to solve national problems regarding compliance costs and uniformity quickly and efficiently.

However, another model does have some promise and could have a role in conjunction with federal oversight of solvency and systemic regulation. This is the so-called competitive federalism model of state insurance regulation. This was discussed by Harrington (2006) and more recently by Butler and Ribstein (2008), who advocate a single state license that would allow an insurer to operate nationwide under the laws of its chartering state. There are technical objections to this model of regulation – the most important being that consumers might not realize that a company is regulated by some other state and that they may not have good access to the regulator. The interesting thing about this competitive federalism proposal provision is

[23] A recent report (NAIC, 2008) states that 43 states are in compliance. What is important is that three important states (FL, NY and CA) are not in compliance some nine years after enactment of the GLB. Without the large states participation, compliance costs are not reduced and the supposed benefits of increased state cooperation as a reason for avoiding an OFC bill are illusory.

that it does provide for true regulatory competition. The OFC style bills, while allowing a choice, the option to be a federally chartered insurer goes only one way. Opting back to state regulation would be too costly. The regulatory competition between the state and federal governments is not going to be all that strong if the cost of leaving federal regulation is high. However, the competitive federalism model is more likely to generate competition among the states for better public polices for insurers, as it is not as costly to move to a state as it would be to leave federal regulation and reintegrate back into a multiple state regulatory system.

However, if this competitive model of regulation works for insurance the way it has for corporate chartering, both the regulator and the regulated firms have an incentive to make consumers aware of who the regulator is as well as the consumers' rights against an insurer in the event of a dispute. The point, however, is not that one should adopt a single state regulatory system, but that there has not been much discussion of regulatory innovation. The OFC bills have taken the lead in all of the policy discussions and little thought was given to how regulatory policies might be reformed.

V. Conclusion

A great deal of policy regarding the regulation of insurance debate concerns the appropriate level of regulation for the industry. Ideally, the appropriate level of government would be the one that would be able to contain all of the benefits and costs of regulation within the state (or federal level) borders. Further, solvency and market regulation conduct arguably can be conducted at the federal level at lower cost to society than separate state regulation of these same activities. Evidence suggests there are some economies of scale in these activities and the costs of regulation are spread beyond the borders of a single state.

Insurance regulation needs to move beyond this level of discussion. It is important, but the other aspects of regulatory improvements must not be forgotten. The proposed 2009 version of the OFC bill does address the issue of systemic risk. While this was important to prevent future events like what happened to AIG, it is not clear how relevant it is for other insurers. However, if the law is passed, one could predict we would have a better understanding of the relationships between various aspects of the financial service industries. This is a beneficial aspect of the law, but there is still avoidance of real subject matter regulatory reform. Should insurers have sophisticated capital models akin to those under discussion in the Basel II accord for banks? Many do, but they are not required by state regulators. Rating agencies seem more interested in them. The states have been slow to innovate and cannot act quickly in concert and thus, we have not seen major regulatory policy proposals discussed and enacted. It is not surprising that the OFC bills look like their 19th century predecessor.

Federal regulation is not a panacea for all that ails insurance regulation, especially if these same types of policies prevalent at the state level are merely transferred to become the responsibility of the federal government. In fact, there are likely to be problems regarding risk regulation in the national market. Interest groups will be able to obtain exemptions to actuarially fair pricing applied nationwide. Federal regulation may make it easier to influence a single federal regulator rather than lobbying 50 state legislatures. The outlook for this type of regulation is not good given that there is likely not one current federal insurance program that is truly actuarially sound. This is due, in part, to restrictions on pricing risk properly. Thus, without a real mandate for what might be termed generally accepted risk pricing, we could see an increased socialization of risk. Instead of seeing it in one state's homeowners insurance markets or in some other state's auto market, it will be done across states.

Finally, the role for the state in the future of insurance regulation is severely circumscribed. States have absolutely no ability to be proactive. At best they are reactive and cannot reach anything like a consensus when one is needed. The perfect example is the inability for every state to integrate its agency licensing system or join an interstate product licensing commission, even in the face of federal preemption of a significant part of regulatory authority. The only possible role a state might have is if the U.S. adopted a competitive-federalism (one nationwide state license) solution, which many think is politically impracticable. Given that we are faced with a new regulatory environment, there is still time to influence the type of regulatory policies that should be adopted and implemented under an optional federal charter approach to insurance regulation.

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