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Optional Federal Charter for Insurers
Frequently Asked Questions, Version 2.0

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One of the greatest challenges facing America's insurers is the irrationally divided nature of regulation for what should be a nationwide industry. The National Insurance Act (H.R. 3200 and S. 40) seeks to address this problem by creating a new federal insurance regulator, setting up a system known as an Optional Federal Charter (OFC), which would let insurers choose to organize under either federal or state law. (The Treasury Department's *Blueprint for a Modernized Financial Regulatory Structure* endorses creating an OFC.)

Currently, insurers operating in a given state must operate only under that state's insurance laws. A federally chartered insurance company would have to obey all general state business regulations, but would work under a new federal regulator, which would enforce the same insurance-specific laws throughout the country. Federally chartered insurance companies would sell homeowners', life, and auto insurance, but not health insurance.

An OFC may not be an optimal situation, but the addition of an *optional* federal regulator to the nation's regulatory firmament would create a degree of regulatory competition between federal and state regulators and thereby improve overall market freedom.

The proposal before Congress would set up new national mechanisms to protect consumers against insurance fraud and to ensure federally chartered insurers' solvency, which would work similarly to existing state-level bodies. Neither the House nor the Senate version of the bill contains any mechanism to let the federal government set rates. However, about 45 states do have such laws (of the other five, four require insurers to file rates with state authorities) and insurance commissioners, self-styled consumer

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advocates, and others have raised questions about whether an OFC would eliminate these price controls. (The statistics above, the most recent available, reflect the situation almost three years ago, thus the "about.")

HOW AN OFC WOULD WORK

Would optional federal chartering create a big new federal bureaucracy? ***Probably not.*** The new federal regulatory apparatus would probably employ fewer people than the insurance commissioner's office of a medium-sized state. About half of state insurance bureaucrats work to review insurance company rate filings, something which the proposed federal agency would not do. Former and current state insurance commissioners estimate that a new federal regulator would need to employ between 200 and 350 people to function—fewer employees than in the Department of Health and Human Services' Inspector General's office, at 378.

Would an OFC increase compliance costs? ***No.*** Compliance costs would likely decrease under an OFC. Right now, an insurance business seeking to operate across the country needs separate regulatory approval from 50 states and the District of Columbia. Under an OFC, it would only need one approval. Compliance costs for multi-state companies—which sell most insurance—would go down, while compliance costs for single-state companies would stay the same. Of course, any expansion of government deserves a good deal of skepticism: Bureaucracies can become much bigger than their proponents initially promise, which is something that Members of Congress should guard against.

Would an OFC help incumbent companies make larger profits? ***Maybe.*** An OFC would likely result in vigorous intra-industry competition and might well reduce profits. Complacent companies with high rates, poor service, or faulty marketing could find themselves in trouble. Profits for the industry as a whole–which, incidentally, have as much to do with investment performance as "the business of insurance" as such—might go up or down under an OFC. However, startups and current niche players that see a new opening on the national stage could well see new profits and expansion. Deregulation of banks, airlines, telephone service, and stock sales all resulted in better value for consumers, as many large incumbent players were forced to shrink their operations, merge with better-run competitors, or, if unable to withstand the new competition, fold. It is very likely that a similar scenario would occur within the insurance industry.

Is an Office of Insurance Information a good idea as a precursor to an OFC? ***Yes, but only as a temporary stopgap measure en route to enactment of an OFC.*** A proposed Office of Insurance Information would serve as the federal agency in charge of negotiating international agreements involving insurance and as a national repository of expert knowledge about insurance. Since international trade negotiations are conducted by the federal government, American insurers lack a political champion internationally. An OII might, therefore, bolster America's international negotiation position for trade in services. And, since the Constitution already gives the federal government the ability to preempt state laws through international treaties, the new agency would not expand federal power over the states. Overregulation, by balkanizing America's insurance market, has retarded the collection of national insurance data. A national Office of Insurance Information might reduce this information gap. Note, however, that enactment of an OFC would promote demand for national insurance information; thus, any proposal to establish an OII should include a "sunsetting" provision for its elimination once private market institutions arise to fulfill the demand for national insurance data.

STATE ISSUES

What would an OFC do to state regulation? What about federalism? ***The current proposals do not touch state regulation.*** Unless states change their laws on their own, nothing will change for insurance companies that continue to subject themselves to state regulation or for their customers. In the longer term, some states may modify their laws in response to an OFC law, so an OFC would likely improve state regulators' sensitivity to market realities, leading to less burdensome regulation.

Will states lose tax revenue under an Optional Federal Charter? ***Not under the current proposals.*** Over 99 percent of taxes from insurance companies are in the form of taxes assessed on all businesses and policy-specific premium taxes—which federally chartered companies would still have to pay to the states in which they operate. States would not charge licensing fees to agents who opt to take federal exams instead of state ones, but they would not be required to license those agents, either.

Would insurance companies withdraw from certain parts of the country under an OFC? ***No.*** To the contrary, more companies likely would come into currently underserved regions. States like Florida and Massachusetts have chased away insurers through overregulation. Even states with less burdensome regulations have trouble attracting business simply because additional regulatory hurdles discourage companies from entering some states. The option of a single national regulator would make market entry easier and thereby increase consumer choice.

Would there be a "race to the bottom"? ***No.*** The history of regulatory competition shows almost no evidence of a "race to the bottom" ever occurring. When only one regulator exists, consumers and businesses must stick with whatever regulatory system their home state imposes. The existence of more than one regulator lets consumers and businesses in different states opt for the level of regulation they find most suitable.

Would an OFC subject insurance companies to both federal and state laws, thus increasing the overall regulatory burden? ***This is a legitimate concern, but the bills currently before Congress would draw a bright line between federal and state regulation***. However, attempts to erase this line and eliminate the optional nature of the proposed legislation would increase the overall regulatory burden and reduce the market's role in insurance provision. Congress should approach any proposal that subjects state-regulated companies to federal oversight with extreme skepticism. An OFC will accomplish its goal of increased regulatory competition only if the line between federal and state control remains clear.

THE CURRENT SYSTEM

What is wrong with the current state system? ***It stifles innovation.*** Quite simply, there is no current "system" to criticize but, rather, 50 separate state systems plus another one for the District of Columbia. Some states' regulations seem to do a decent job of serving customers and insurers, but many do not. One major problem stands out: The current system has brought insurance innovation to a standstill. The industry has not introduced a single entirely new property and casualty insurance product for individual customers since insurers introduced modern homeowners' insurance in *1950*.

Will an OFC help to produce new products? ***Probably.*** Wholly new insurance products have not come out because any new product needs at least 51 sets of different regulatory approvals. Insurance works best when large numbers of people pool their risks together; it is very hard to make money—or simply break even—by launching a product in only one or two states.

Is the insurance industry unified in its support of OFC? ***No.*** The industry appears equally divided on OFC. Two major trade associations have come out in support and two major trade associations against. The largest insurance agents' group opposes it but a new group with heavy support from life insurance agents supports it. Insurance companies themselves are roughly equally divided and some who support an OFC in principle seem much more enthusiastic than others. Many vested interests that oppose an OFC see—correctly—that the more competitive environment it would help create would erode their profits and market share.

CONSEQUENCES OF AN OFC

If consolidation happens, how would it impact consumers? ***Paradoxically, it would probably increase their choices for insurance coverage.*** There is no guarantee that insurers would consolidate under an OFC, but it is a distinct possibility. If it does happen, it would probably result in more national companies. The key issue for consumers is not how many companies exist somewhere in the country, but how many exist that make a genuine effort to serve the communities where consumers live. For example, the existence of fewer, larger banks has generally led to increased hours, locations, range of services, and number of branches in any given town. Similarly, fewer, larger insurers would likely work to serve more areas of the country more comprehensively.

Would local insurance agents go out of business under an OFC? ***Insurance agents would face new business challenges under an OFC regime. Some would use these as opportunities to grow their businesses, while others would likely run into problems.*** Insurance agents ambitious to grow their businesses while maintaining lifetime customer relationships would find new opportunities under an OFC. Rather than having to secure new licensing in every state in which they want to operate, agents could simply seek a federal license and follow their customers anywhere in the country. Good insurance agents are trusted financial advisors and they should be able to serve their customers even after their customers move across state lines. More flexible licensing could also give agents new products to sell.

Some OFC opponents point out that only a small percentage of agents—about one in five—currently work in more than one state. This is true but misleading. The current regulatory environment makes it very difficult for agents to work across state lines. Each additional state in which an agent wishes to work requires a new licensing exam, fees, and background checks. Under an OFC more agents would be able to follow their customers and maintain businesses in more than one state. While it is true that insurance agents who want to keep all of their customers in a small, confined geographic area would likely have a harder time competing under an OFC, many agents who do not currently work across state lines would begin to do so.

Supporters and opponents of an OFC alike both cite Illinois as an example of what the market would look like under an OFC. What is the Illinois market like? ***It's good but not perfect.*** In most respects, Illinois's system seems to work. Premiums for both automobile and homeowners' insurance are a bit below the national average—$610 a year vs. $668 a year for homeowners insurance and $761 vs. $821 a year for property and casualty insurance. Just about everyone gets insurance through the voluntary insurance market: Less than 0.1 percent of the population (mostly people with drunk driving convictions) needs to rely on the state-run residual market. Because of the absence of rate regulation, just about every company with any pretense of national operations will sell insurance everywhere in the state. Because Illinois is home to the nation's two largest writers of property and casualty insurance, however, the market ranks amongst the nations' most concentrated: Not surprisingly, other companies have a hard time selling in the literal backyard of these large companies. The Illinois experience, nonetheless, may indicate some degree of market consolidation is likely under an OFC.

INTERNATIONAL ISSUES

What would an OFC do for America's international competitiveness? ***It is hard to say for certain.*** Americans pay more for insurance than do consumers in other wealthy countries. An OFC could reduce overall insurance premiums by letting companies operate more efficiently while increasing competition. By creating a single point of contact within the U.S. government, an OFC would make it easier to negotiate trade deals involving insurance, which could aid economies of scale.

Do other developed countries have something like an OFC? ***Nearly all do.*** The European Union allows most property and casualty insurers to sell their products across international borders (although individual members states can place certain additional restrictions on them). Countries like Japan, the United Kingdom, and France, which have strong central governments, regulate insurance only at the national level. Other countries with federal systems have a variety of systems for regulating insurance.

Canada's system is most directly comparable to what would exist under an OFC: Insurers can opt for provincial or federal regulation. While most companies are regulated at the provincial level, Statistics Canada reports that the great majority of the market—about 80 percent of total premiums—comes from companies operating under federal charters.

CONSUMER PROTECTION AND FAIR PRACTICES

Would an OFC protect consumers from unscrupulous insurance companies? ***Yes, at least as much as they are protected today.*** The proposed OFC law before Congress would create a consumer ombudsman and the first-ever anti-insurance fraud federal programs. However, many measures listed as "consumer protection" in fact limit consumer choice or ration products, so in that regard an OFC does not "protect" consumers the way some state laws do. Yet there is no reason to expect fraud to become worse under and OFC.

Will it confuse consumers? ***Confusion already exists.*** Former District of Columbia insurance commissioner Lawrence Mirel says that his office frequently got calls from people looking for the federal agency that oversees insurance—which does not exist. An OFC would create such an agency, while leaving state regulators in place for insurers and consumers who choose to stay under the old system.

Don't government-set rates protect consumers? ***No, they hurt consumers and encourage foolhardy risk taking.*** It is worth asking: "Why should government set rates at all?" Each time government demands a profit-making insurance company to lower its rates for one group or ignore a risk factor, it will necessarily force that company to raise rates for another group. Non-profit insurers, likewise, still have to break even on their operations and, for the most part, are subject to the same competitive pressures as their for-profit counterparts. Thus, insurance rate setting by states redistributes wealth from the risk-averse to the risk-prone. When government mandates low insurance rates for people who drive fast sports cars or build mansions on sand dunes, it inevitably raises rates for careful minivan drivers and inland residents.

The Consumer Federation of America has presented data showing that publicly held insurers are relatively safe investments and have become safer in recent years. Does this prove that the insurance industry is reaping more profit than it deserves and should not get the reward of an Optional Federal Charter? ***No***. By the nature of what they do insurance companies *should* rank amongst the most conservatively managed businesses around. The fact that insurance companies have become more stable and offered a better return on investment shows that they are also more capable of paying policyholders' claims. Anyway, for-profit insurance companies exist for the primary purpose of making profits. If they fail to do so, they fail their shareholders. Non-profit insurers—which generally pay "policy dividends" out of their profits—should increase their dividends and thus reduce effective premiums unless they can find better investments for whatever surplus they retain from year to year.

Does a "revolving door" between the industry and regulators prove that the former wields undue influence over the latter? ***Not more so than in any other heavily regulated industry.*** Insurance regulation is a complicated business that requires a high degree of specialized knowledge of the industry and state regulations. Close ties between regulators and regulated are inevitable in any heavily regulated industry: The industry provides a pool of people who can understand the intricacies of its own regulation and former regulators will make very appealing hires for any company in the industry. The only way to avoid a revolving door is to deregulate the industry. An OFC would help accomplish that.

FREE MARKET ALTERNATIVES TO AN OFC

Is an OFC the only way America could liberalize its insurance markets? ***Definitely not.*** An optional federal charter is a first step towards a truly free market for insurance. Free market advocates should approach any new federal regulator with a healthy dose of skepticism. The best feature of an OFC is its creating competition between regulators. A wealth of academic literature shows that regulatory competition leads to better outcomes for consumers. For example, since the United States liberalized banking laws in the 1990s, customers have gotten higher interest rates on deposits, paid less for loans, and seen banks add longer and weekend hours.

The creation of an Optional Federal Charter is the best option with serious support today. Congress should also investigate measures to authorize private entities to regulate insurance companies, let insurance companies sell policies across state lines under the laws of their home state, and let the market create entirely new types of risk-transfer products.

What are some alternatives to an OFC? ***Two major possibilities exist***. First, Congress could authorize interstate insurance choice. One study from the Competitive Enterprise Institute ("The Case for Interstate Insurance Choice" by Ned Andrews, February 2008) proposes a Property and Casualty Insurance Choice Act. The legislation—modeled on the Health Insurance Choice Act (H.R. 4460) already proposed in Congress—would allow property and casualty insurers to sell insurance across state lines under the laws of their home states. Insurance companies that chose to domicile in Illinois, Vermont, or other states with reasonably free market regulatory regimes would operate very much like companies under an OFC.

Second, the existing Interstate Life Insurance compact created as part of a broad 1999 Gramm-Leach-Bliley banking deregulation act offers a potential model for Congressional authorization of a voluntary compact to allow the sale of property and casualty insurance policies across state lines. Like the existing life compact, however, a property and casualty compact would likely have a difficult time attracting participation from the states with the most troubled markets, but would offer greater choice than the status quo. Other good options may exist and, if so, they deserve exploration. In short, an OFC should not be the only option on the table.