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National Regulatory Modernization for Insurers Frequently Asked Questions

By Eli Lehrer and Michelle Minton*

There are currently several proposals to create national regulation for insurance. Currently, insurers operating in a given state must operate under that state's insurance laws. A federally chartered insurance company would have to obey all general state business regulations, but it would be regulated by a new federal bureau, which would enforce the same insurance-specific laws throughout the country.

The proposals currently under discussion have many similarities to previous proposals for an Optional Federal Charter (OFC), but are *not* the same thing. They create a national regulator for insurance, but also allow significant powers to remain at the state level and require the creation of state-level offices.

Were a federal regulatory system to become law, it is highly likely that most sizeable insurance companies would create new federally regulated subsidiaries that would have a measure of legal independence but would operate under the same corporate umbrella as their existing operations. Nearly all insurers would maintain some state-regulated operations alongside these new federally chartered bodies,.

A bill currently before the House of Representatives (H.R. 1880) would create a new national mechanism to oversee property and casualty, life, and commercial insurance. Medical insurance would not be included. Treasury Secretary Timothy Geithner has also proposed a degree of national oversight for insurers and a companion bill to H.R. 1880 is expected to appear in the Senate soon.

The proposals before Congress would set up new national mechanisms to protect consumers against insurance fraud and to ensure federally chartered insurers' solvency.

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These systems would work similarly to existing state-level bodies. In other words, a degree of government oversight would remain. The proposed House and Senate bills contain no mechanisms to let government set rates. However, about 45 states do have such laws and much of the controversy over these bills stems from the fact that the proposals would create new federal laws.

HOW AN OFC WOULD WORK

Would the proposals create a big new bureaucracy? ***Maybe.*** Several factors indicate that the mechanism needed to regulate insurance at the federal level could be smaller than that of the combined states. About half of state insurance bureaucrats work to review insurance company rate filings; the proposed federal agency would not do that. On the other hand, the legislation before the House (although not Geithner's proposal) would require the establishment of federal insurance regulation offices in all 50 states. This may be unnecessary and could limit flexibility. Sparsely populated states—Wyoming, for example—probably do not need their own offices, while largely populated states like Florida, where insurance is a major political issue, may find it better to have multiple offices. It is probably best to let the Treasury Department or some other federal agency decide on the specific locations of offices rather than having Congress mandate it.

Would these national regulatory proposals increase compliance costs? ***No.*** Compliance costs would likely decrease. Right now, an insurance business seeking to operate across the country needs separate regulatory approval from 50 states and the District of Columbia. Under national regulations, 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 the creation of a national regulator help incumbent companies make larger profits? ***Maybe.*** National regulation would likely result in vigorous intra-industry competition and might well reduce profits. Complacent companies with high rates, poor service, or ineffective marketing will likely find themselves in trouble. In fact, it is highly likely that a large percentage of new profits (if any) will accrue to companies that are either startups or current niche players that see an opening on the national stage. Deregulation of banks, airlines, telephone service, and stock sales all resulted in better deals for consumers coupled with many large, incumbent players being forced to close their doors, shrink their operations, or merge with better-run competitors. There is every reason to believe something similar would happen in the insurance industry. (It is also worth noting that profits for the industry as a whole have as much to do with investment performance as with "the business of insurance" itself, which provides insurers with some business model flexibility.)

Is an Office of Insurance Information a good idea as a precursor to a national insurance market? ***Yes, regardless of whether the nation ever adopts an***

OFC. A proposed national Office of Insurance Information (OII) would serve as the federal agency in charge of international agreements involving insurance and as a national repository of expert knowledge about insurance. The proposal makes sense for two reasons. First, an OII could give America a way of negotiating international trade deals that involve insurance (and most do). Currently, the nation relies on an ad hoc, haphazard system involving the National Association of Insurance Commissioners. This places American companies at a disadvantage around the world. Doing this would not expand federal power, because the Constitution already clearly gives the federal government the ability to preempt state laws on insurance through international treaties. Second, an OII's proposed capacity to collect data and do studies would also correct an existing government failure, which is that overregulation has retarded the collection of data about the national insurance environment. The office would give policy makers—both OFC supporters and opponents—the opportunity to test out ideas for national regulation. However, Congress should incorporate into any OII proposal provisions for the agency's closure in the event that a more developed national insurance market allows for private sector options for the OII's information services to flourish.

STATE ISSUES

What would the proposed national regulators affect state regulation? What about federalism? ***The current proposals do not touch state regulation.*** Both Geithner's proposal and the bill before the House of Representatives do nothing to change state insurance laws.

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 North Carolina 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. A single national regulator would make market entry easier and 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 work together to figure out more optimal levels of regulation.

Would an OFC subject insurance companies to both federal and state laws, thus increasing the overall burden of regulation? ***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—since it is that very optional nature of an OFC that brings competitive pressures to bear on the regulation of insurance. Congress should be wary of any proposal that subjects state-regulated companies to federal oversight. An OFC will only be effective—and truly *optional*—if the line between federal and state control remains clear.

THE CURRENT SYSTEM

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

Will an OFC help the development of new insurance 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 to be equally divided on OFC. Two major trade associations have come out in support of it 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 it in principle seem much more enthusiastic about it than others. Many parties who oppose it see correctly that the more competitive environment of an OFC would erode their profits and market shares. Congress, however, should take into account the interests of consumers, not just those of insurers.

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 happens, it would probably result in more national companies. The question from a consumer's standpoint is not how many companies exist somewhere in the country, but how many do an effective job in serving the community where the consumer lives. The existence of fewer, larger banks have generally increased hours, locations, range of services, and number of branches in any given town. In similar fashion, fewer, larger insurance companies 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 certainly 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 operations 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 both cite Illinois as an example of what the market would look like under an OFC. What is the Illinois market like? ***It is 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 automobile 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. Due to 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 nation's most concentrated. Not surprisingly, other companies have a hard time selling in the literal backyard of other companies. The Illinois experience indicates that 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, but its impact is likely to be positive.*** Americans pay more for insurance than residents of other wealthy countries, and it's possible that an OFC would reduce overall insurance prices by letting companies operate more efficiently while increasing competition. In addition, by creating a single point of contact within the U.S. government, an OFC would make it easier to negotiate trade deals involving insurance.

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 member states can place certain additional restrictions on them). Countries with strong, central national governments—such as Japan, the United Kingdom, and France—regulate insurance at the national level only. Countries with federal systems have a variety of options for regulating insurance. Canada's system, in which insurers can opt for provincial or federal regulation, is most directly comparable to what would exist under an OFC in the United States. While most Canadian insurers are regulated at the provincial level, the great majority of the market—about 80 percent of total premiums—is comprised of companies operating under federal charters.

CONSUMER PROTECTION AND FAIR PRACTICES

Would an OFC protect consumers from insurance fraud? ***Yes.*** The proposed OFC law before Congress would create a consumer ombudsman and the first ever federal programs designed to protect consumers from insurance fraud. By that standard, it would enhance consumer protection. However, many measures listed as "consumer protection" in fact limit consumer choice or ration products. If one believes that the government should control which products a consumer buys or set prices for those products, then an OFC does not "protect" consumers the way some existing state laws do.

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—non-existent—federal agency that oversees insurance. An OFC would create such an agency.

Do 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 cause that company to raise rates for another group. Non-profit insurers 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 lower 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.

J. Robert Hunter of the Consumer Federation of America has presented a range of data showing that publicly held insurance companies are relatively safe investments and have become safer in recent years. Does this prove that the insurance industry is reaping more profits than it deserves and should not be rewarded with 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 do not, they are failing their shareholders. Non-profit insurance companies, on the other hand, should increase their dividends—thus reducing their customers' actual costs of insurance—if they make cash that they cannot invest in things that benefit their members.

Does a "revolving door" between the industry and regulators prove that the insurance industry and the state regulatory systems are corrupt or that the insurance industry "owns" state regulators? ***Not more so than 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. A revolving door is inevitable under any system that involves heavy regulation. The industry will provide a unique 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. And an OFC would help do just 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 only a small 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 Competitive Enterprise Institute generally supports an OFC in concept (although not necessarily the particular bills before Congress) not out of love for a new federal regulator, but because an OFC would create competition between regulators. A wealth of academic literature shows that competitive regulation produces better regulation for everyone. 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 weekend hours.

The creation of an Optional Federal Charter is the best option with serious support right now. 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, *OnPoint* No. 131, March 13, 2008) proposes a Property and Casualty Insurance Choice Act. The bill would be explicitly modeled off of the Health Insurance Choice Act (H.R. 4460) already proposed in Congress and 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 offers a potential model for congressional authorization of a voluntary compact that would 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.

Other good options may exist and, if so, they deserve exploration. An optional federal charter—whatever its merits—should not be the only option on the table.