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Pros and Cons of Optional Federal Chartering for Insurers

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The National Insurance Act (NIA) (H.R.3200, S. 40) proposes an optional federal chartering (OFC) system for the nation's insurance industry. An OFC would allow insurers to choose between the existing state licensing system or the proposed federal licensing system.

Optional federal chartering can offer two clear benefits. First, participating insurers may operate in any state without having to file separate state applications. Second, having the federal and state governments compete for licensing revenues should encourage both to create more efficient regulations. Caution is called for in a world of high administrative costs, consumer confusion, and political regulation.

Some consumer groups, including the Consumer Federation of America, back an OFC and emphasize the benefits of uniform minimum protection standards.¹ The life insurance industry also favors the NIA, because it would level the playing field—on which the banking and financial services industries already offer similar products nationwide.

This essay weighs the pros and cons of both federal and state insurance regulation, as well as of competition between the two. Such competition, as will be shown, promises considerable benefits, if done right. In addition, it should be kept in mind that regulatory competition could be further enhanced by the participation of private agents, but the details of such a discussion are beyond the scope of this essay.

State Regulation. The current state regulation system has several drawbacks which increase insurance costs for consumers. In addition to needing separate licenses to operate in each state, insurers must also contend with poor administration of regulations.² Insurers also complain that state licensing and product approval takes too long. This lengthy licensing and approval process create barriers to entry for small businesses.³

While the sheer number of state systems poses a challenge on its own, regulatory requirements also vary across states. States have different requirements for information technology and universal coverage, and some states have unique standard rates and rating classes for insurance

policies.⁴ There are also redundant regulatory requests. These contradictions and duplications create an unnecessarily complex regulatory process.

However, state regulation does have advantages. If run properly, it can allow regulators to quickly process complaints. In addition, state regulators are more familiar with local risk profiles than a federal agency would be. Because property and casualty insurance are local in nature, regulations can be tailored to specific jurisdictions according to their specific risk factors.⁵

Federal Regulation. Federal regulation would not be without problems. The National Insurance Act would create yet another regulatory body.⁶ Under a federal system, a bad policy would affect insurance agents and consumers nationwide, rather than being contained in one state.⁷ Consumers who do not monitor their insurance companies' licensing status may become confused about where to file complaints.⁸ Finally, a federal regulator's greater resources, including the budget to hire specialists, may push some state regulators to close up shop.⁹

However, if state systems can remain healthy, an optional federal charter would offer an alternative, uniform, national set of regulations that would eliminate some of the problems associated with conflicting or duplicate state requirements. Those national standards could help consumers better compare differences in policies and premiums.¹⁰ Under the NIA, an OFC system would pay for itself through licensing fees for regulated carriers.¹¹

State and Federal Regulatory Competition. It is possible that under the National Insurance Act insurance companies could end up with the worst of both systems. The more likely outcome is that state and federal regulators vying for licensing fees work to improve their regulations to attract insurance companies.

Under a competitive regulatory regime, two sources of pressure push regulators to produce more efficient regulations. First, limitations on competition between companies are no longer at the discretion of a single regulatory body. Second, one regulator will be unable to unilaterally impose new requirements if the regulatory requirement is competing with another for licensing revenue.¹²

Historical experience bears this out. Since the mid-1970s, the banking industry has utilized the OFC which was gradually granted to it under the National Bank Act of 1863 and its follow-on acts. The banking OFC has resulted in bank consolidations and employee layoffs, but also in better customer service through an increase in the number of bank branches, larger service and product menus, and improved bank security and economic stability.¹³

Conclusion. No one can predict what an optional federal charter for the insurance industry will accomplish specifically. State-chartered insurance companies could still face conflicting or duplicate regulatory requirements and long waits for product approval. Federally chartered insurers may not have the responsiveness that comes from intimate knowledge of a state or region. However, competition between federal and state regulators for licensing revenue likely will spur both parties to remedy their shortcomings and create new and more efficient regulations. Even better would be the prospects of regulatory competition under a system in which private regulators can also compete.

Notes

¹ Sheila Bair et al., "Consumer Ramifications of an Optional Federal Charter for Life Insurers," (Amherst, Mass.: University of Massachusetts, Amherst, Isenberg School of Management, March 2004), p. 12, <http://www.isenberg.umass.edu/finopmgt/uploads/basicContentWidget/8631/bair-cons-ramifications.pdf>.

² Harold D. Skipper, Jr. and Robert W. Klein, "Insurance Regulation in the Public Interest: The Path Towards Solvent, Competitive Markets," The Coordinating Committee on International Insurance Issues Coalition of Service Industries, August, 23, 1999, p. 19, http://rmictr.gsu.edu/Papers/Competitive_Markets.pdf.

³ Bair et al., pp. 3, 51. Also see, Computer Services Corporation, “Economic Impact of an Optional Federal Charter on the Life Insurance Industry: A Survey of Leading U.S. Insurance Companies,” 2005, p. 17.

⁴ Ibid., p. 16.

⁵ Independent Insurance Agents & Brokers of America, “Big ‘I’ Opposes Federal Charter Bill,” September 28, 2006, <http://cofir.us/BIGI.OFC.PR.pdf>.

⁶ Bair et al., p. 3. Also see Independent Insurance Agents & Brokers of America.

⁷ Bair et al., pp. 81 – 82. Also see Catherine England, “Federal Insurance Chartering: The Devil’s in the Details,” Competitive Enterprise Institute, January 10, 2005, p. 10, <http://www.cei.org/pdf/4358.pdf>.

⁸ Bair et al., p. 3.

⁹ Ibid., p. 69.

¹⁰ Ibid., p. 12.

¹¹ Scott, p. 3. There were earlier complaints about a federal requirement for community reinvestment and reduced consumer protection. Under NIA, there will be an Office of National Insurance, complete with a complaint division which would make consumer fraud a federal offense for the first time in U.S. history. There will be no reinvestment requirement.

¹² Kenneth E. Scott, “The Dual Banking System: A Model of Competition in Regulation,” *Stanford Law Review*, 30 (1), 1977, pp. 33-34.

¹³ Peter S. Rose, *Banking Across State Lines: Public and Private Consequences*, Quorum Books, Westport, Connecticut, 1997, pp. 36-37, 71. Also see Michael H. Moskow, “Stability in Times of Change,” 2006 Annual Report, Federal Reserve of Chicago, http://www.chicagofed.org/about_the_fed/annual_report.cfm, 2.