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Free Market Strategies for Insurance Reform

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The provision of property and casualty insurance has long been the largest and most important sphere of economic activity regulated entirely at the state level. Since shortly after the Civil War, however, many insurance reform proposals have included partial or total federal regulation of insurance. In recent years, proposals for federal regulation have centered around ideas for optional or largely optional federal chartering that would allow most insurers to pick between federal and state regulation. In recent months, two major proposals to regulate insurance federally have appeared.

The first, the National Insurance Consumer Protection Act (NICPA, H.R. 1880), would establish a federal regulator for insurance. Under the proposed law, known as NICPA, a new federal bureau would regulate insurers' rates, forms, and solvency. However, insurers would still have to pay state taxes, participate in state-run residual markets and state guarantee funds (as well as a newly created federal one), conduct most litigation in state courts, and follow all general-purpose state business laws.[1] Homeowners', automobile, commercial, and life—but not health—insurance would all fall under the sway of the new federal bureau.

Under NICPA, insurers would still have to charge rates high enough to maintain the capital needed to pay their likely claims, but would not have to file rates or justify how high rates would go. However, they would have to document rate decisions to government inspectors upon request. Proponents of the law argue that it would allow insurers to market the same products throughout the country—something that current law makes nearly impossible because each state requires a separate filing for each product. They also argue that it would encourage risk-based rates and product innovation. Groups like the National Association of Insurance Commissioners (NAIC) and the Coalition Opposed to a Federal Insurance Regulator have opposed the bill claiming that it fails to protect consumers from excessive insurance rates and grabs power for the federal government.[2]

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The second proposal stems from the Obama administration. Under Secretary of the Treasury Timothy Geithner's proposals—yet to be released in the form of specific legislation—the federal government would assume responsibility for overseeing a new system for regulating against yet-to-be-defined systemic risks.[3] Most other affairs, including most or all existing powers over rates, forms, and solvency of most companies would remain with state regulators.[4]

Given the recent turmoil in financial markets, a revision of the federal role in insurance regulation appears very likely. Of all the proposals that have been put forth, a full-scale optional or largely optional federal regulator would go the farthest toward creating a more open national insurance market. This would benefit consumers through increased choice and insurers through the opening up of new business opportunities. However, given the political difficulty of major reform, and the political likelihood of greater federal regulatory involvement over certain aspects of insurance, aspects of other, more piecemeal proposals may be worth considering.

This paper explores six proposals that are less comprehensive than NICPA, but are still designed to free the nation's insurance markets while improving the quality of regulation and oversight. Thus, the six proposals represent a potential "middle ground" from which a better system for regulating insurance might possibly emerge. The options are:

- An Office of Insurance Information (OII) that would serve as a repository of insurance-related knowledge in the federal government but have no regulatory powers.
- An interstate property and casualty compact (or law) that allowed states to delegate certain insurance-related functions to a federal regulator.
- A phased implementation of NICPA.
- A "life only" federal charter that would give life insurers the option of subjecting their life insurance operations to a federal charter but leave other lines out.
- A "three pack" optional federal charter that would largely follow the outlines of current federal chartering legislation but leave the regulation of insurance for homes and other non-commercial real property at the state level.
- A "federal charter-lite" that would allow interstate insurers to subject themselves to federal regulation of rates and solvency requirements while otherwise remaining under state oversight. (This proposal appears consistent with Secretary Geithner's stated goals for regulation and could be considered a version of the Obama administration's proposal.)

This paper describes each of these options and outlines their advantages and disadvantages from a free-market perspective.

Office of Insurance Information. A national Office of Insurance Information (OII), as proposed by Rep. Paul Kanjorski (D-Penn.), under H.R. 2609, would establish a federal office at the Department of the Treasury to collect data on and produce reports about the insurance industry and represent the interests of the United States in international forums involving insurance. The office would have no power to oversee rates, forms, or any other aspect of insurers' conduct.

Advantages. An OII would establish a discrete depository of insurance knowledge within the federal government and give the United States a consistent policy voice in international negotiations related to insurance. This would improve on the status quo. Currently, a representative from the National Association of Insurance Commissioners—often somebody with no real experience in international affairs—serves as America's chief international negotiator on most insurance-related issues. In addition, a federal repository of insurance-related data and statistics expertise could help set the stage for the development of a national insurance market. Right now, since all insurance regulation exists on the state level, there is no economic incentive for anyone to even collect many types of national statistical information about insurance. Rep. Kanjorski's proposal appears to enjoy widespread support. Although a nearly identical bill failed to pass last year, some groups opposed to broader federal regulation—including the powerful National Association of Insurance Commissioners—support the idea of an OII.[5]

Disadvantages. Creating an OII would represent only a very timid step towards market reform. The new office, as Rep. Kanjorski has proposed it, would have little power to do anything besides collect data and represent the United States internationally. Besides issuing reports, it would not—and could not—actually *do* anything to unify the national insurance market or maintain the solvency of insurance companies. At most, it might blow the whistle on states that fell down on their obligations to provide for insurer solvency. (Rep. Kanjorski's proposal would also set up a new federal agency, so a provision to sunset some of the agency's responsibilities once a national insurance market has had a chance to develop would represent an improvement.)

Contractual/Compact Implementation of a Federal Charter. A contractual or compact-based implementation of a federal charter would give states the option to participate in a federal insurance regulatory regime. Congress might authorize an interstate compact relating to property and casualty insurance (something that only Congress can do, under Article 1, Section 10 of the Constitution) or create a federal regulator but give states the option of participating in its programs. States could probably contract for any combination of federal services. States that did not like the idea of a federal regulator could continue to regulate everything themselves. States that wanted federal solvency oversight but wanted to retain rate and form regulation could do so. States could even abolish their own insurance departments and make the federal government the sole insurance regulator within their borders. (In principle, a compact could provide many of the same choices.)

***Advantages*.** Each state would retain full decision-making authority under a compact/contract version of a federal charter. This would convey three advantages. First, it would make it easier for governments to pick and choose the federal regulatory features they like. If a state's voters and elected officials were to strongly dislike a given federal regulatory proposal, then a contract or compact version of a federal regulator would allow them to pick and choose which features to adopt. Second, this flexibility would allow widespread state-level experimentation on the workings of a federal regulator. Since only a few states would initially sign up for the new regulator, government officials, consumers, and insurers in non-adopting states could observe the results and decide if they wanted to participate. Finally, states could achieve administrative savings by abolishing their own insurance departments and letting the federal government regulate all insurance within their borders.

Disadvantages. Under a compact/contract version of a federal regulator, federal regulation would not really be optional at all and the system would not become more flexible. Insurers and consumers would remain subject to the decisions of state governments. No consistent national system would exist, so until the great majority of states took part in such a system, no product innovations would likely result, since insurers would not be able to market products nationally. Consumers would still have only one choice of regulatory system in which to buy products. Furthermore, states with the most problematic systems might prove the most reluctant to participate in any sort of national system.

Phased Implementation of a Federal Charter. A phased implementation of NICPA or a similar bill would move to implement an overarching property, casualty, and life insurance federal regulator in phases. A bill might, for example, set up a life insurance regulator immediately, move personal lines automobile insurance under a federal regulation a few years later, and finally move commercial insurance—liability and real property—and personal real property—homeowners'—insurance under an optional federal regulator. The fundamental design of NICPA would be retained but the legislation would not go into effect all at once.

Advantages. A phased implementation of a federal regulator would limit dislocations and give both regulators and regulated parties more time to decide on the wisdom of a given regulatory reform. If, for example, life insurers came under federal regulation first, then property and casualty insurers could observe the faults and merits of the system before deciding if their businesses should come under federal regulation for life insurance. Regulators, likewise, would be able to start small and figure out best practices before having to regulate the entire insurance sector. Finally, since Congress would establish a specific timetable for implementing a federal charter, companies would have time to prepare and make deliberate decisions to choose between federal and state regulation.

Disadvantages. A phased implementation would almost certainly result in considerable political wrangling as each new part of the insurance business came under federal regulation. While policy fine tuning is a necessary part of the legislative and regulatory processes, phased implementation could draw out the debate over federal chartering for an unnecessarily long time and expose the system to greater political interference.

"Life Only" Federal Charter. Many aspects of life insurance regulation are already harmonized under an interstate compact run through the National Association of Insurance Commissioners. As of the late spring of 2009, 41 states, Puerto Rico, and the District of Columbia had either entered into the compact or had their entrance pending.[6] (The compact also covers closely related annuity, disability income, and long term care insurance.) All whole life products, furthermore, include an investment component that a federal financial regulator—generally the Securities and Exchange Commission—already oversees. Most states do not set limits on how high life insurance rates may go. As a result, life insurance rates are already largely risk-based throughout the country. A "life-only" federal regulator appears to have widespread support. The powerful chairman of the House Financial Services Committee, Rep. Barney Frank (D-Mass.), has repeatedly said that it is the only form of a federal charter he could endorse.[7]

> ***Advantages*.** A life-only federal charter measure makes sense as a matter of common sense and good government. The federal government already regulates the investment component of all life insurance policies. Since most states do not regulate rates of life insurance, it is likely that rates would either stay the same or, more likely, go down—thanks to administrative efficiencies—for just about everyone if a federal regulator were adopted. A single federal bureau could do a more efficient job managing product filings than the NAIC and the current interstate compact. More life insurance products would likely become available. There is little evidence that state laws result in a very large difference in rates or availability, but, if they were to, a federal charter would overcome any difficulties they would impose.
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> ***Disadvantages*.** Because so many aspects of life insurance are already federally regulated and because most consumers live in states that have adopted the compact or plan to, consumers would see few changes besides small decreases in premiums.[8] Many benefits of a life-only federal charter would accrue more to life insurers than to individual policyholders. While the pilot program would have some value—and do no harm—it would produce few significant improvements.

Federal Charter "Three Pack." An optional federal charter "three pack" would create a "three-quarters federal charter." A "three pack" bill would contain essentially all of the mechanisms in NICPA but exclude homeowners', other personal lines, real property insurance, and perhaps some smaller-scale commercial policies from the federal regulatory mix. States would continue to regulate all aspects of homeowners' insurance, while companies and consumers wishing to shop for other types of insurance would have the choice between federally and state regulated companies. No one has proposed "three pack" legislation to date, but several members of Congress and several insurers have expressed interest in the concept to this author.

> ***Advantages*.** A "three pack" federal charter—covering life, larger commercial, and automobile insurance—would help transform the national insurance market and should mitigate many of the concerns that anti-federal regulation groups have expressed. The case for a life federal charter is made above and applies equally to a federal charter that includes more than life insurance. The activities covered under the "three pack" are the low-hanging fruit of the federal chartering debate. Two—life and commercial—are rarely rate-regulated in any case and rates for the other—auto insurance—are increasingly governed by market forces in most states. Automobile insurance deals with an inherently interstate activity—almost all cars cross state lines at one time or another and it makes sense for consumers to have the option of sticking with the same auto insurance policy wherever they happen to reside. Similarly, commercial insurance typically gets little rate regulation, and for larger companies almost always involves interstate transactions. Businesses and good drivers would likely see significant savings as a result of this type of federal chartering.[9] Bad drivers would likely see their insurance rates go up.

Disadvantages. By leaving out personal real property insurance, a "three pack" largely sidesteps the single issue—catastrophic natural disaster losses—most likely to threaten the solvency of property and casualty insurers. Under a three pack, dangerously unstable mechanisms such as Florida's Citizens Property Insurance Corporation and Florida Hurricane Catastrophe Fund—which encourage building in disaster-prone areas by offering rates that do not reflect the risks involved—would remain in place. For homeowners' insurance customers, nothing would change.

Federal Chartering "Lite." A so-called "optional federal charter-lite" appears to be consistent with Treasury Secretary Geithner's public statements. It would leave all form regulation at the state level, have states play a role in solvency oversight, and allow state governments to regulate rates for smaller companies. Larger companies judged by the government to be "systemically important" would likely come under mandatory federal regulation. It remains unresolved how the government would define "systemic importance" or what would happen to medium-sized companies—all but the few largest—under this type of proposal. If the federal government wishes to implement "systemic" regulation, it would need to be able to either accept rate filings from insurers directly or override decisions of state regulators that endanger solvency—such as, for example, a state requiring a company to write coverage at an actuarially inadequate rate. Without this power, the proposal would accomplish nothing.

Advantages. A federal charter-lite would retain certain desirable features of the state system while overcoming the economic burdens imposed by rate regulation and doing more to protect solvency. State-level consumer protection, form regulation, and the like would remain in place. Insurers would not have any limits on pricing under such a system, so they would be able to do a better, more complete job of pricing for risk. Furthermore, a federal regulator's broader view of a company's operations could give it an advantage in helping to prevent the collapse of major insurers. The largest insurers are simply too large for state regulators to oversee in an effective manner. For example, before its collapse, AIG had 72 state-regulated subsidiaries and nobody outside the company had a clear view of how they were interrelated.

Disadvantages. Many of the advantages of an optional federal charter would be lost under a federal charter-lite system, which could benefit large companies at the expense of small ones. Insurers would still need separate product approvals from each state, so such a system would be unlikely to encourage the development of new insurance products. Consumers would gain less than they would under a full-scale optional federal charter. In addition, the system could potentially impose a significant moral hazard, as larger companies judged systemically important might well be deemed "too big to fail" and thus become eligible for government bailouts. Finally, smaller purely state-regulated companies could be placed at a competitive disadvantage if they could not charge adequate rates while larger, federally regulated companies could.

Conclusion. For the goal of fostering a freer, more creative market for property, casualty, life, and commercial insurance, a comprehensive optional federal charter remains the best option. Short of a full-scale optional federal charter, certain more modest approaches have significant merit. Two—a life-only federal charter and an Office of Insurance Information—seem particularly attractive. Insofar as the federal government has a role in maintaining the stability of "systemically important" insurers, a "federal charter-lite" appears likely to accomplish these goals. None of these measures goes all the way toward a free market for insurance (a federal charter in anything like the form that has been proposed would not do so, either), but all represent important incremental advances. Congress should remember that insurance regulatory reform need not be an all-or-nothing game. Incremental change would make sense, if it is in the right direction.

Notes

[1] For more on the Act, see: Verlan Lewis and Eli Lehrer, National Insurance Consumer Protection Act, NICPA.org.

[2] For a sample of anti-OFC opinion, see Coalition Opposed to a Federal Insurance Regulator, "Congressional Testimony," http://www.cofir.us/resource-center/congressional-testimony.php.

[3] Timothy Geithner, Testimony to House Financial Services Committee, March 24, 2009.,http://www.realclearpolitics.com/articles/2009/03/geithners_testimony_to_house_f.html.

[4] National Association of Insurance Commissioners (NAIC), "Geithner Proposal Maintains State Insurance Supervision," http://www.naic.org/Releases/2009_docs/geithner_proposal.htm.

[5] NAIC, "NAIC Offers Conditional Support for Establishing Office of Insurance Information," June 10, 2008, http://www.naic.org/Releases/2008_docs/treasury_ins_info_office.htm

[6] NAIC, "Interstate Insurance Product Regulation Compact," http://www.naifa.org/advocacy/irr/irc.cfm.

[7] National Association of Professional Insurance Agents, "Rep. Frank Says OFC for Life Only," March 10, 2009, http://www.pianet.com/IssuesOfFocus/HotIssues/modernization/3-10-09-5.htm.

[8] Even these small premium cuts would probably end up being limited because most people buy life insurance under a policy that provides a level or predictable premium over the life of the policy contract. Thus, most existing life insurance customers probably would not actually realize any savings.

[9] Since business rates generally are not regulated, businesses that engage in risky behavior or fail to take adequate safety precautions against insurable events already pay high-risk based premiums. Insurers would realize administrative savings and its highly likely that at least some business customers would share in them.