



Issue Analysis

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# Federal Insurance Chartering

The Devil's in the Details

by Catherine England

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## Executive Summary

Of all the financial services firms in the United States, only insurance companies lack a federal regulator. While crises in the industry led to occasional calls for federal oversight, until recently, the insurance industry has joined state regulators in opposing a federal role in regulating insurance firms and markets.<sup>1</sup> Industry opposition to federal oversight has begun to weaken, however. Large, transnational insurance firms have expressed a growing interest in federal regulation.

There are several reasons for the industry's sudden interest in optional federal regulation. We will first examine insurers' support for—and their goals in seeking—an increased federal role. A brief look at the dual banking system, which allows banks to choose a federal or state charter, will help identify several of the key questions in designing a new regulatory structure. How policymakers answer these questions will determine whether a newly created “dual insurance” system will meet the goals of industry advocates.

Concern about efficient insurance regulation does not end with the executives and owners of the insurance companies. Policyholders and taxpayers also have an interest in creating an insurance regulatory system that encourages competition, innovation, and financial stability.<sup>2</sup> The goal of policymakers should be to create a regulatory structure that enhances rather than impedes the operational advantages of a competitive market. Such a regulatory system will serve the needs of customers while maintaining the financial health of the industry. This requires an “incentive compatible” system in which regulators, whether state or federal, balance the multi-faceted interests of insurance company owners and their customers, as well as taxpayers. Incentive compatibility requires unambiguous goals, clear lines of responsibility, and the attachment of costs to those responsible for regulatory failures. The savings and loan crisis of the 1980s stands as a stark and costly example of what can go wrong when policymakers and regulators can shift responsibility for bad policy decisions.<sup>3</sup>

This study neither supports nor opposes a federal oversight option for the insurance industry. A well-designed system that includes a federal chartering option could benefit both insurance company owners and their policyholders. It is important to recognize, however, that federal chartering is not a panacea. A poorly designed system could irreparably harm both insurance companies and their customers.



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## Introduction: Reconsidering Federal and State Oversight

After decades of resisting federal inroads into insurance industry regulation, several large insurance companies and their trade associations have become advocates of a federal chartering and regulation option.<sup>4</sup> What has caused this shift in attitudes among some insurers?

The competitive environment facing insurance companies has changed substantially during the past three decades. As a result, the insurance industry has encountered new competition across two dimensions of the market for financial services. Both geographic boundaries between markets and lines that once sharply divided products and services offered by different financial institutions have virtually evaporated.

As recently as 1980, the consumer market for financial services was, in large part, a local market. At one extreme, banks and other depository institutions could not cross state or sometimes even county lines. Even though insurance companies faced no similar limits on their geographic expansion, moving into a new state meant satisfying another set of regulations.<sup>5</sup> In addition, information was costly to obtain and transport. Financial services providers generally preferred to live and work where they sold their products, and where they could understand opportunities and risks firsthand. Similarly, consumers had little information about services and prices available in the next state or across the country.

This landscape has changed. At the dawn of the 21<sup>st</sup> century, the market for financial services, including insurance, has become increasingly national, if not international, in scope. Rapid advances in telecommunications technology have dramatically lowered the costs of obtaining and processing information. The Internet has allowed financial services providers to seek customers in distant locations, just as it has enabled consumers to compare prices and services offered by financial services providers across the country.<sup>6</sup> Geographic markets once deemed safe from competition now face an influx of new entrants.

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In addition to geographic specialization, financial services firms 25 years ago also served clearly defined financial market niches. These once clear distinctions separating the businesses of banks, S&Ls, credit unions, insurance companies, and securities firms have steadily eroded, however. As Wood remarks, “Banks sell insurance and own brokerage houses. Stockbrokers make loans and sell insurance. Insurance companies own banks and brokerage houses.”<sup>7</sup> Mergers among financial services firms have become commonplace, as has the proliferation of hybrid financial products that mix aspects of insurance with loans or securities.

Product innovation is increasingly necessary, especially if insurers are to respond to these new competitive threats. For life and health insurers, banks and securities firms represent the most important sources of new competition. For all other insurers (collectively known as property-casualty insurers), alternatives to traditional insurance products include the financial derivative markets, increasingly sophisticated contingency contracts, risk-pooling mechanisms, and offshore captive insurers, to name just a few.

Insurance companies’ ability to develop and offer new types of insurance contracts at attractive prices is limited by state pre-approval requirements that new insurance products, contractual terms, forms, and rates must meet. Price and product regulations often vary by state, so a company selling insurance in multiple states must satisfy regulators in every state where it operates.<sup>8</sup> This prerequisite increases the costs of developing and offering new products and services, as an insurer may have to offer different contractual terms for the same basic product in each state where it sells a certain product. Such complexities slow the rate of innovation within the industry, and it may well keep useful products off the market entirely.<sup>9</sup> The significant regulatory oversight that governs prices and terms of contracts—a unique feature of the insurance industry—further exaggerates this effect. By contrast, consumer protection regulation of the banking and securities industries rely primarily on the disclosure to consumers of relevant or material information rather than pre-approval of contracts by regulators.<sup>10</sup>

Insurance customers pay for this state-by-state regulatory structure through fewer choices and through higher premiums. Increased regulatory costs reduce the rate of return earned by insurance company stockholders for a given level of premiums. Stockholders will not long accept lower returns on their insurance company investments when higher returns are available on other investments of similar risk.<sup>11</sup> If insurance company returns fall below returns available elsewhere, stockholders and/or managers of diversified financial services firms will reallocate financial capital away from insurance to lines of business

with higher rewards, writing fewer policies. They will exit the insurance business altogether or offer other, more lucrative types of financial services instead of insurance. As the supply of insurance shrinks, premiums will rise. The cost of insurance to policyholders will increase until the return on insurance is once again comparable to the returns available on other equally risky investments.

Thus, we arrive at the crux of the matter. During earlier insurance crises, state oversight of insurance company solvency was the biggest concern of reform advocates. Solvency regulation is not behind the industry's current call for federal oversight.<sup>12</sup> This most recent push for optional federal regulation is primarily a response to state-by-state price and product regulation.<sup>13</sup>

Those who favor a federal insurance option also make other arguments. For example, financial services, including insurance, represent a growing component of international trade. State insurance regulators have no seat at the debates over international trade agreements. Only the federal government may enter into negotiations with foreign authorities.<sup>14</sup>

Some observers expect a federal insurance regulator to act as an industry advocate on issues such as monetary policy and changes in the tax code.<sup>15</sup> Martin F. Grace and Robert W. Klein have suggested that federal regulators might be better able to help insurers during a major solvency crisis because these regulators have the vast resources of the federal government at their disposal.<sup>16</sup> In addition, the Gramm-Leach-Bliley Act or Financial Modernization Act of 1999 set in motion changes within the financial services industry that are hastening the elimination of distinctions between different types of financial firms.<sup>17</sup> Federal financial services regulators are coordinating their efforts as they settle jurisdictional disputes and institute functional regulation. There is no federal official charged with understanding and explaining the operation of the insurance industry to federal overseers of depository institutions and securities firms, however.

Consumer advocates who favor a federal role in insurance regulation cite concerns about a "race to the bottom" among state regulators.<sup>18</sup> These individuals suggest that a federal regulator could play an important role by establishing minimum standards for solvency and consumer protection. Hunter also expresses concern about the "merger mania" among financial services firms. Individual states might lack the resources necessary to deal with future super-sized financial services firms that sell insurance.<sup>19</sup>

In summary, the primary objective of industry advocates of a federal oversight is to eliminate what the insurers view as duplicative state-by-state price and product regulation. There is also a desire among

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insurers to create an alternative to state rate regulation that holds premiums below the cost of providing certain types of insurance coverage, although some supporters of federal insurance regulation believe the federal government could play an important role in establishing stronger, uniform consumer protections. Finally, others promote an optional federal insurance charter as a way to provide a more credible industry voice in international trade, tax, and financial regulation discussions at the federal level.

## **The Dual Banking System as a Model?**

Many advocates of optional federal regulation for insurance point to the dual banking system as a potential model. Depository institutions generally can choose between state and national charters. The dual chartering system for banks came about more by accident than by design. When Congress passed the National Currency Act and the National Bank Act in 1863 and 1864, respectively, it had two goals. The first was to help finance the Civil War. The second was to drive state-chartered banks out of business and create a national currency.<sup>20</sup> Rather than fade away, however, the state-chartered banks innovated and survived, and the dual banking system was born. This dual chartering system served as a model for both savings and loan associations and credit unions.

There are differences worth noting between the banks' dual chartering system on the one hand and the chartering and regulatory system for savings and loan associations and other thrift institutions on the other.<sup>21</sup> Until recently, the Office of the Comptroller of the Currency generally assumed that nationally chartered banks were subject to the laws of the states in which they operate unless the federal government specifically preempted those regulations.<sup>22</sup> By contrast, the Office of Thrift Supervision has typically assumed that federally chartered thrift institutions are exempt from state regulations unless those regulations are specifically applied.<sup>23</sup> The general attitude of federal insurance regulators toward state rules' application to federally chartered companies will be one of the keys to determining the impact of optional federal regulation, should it be introduced.

Proponents of a dual insurance system hope to create competition between state and federal overseers. Providing insurance companies a regulatory exit strategy if state—or federal—regulation becomes too burdensome would lead, presumably, to a more efficient regulatory structure. The dual banking system has provided such periods of regulatory competition. At times, the federal and state criteria for chartering banks have differed, so that one or the other source of bank charters was more willing to license new institutions. State and federal regulators have established different limits on interest rates banks and S&Ls could pay to depositors or charge to borrowers.<sup>24</sup> The list of activities deemed acceptable for a bank or S&L has differed depending on whether the institution

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held a federal or state charter. At one time, the bank chartering authority also established certain safety and soundness regulations such as reserve requirements. Before 1980, for example, Illinois imposed no minimum reserve requirement on its state-chartered banks.

Increasingly, however, the federal government has “trumped” or preempted state regulation. Some consumer protections, such as Truth-in-Lending and the Community Reinvestment Act, are applied to all depository institutions regardless of the source of their charter. The 1980 Depository Institutions Deregulation and Monetary Control Act made all depository institutions subject to reserve requirements set by the Federal Reserve. In the aftermath of the savings and loan and banking crises of the 1980s, the federal government began to apply federal standards to all “federally-insured depository institutions,” regardless of charter. The argument (sensibly) was that the entity responsible for deposit insurance should oversee and regulate the financial health of the institutions it insured. Other examples of spreading federal influence abound.

Despite these trends, much consumer banking regulation lies in state hands, even where nationally chartered institutions are concerned. The states have actively defined and regulated “predatory lending,” for example. Until 1994, geographic restrictions (i.e., the ability—or not—of banks to open branches within a particular state or across state lines) were left entirely with the states for both state- and nationally-chartered banks.

An exception to this general pattern of state consumer oversight occurred in 1980 when the federal government preempted state usury laws. More recently, in January 2004, the Comptroller of the Currency drafted new regulations granting the OCC the right to write and enforce all rules (including consumer protection regulations) applied to nationally chartered banks.<sup>25</sup> Naturally, state banking regulators and attorneys general oppose such a move by the federal government, and efforts are underway to reinstate state authority.<sup>26</sup>

The dual chartering system, bringing with it a certain degree of regulatory competition, has generally served depository institutions and their customers fairly well. There are probably more chartered institutions than there would have been under single regulator. And the dual chartering system has led to more new products and services than would have appeared in its absence.<sup>27</sup> Successful innovations spread, while the problems associated with unsuccessful ideas were limited.

Of course, until 1994, depository institutions were generally unable to cross state boundaries, so no single bank needed to meet the regulatory requirements of multiple state regulators.<sup>28</sup> Furthermore, it became apparent

***...the dual chartering system has led to more new products and services than would have appeared in its absence.***



during the 1980s that serious problems can develop when responsibility for oversight is separate from responsibility for providing deposit insurance.<sup>29</sup>

Regulatory competition between the states and the federal government can have advantages, but it would be naïve to ignore the possibility that federal oversight and regulatory preferences might come to dominate or even eliminate state systems. Furthermore, whether the federal government would ultimately support a more or less stringent rate and product regulation is an open question. Whether the benefits of a new dual insurance system will outweigh its costs will depend on policymakers' answers to certain key questions.

## **A Federal Insurance Regulator: What? How? Where?**

The designers of a dual insurance system will face a number of key issues:

- What should the federal regulatory system accomplish? What should be its functions?
- What role, if any, will state insurance regulators play in overseeing the operations of federally chartered insurers in their jurisdictions? Specifically, will states have a role in establishing and enforcing consumer protection regulations?
- How will the policies of federally chartered insurance companies be guaranteed? By whom?
- Where will the new federal regulator be housed? How will it be financed?

***It became evident during the 1980s that a poorly designed government guaranty system can undermine the health of an entire industry.***

Finally, a host of miscellaneous issues will also be addressed.

The first three of these questions are especially important. Defining the government's regulatory functions helps identify its scope. The scope of federal oversight will affect answers to the remaining questions. First among these will be the question of consumer protection regulations. As noted earlier, insurance industry advocates of optional federal chartering are clearly concerned with the inefficiencies inherent in state rate and product regulation. If states retain their power in these areas, many supporters of federal regulation will no doubt rethink their positions.

Second, the design of the guaranty system for federally chartered insurance companies is vital. It became evident during the 1980s that a poorly designed government guaranty system can undermine the health of an entire industry.<sup>30</sup> Policymakers' answers to these questions will influence greatly the success or failure of a system of optional federal insurance regulation.

## The Regulatory Role

It is useful to begin with what a federal regulatory system, indeed any insurance regulatory system, should accomplish. The table below reproduces lists of regulatory functions provided by J. Robert Hunter, Director of Insurance for the Consumer Federation of America, and Professor Scott E. Harrington.<sup>31</sup> These lists are reasonably representative of others provided elsewhere.

| <b>REGULATORY FUNCTIONS</b>   |  |
|---|--|
| <b>Robert Hunter</b>  | <b>Scott Harrington</b>  |
| Solvency regulation<br>Licensing  | Solvency regulation  |
| Competitive information, including making loss cost and actuarial information available to smaller insurers | Facilitation of information sharing between insurers   |
| Consumer education, including making price, service, and solvency information available to consumers        | Market conduct regulation and regulator oversight of contract terms, particularly for relatively unsophisticated policyholders |
|   | Limited protection of policyholders with claims against insolvent insurers   |

The two lists cover much of the same ground, although in his discussion, Harrington warns that regulation is justified only where there is a “demonstrable market failure” *and* “substantial evidence that regulation can efficiently address the failure.”<sup>32</sup> Grace and Klein note the important distinction between market failures and market problems (high prices, for example).<sup>33</sup> Insurance premiums may be high in certain markets to reflect high risks, i.e., a high probability of payouts. Further, the supply of insurance does not always adjust instantaneously to new information or newly recognized risks, although it can adjust relatively quickly in the right regulatory environment. High premiums can then attract additional supply, leading to moderation in pricing. The distinction between market failures and market problems will be important in discussions of market conduct regulation and ratemaking below.

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***The potential for economic spillovers in the event of widespread insurance company failures further bolsters the case for solvency regulation.***

Solvency regulation is a key concern. There are individuals who argue that government oversight of insurance company solvency would be unnecessary in a properly functioning market, i.e., one without other forms of government interventions or distortions. That debate is unlikely to influence the question of optional federal insurance in the current debate, however, and will not be pursued here.

As it stands, few question that the chartering agent, whether state or federal, should oversee the financial health of the insurance companies in its domain. Individual (particularly retail) policyholders generally are considered incapable of monitoring the financial health of insurers on their own. The potential for economic spillovers in the event of widespread insurance company failures further bolsters the case for solvency regulation.

The second set of regulatory responsibilities involves information sharing among insurance companies. Insurers rely for their profits, indeed their survival, on their ability to play the averages. Consider homeowners' insurance, for example. The risk of a fire for an individual homeowner is a generally unacceptable all-or-nothing proposition. The *probability* that your house will burn means almost nothing. Either your house catches fire (and you lose everything) or it does not (and you lose nothing). For an insurance company insuring a large number of houses, probabilities are very important, however. Insurance company executives know they will be required to pay some claims every year because of house fires. Knowing the probability that any given insured house will burn, and hence the number of claims they can expect out of the thousands of homes insured, allows insurers to control their risks and set a fair premium. The more data the insurer has about house fires, including information about the age, location, and construction of houses that burn, the better the insurance company can predict the number and size of expected payouts and set premiums accordingly.<sup>34</sup>

Obtaining industry-wide information about the size and circumstances of insured losses is especially important for smaller insurance companies and new entrants. There are economies of scale in information gathering. Prohibiting information sharing among insurers would thus give larger insurance companies an important competitive advantage. Absent information sharing, the industry would also find it more difficult to respond to newly recognized risks with appropriate (and appropriately priced) insurance products.<sup>35</sup>

Antitrust laws typically prohibit firms from sharing information about their costs. Consequently, insurance companies have been granted a limited antitrust exemption. Observers who attack the industry's antitrust exemption either do not fully understand the reasons behind the

exemption or think the exemption is too broad.<sup>36</sup> Among those who believe the exemption is too broad, there is a search for mechanisms that allow appropriate information to be shared while thwarting insurers' ability to use shared cost information to facilitate price agreements.<sup>37</sup>

The third set of regulatory functions identified by Hunter and Harrington addresses consumer protection issues. Hunter lists consumer education, law enforcement, market review, and ratemaking as regulatory functions. Harrington lists only market conduct regulation and oversight of contractual terms, particularly for unsophisticated policyholders. "Ratemaking" seems to be the most important difference between the lists provided by Hunter and Harrington.

Rate regulation has evolved over time. Initially, rate regulation established minimum premiums on the pretext of guaranteeing insurance company solvency. Today, state rate regulation establishes maximum premiums, arguing that such oversight is necessary to protect consumers. Even here, Hunter asserts that the Consumer Federation of America (for whom he speaks) favors effective competition over effective regulation as a means of controlling premiums.<sup>38</sup> The difference between Hunter and Harrington lies in their respective definitions of "effective competition."

Hunter notes, "consumers define 'competition' classically, not as the insurance companies often do. For example, we do not believe that competition can be effective if 'competitors' can agree on prices or even on such elements of pricing as the anticipated cost changes over the coming year."<sup>39</sup> Hunter notes problems in markets for insurance products like credit insurance, and he argues that at least some insurers have practiced redlining.<sup>40</sup> To Hunter, such problems are indicative of too little market competition. Hunter clearly leaves the door open for rate regulation by someone.

By contrast, Harrington writes:

Insurance markets that are relatively free from regulatory constraints on prices and risk classification exhibit pervasive evidence of competitive conduct and performance. Insurers vary substantially in terms of price, underwriting, and service. Prior approval rate regulation therefore cannot be justified as an efficient response to monopoly or oligopoly pricing, nor is it necessary to prevent collusion.<sup>41</sup>

Harrington concludes, "Rate regulation is an inefficient tool for addressing information problems . . . [and] a crude method of subsidizing low-income policyholders."<sup>42</sup>

There seems to be ample evidence that rate regulation causes significant net harm. In states with extensive rate regulation, insurance

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premiums depend more on the relative political power of the parties involved than on the financial and economic considerations that should drive prices. As insurance premiums become distorted, several problems develop.

First, insurance premiums can be an important signal, identifying and discouraging risky behavior. When automobile insurance premiums are held below their market value, for example, more drivers with poor records stay on the roads, raising the risks for everyone. Second, holding insurance premiums artificially low reduces the number of insurance companies operating in a particular market. Fewer companies would mean less competition, negatively affecting service quality and leading to other market conduct problems. Insurers will be better able to “pick and choose” among clients. Insurance company customer assistance will be less helpful, policies will be read more strictly, and claims will be paid more slowly.<sup>43</sup> Finally, someone has to pay. Someone, somewhere is subsidizing those individuals whose insurance premiums do not fully reflect the risks they represent. Subsidies may come from insurance company stockholders (for a time), taxpayers, or other less risky policyholders who are paying higher premiums than they would otherwise.

In short, some argue for a role for insurance regulators in establishing minimum disclosure requirements, educating consumers, and disseminating information about insurance company practices and the meaning of particular contractual terms. Regulators may have an interest in identifying minimum standards for policies designed primarily to protect third parties. There is certainly a role for regulators in identifying and prosecuting fraudulent behavior in the insurance market. There is no need, however, for insurance regulators to pre-approve or establish maximum rates. This conclusion does not address the question of where primary responsibility for consumer regulation will reside, nor does it guarantee that federal insurance regulators will agree that rate regulation is unwarranted.

Finally, Harrington adds to his list of regulatory functions “limited protection of policyholders with claims against insolvent insurers.” (The question of policyholder guarantees will be discussed more fully later.)

In considering the question: “What should be the functions of the federal regulatory system?” we have developed a list of general regulatory functions rather than a list specific to the federal government. There is no reason in principle that the market cannot perform these functions. But the terms of the current debate envision a government role (either state or federal) in solvency regulation, the facilitation of information sharing while guarding against anti-competitive behavior, limited consumer protection regulation, and provision of a guaranty system. Other than establishing the responsibility of the chartering agent for solvency regulation, we have (so far) left largely untouched the discussion of which regulator or regulators

would oversee consumer protection regulation and who would provide guarantees for creditors of failed insurers in a dual insurance system.

## **Market Conduct and Consumer Protection**

The debate about who oversees consumer protection promises to cause a political firestorm. How comprehensive will federal oversight be? Should the federal regulator have responsibility for establishing and enforcing consumer protection regulations for federally chartered insurers? For all insurers? Or will that responsibility fall to the state governments?

As noted earlier, the regulatory model applied to insurance is different from that applied to other financial services firms. Consumer protection is pursued, typically, by regulators' vetting insurance contracts in advance, as they review proposed rates, forms, and contractual terms. This state-by-state pre-approval process is the most frequently cited argument in favor of an optional federal charter. Opponents of state-by-state approval argue that it slows innovation, limits the ability of insurers to respond to competitive challenges, reduces the amount of experimentation with terms and rates that might otherwise take place, and causes unnecessary confusion when policyholders themselves cross state lines.<sup>44</sup>

Even if Congress passes legislation creating an optional federal insurance charter and providing for federal solvency regulation, many will argue that consumer protection regulation should remain with state regulators. Advocates of state-based consumer protection claim that local and state government officials are in a better position to understand and meet the unique needs of individual states.<sup>45</sup> White also notes that differences in states' tort systems affect regulatory requirements applied to insurance companies operating across the country.<sup>46</sup> Finally, some claim state-based regulators respond more effectively to in-state taxpayer-consumers than more distant federal overseers can.<sup>47</sup>

On the other hand, consumer protection regulation generally, and rate regulation, in particular, can influence the financial health and stability of an insurance company. Separating responsibility for consumer protection regulation from responsibility for solvency regulation could tempt state governments to satisfy their consumer constituents by holding insurance premiums below the cost of providing coverage.<sup>48</sup> If the goal is to create an incentive-compatible system of insurance regulation, then consumer protection regulation logically should be handled by the same regulators who oversee financial safety and soundness. Combining these functions puts the overseer in a better position to understand the tradeoffs necessary to balance the concerns of all interested parties.

That raises other problems, however. If the chartering agent is responsible for consumer protection regulation, competing companies

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may be subject to different rate requirements, disclosure requirements, or contractual terms. Some will argue that consumers cannot judge insurers and policies subject to different rules. Consumer education and dissemination of information could then take on an increasingly important role for all regulators, state and federal. Further, insurers exempt from rate regulations (if any are) may continue to find it difficult to increase premiums if their alternatively chartered competitors remain constrained by government-mandated maximum premiums.

Of course, the federal government could resolve the confusion by establishing consumer protection regulations applied to all insurers, regardless of charter. The federal government already establishes minimum standards or requirements for certain types of insurance. Examples include provisions of the Employee Retirement Income Security Act (ERISA), federal requirements regarding the provision of employee health care insurance and minimum standards for group health plans, and direct federal involvement in the markets for flood insurance and terrorism insurance, to name a few.<sup>49</sup> There is also the possibility that the federal regulator will turn out to be more stringent than some states in terms of consumer protection requirements.

One short-term answer to this political knot is to avoid the issue altogether. Optional federal chartering and regulation could begin with commercial insurance lines.<sup>50</sup> Market conduct regulation is not nearly as controversial an issue in commercial lines where policyholders are presumed to be reasonably sophisticated. Furthermore, many commercial line customers operate across state and national boundaries, themselves, and so might benefit from increased uniformity.

LaRocco reports that the American Bankers Association (ABA) Insurance Association has explored the possibility of creating a self-regulatory organization (SRO) within the insurance industry to take on responsibility for consumer protection for both state- and federally-chartered insurance companies.<sup>51</sup> Realistically, however, given state insurance regulators' reluctance to yield power to the federal government, it is difficult to imagine their handing over responsibility for consumer protection to the private sector.

As politically difficult as questions over regulatory oversight are, they lie at the heart of most insurers' interest in optional federal regulation, and with good reason. Grace and Klein set out to measure potential cost savings resulting from an alternative regulatory regime. They conclude that significant cost savings for insurers (and eventually for policyholders) can only be expected if the scope of market regulation, including rates, forms, and contractual terms, is reduced and the federal regulator preempts state regulations for federally chartered insurers.<sup>52</sup> Thus, in a dual insurance

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system, consumer protection and market conduct regulation should be handled by the same regulator who oversees insurer solvency. Coupling these responsibilities will both ensure that regulators consider all the consequences of their actions and enhance the effectiveness of regulatory competition for both insurance companies and consumers. Policyholders, after all, can refuse to deal with insurance companies supervised by an ineffective regulator or a regulator too ready to sacrifice consumer welfare. Finally, leaving consumer regulation entirely in the hands of the state insurance regulators will substantially reduce industry support for optional federal oversight.

## ***The Insurance Guaranty System***

Incentives created by the guaranty system can either reinforce or undermine the safety and stability of the industry. The design of the guaranty system may not be as politically charged, but it will be a challenging and important issue facing policymakers. Several questions must be addressed, including the following:

- Who will guarantee the promises of federally chartered insurance companies?
- Will federal- and state-chartered insurance companies form distinct groups for the purposes of providing policyholder guarantees?
- Will the federally chartered insurance companies participate in a pre-funded guaranty system? Or will they continue to use post-failure assessments as a means of securing the industry's promises to policyholders?
- Will industry representatives continue to participate in the management of the guaranty system for federally chartered insurers? Alternatively, will it come under the control of government agents?
- What limits (if any) will be applied to payouts to a failed federally chartered insurance company's creditors?

The first question is the most fundamental. Who will guarantee the promises of federally chartered insurance companies? Several early proposals envision insurers' continued participation in the existing state insurance guaranty plans.<sup>53</sup> Furthermore, questions about post-failure assessments and industry management of guaranty systems arise because of the current structure of the state systems. Therefore, before discussing what might change, we will review how the states currently protect creditors of failed insurers.

Insurance companies must participate in guaranty systems in each state where they provide protected insurance products.<sup>54</sup> These

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guaranty systems are organized as non-profit associations, with boards of directors that include representatives of the member companies along with regulators.<sup>55</sup> When an insurance company fails, regulators determine the dollar value of covered claims. Each surviving company offering the same line(s) of insurance then pays a share of the protected claims, determined by the individual insurer's share of the market.<sup>56</sup> That is, if a company providing homeowners insurance fails, surviving homeowners insurance providers share proportionally in the cost of protecting policyholders based on the survivors' shares of the homeowners insurance market in that state. Firms with larger market shares pay more. Guaranty fund assessments generally offset state premium taxes, thus passing along to the state's taxpayers at least part of the cost of protecting policyholders. Finally, coverage differs by type of policy and by state.

Note that asking who will guarantee the policies of federally chartered insurers requires a shift in the traditional thinking of federal policymakers and individuals more familiar with the operation of the dual banking system. Two differences between deposit insurance and the insurance industry's guaranty system are worth emphasizing. The first is that the insurance industry relies, for the most part, on a post-failure assessment to meet the failed institution's obligations. The second difference, arising in part from the first, is the role played by surviving companies in running the insurance guaranty system. Deposit guarantee systems are pre-funded government agencies run by government employees.<sup>57</sup>

We will return shortly to the question of who should guarantee federally chartered insurers, but let us begin by assuming that federal legislators set out to design a federal guaranty system for federally chartered insurance companies.<sup>58</sup> Should the system be pre-funded, or will it follow the industry norm and impose post-failure assessments?

The federal government's experience with providing financial guarantees has been primarily with pre-funded deposit insurance. If the federal government adopts the pre-funded model, insurance companies protected by the system would pay regular premiums. The monies would be set aside in advance, ready to pay policyholders in the event a federally guaranteed insurer failed. Under normal circumstances, surviving insurers would not be required to generate additional funds to protect a failed competitor's policyholders. This would have the advantage of creating more predictable cash flows for insurance companies. However, a pre-funded insurance guaranty system raises other important questions.

First, how large should the insurance guaranty fund be? The size of the fund (as determined by its government overseers) will determine what it will cost insurers each year to participate in the federal system. Determining

the optimal size of an insurance guaranty fund is significantly more difficult than arriving at an optimal deposit insurance fund.<sup>59</sup>

Unlike deposits, which are all insured to \$100,000, coverage varies for different types of insurance policies and for different types of policyholders (individuals vs. business, for example). In addition, the liabilities of property-casualty insurers are theoretically unlimited, and those of banks are not. Creation of a pre-funded guaranty system will require that designers decide whether to establish a fund that covers average annual losses or prepares for worst-case scenarios. What if the guaranty fund proves to be too small? Will the federal insurance guaranty fund have access to the U.S. Treasury?<sup>60</sup> Will the federal guarantor turn to insurance company members with a supplemental assessment? What if the fund grows too large? Will insurers receive a rebate? And who will define “too large”?<sup>61</sup>

A pre-funded insurance guaranty system would presumably impose risk-sensitive guaranty premiums. But risk-based guaranty premiums may prove to be a political hot button. The risk of a bank is not heavily dependent on the types of deposit customers protected by deposit insurance. By contrast, risk for property-casualty insurance companies, especially, comes directly from the types of policies written for policyholders of different categories. That is, the individuals protected are one source of the risk for insurance companies. Raising guaranty fund premiums charged to insurers who offer certain types of riskier policies could contribute to availability crises in some insurance markets.

Furthermore, insurance guarantees are currently provided by line or type of policy. As a result, companies that choose to create more conservative portfolios of well-understood risks (say homeowners, renters, and auto insurance policies, for example), need not worry about paying for losses by insurers providing policies with less predictable payouts (directors and officers insurance (in recent years), environmental liability policies, or terrorism insurance, for example). What kinds of guaranty risks will federally protected insurers face with a new federal insurance guarantee fund? Will premiums be accumulated by line? Alternatively, will there be a single, undifferentiated fund, spreading risks to companies that provide policies?

Post-failure assessment systems avoid the problems associated with accumulating a guaranty fund. More important, a post-failure assessment system creates incentives that lead participating insurance companies to discourage a regulatory “race to the bottom.”

When all financial institutions pay into a guaranty fund in good times and bad, premiums become a normal cost of doing business. There is less incentive to insist that one’s fellow guaranty fund participants are carefully monitored. The failure or survival of a company’s competitors will not affect

***Raising guaranty fund premiums charged to insurers who offer certain types of riskier policies could contribute to availability crises in some insurance markets.***

the insurer's immediate cash outlays. Premiums will still need to be paid, and each insurer can focus on reducing the regulatory burden faced by his or her firm.

In a system with post-failure assessments, however, insurance companies' costs rise when a competitor fails. While insurers generally can offset their premium taxes by an amount equal to their guaranty fund assessments, a future offset does not necessarily help with cash flow needs in the near-term. Indeed, because insurance company failures tend to occur during periods of unexpectedly high payouts, cash flow concerns often take on added importance as surviving insurers scramble to meet obligations to their own policyholders. As a result, insurers covered by a post-failure assessment system should be more concerned about the quality of the regulatory system under which they operate than insurers covered by a pre-funded system. It is not enough to be confident that one's own company is sound. Insurers facing post-failure assessments must also be concerned about the financial health and stability of their fellow fund participants. As Harrington notes, "Joint guarantees help maintain collective pressure for efficient solvency regulation by giving member insurers a direct stake in the outcomes of such regulation."<sup>62</sup>

The role of the insurance industry in the operation of the guaranty system is also caught in the question of pre-funding versus post-failure assessments. In a pre-funded system, premiums must be assessed and collected, and the resulting fund has to be managed. In the case of a government mandated guaranty system, these functions would seem to fall more naturally to government agents. It is much easier to see a role for industry representatives in a system with post-failure assessments. Insurance industry representatives generally would have an advantage over regulators (state or federal) in processing the outstanding claims of a failed institution, collecting, and then distributing funds to the claimants.

***A guaranty system of post-failure assessment managed in part by industry representatives.***

To summarize the discussion to this point, a guaranty system of post-failure assessment managed in part by industry representatives has advantages over a pre-funded, government-managed system. Post-failure assessment creates incentives for insurers themselves to insist on efficient, effective solvency regulation. Participation by industry representatives in managing the guaranty system then gives surviving insurers access to information that can prove helpful in identifying and correcting regulatory shortcomings.

Finally, designers of a federal insurance guaranty system would also have to specify the extent of coverage the federal system would offer. Coverage differs from state to state, so a decision at the federal level would not be a trivial issue. If the federal government establishes its own coverage limits separate from the states, neighbors purchasing their homeowners

insurance from different companies, one state-chartered and the other federally chartered, might recover different amounts in the event of failures. Nor does simply applying the various state standards address the problem. How could the federal guarantor justify paying residents of one state more than residents of another if a federally chartered insurer failed? As a third option, the federal government could impose a standard for coverage on the state guarantors. The federalization of this decision would undermine regulatory competition between the states and the federal government.

Each alternative available to a separate federal guarantor has drawbacks. The goal of regulatory competition would be better served, however, by allowing a separate federal guaranty system, if one were created, to establish its own coverage limits. Policyholders would then be able to determine the extent of their protection depending on whether their insurer participated in the state or federal guaranty system. Should a separate federal guaranty system be established, federal policymakers should think carefully about limiting coverage in line with current state practices. If the federal government proves more generous or more inclusive than the states in protecting policyholders of failed insurers, market discipline of insurance companies will be muted as moral hazard rears its ugly head.<sup>63</sup>

Who then should provide guarantees for federally chartered insurers? More specifically, should state-chartered and federally chartered insurers form distinct groups with different guaranty systems? The primary argument in favor of creating a federal insurance guaranty system is that regulatory responsibility for financial health and solvency should be coupled with financial responsibility for insurance company failures. That is, federal examiners will have stronger incentives to supervise insurance companies efficiently and effectively if it is clear that federally chartered insurers and the federal government will bear the cost for regulatory errors.<sup>64</sup> As noted earlier, this link between oversight and financial responsibility can reduce the chances of an undesirable “race to the bottom” in which chartering agencies encourage financially unsound insurers to operate under their watch.

The primary argument in favor of maintaining the current state-based system lies in the nature of property-casualty insurance company liabilities. Unlike the liabilities of depository institutions, or even the liabilities of life insurance companies, the ultimate liabilities of a failed property-casualty company can be unpredictable. Think about the payouts facing insurers in the wake of a major natural disaster or in the aftermath of a terrorist attack. The failure of an insurance company providing extensive coverage to numerous policyholders in such circumstances could place a substantial burden on surviving members of the industry just when these companies are facing unexpectedly high claims of their own. By reducing the number of insurance

***The primary argument in favor of maintaining the current state-based system lies in the nature of property-casualty insurance company liabilities.***

companies participating in a state guaranty plan, creation of a federal insurance guarantor would concentrate that burden on fewer companies.

Such considerations raise the possibility of a third option—the creation of a federal insurance guaranty system that state-chartered insurers could join. This would parallel federal deposit insurance in the dual banking system. Since its introduction, the federal deposit insurance system has been open to state-chartered banks and S&Ls that choose to participate. Taking this third route almost certainly would lead to ever-increasing dominance of the federal government in insurance regulation, just as the federal government has steadily gained ground in the regulation of depository institutions. State-chartered insurance companies would likely find it a competitive advantage (and maybe a competitive necessity) to offer their policyholders federal protection. State guaranty funds would be weakened by the defection of insurance company members, particularly larger insurance companies, to the federal guarantor, causing more insurers to shift to the federal system.

Meanwhile, the federal guaranty system could find itself protecting insurers regulated by states with which the federal authorities disagreed. Congress would be encouraged to apply any new insurance laws to all federally guaranteed insurers, thus granting federal regulators authority over their regulatory competitors. In the meantime, insurance companies and their regulators would face an incentive-incompatible system in which insurers regulated by the states would help guarantee the liabilities of companies regulated by the federal government and *vice versa*. In such a nationwide system, the costs of failure would fall less directly on the insurance companies operating in a particular base state, but would be shared by a much larger group. The ability of insurers to affect—indeed their interest in affecting—the regulatory policies of a single state could thus become muted.

There are clearly advantages and drawbacks to each available choice. On the surface, creating an incentive-compatible system for insurance regulators would seem to imply that state-chartered and federally chartered insurance companies should form distinct groups for the purposes of providing guarantees to policyholders. On the other hand, removing many of the nation's largest insurance companies from the state guaranty systems could undermine the ability of these systems to respond adequately in the wake of a failure or failures. Furthermore, insurers currently participate in guaranty systems in each state in which they sell protected policies, not just in their states of domicile. These latter considerations, especially the need to maintain a stable, well-functioning guaranty system, add weight to the arguments of those who would maintain the current state-based guaranty system. Finally, continued operation of the state-based guaranty systems eliminates the need for the federal government to establish coverage limits.

***...removing many of the nation's largest insurance companies from the state guaranty systems could undermine the ability of these systems to respond adequately in the wake of a failure or failures.***

There are a host of additional questions that would be raised by an optional federal charter and the creation of a federal insurance guarantor. For example, would federally chartered insurance companies be allowed to borrow from the Federal Reserve's discount window like depository institutions do today? Would access to the discount window depend on whether the insurance company participated in the federal or a state guaranty fund (assuming a federal system is created)? Finally, assuming the creation of a federal insurance guarantor, where would it be housed? Specifically, would the federal insurance guaranty system be operated by the federal insurance regulator?<sup>65</sup> Or would the federal insurance guarantor be operated as a separate entity?<sup>66</sup> In the latter case, would a Federal Insurance Guarantor (FIG) join the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF) within the Federal Deposit Insurance Corporation?

The recommendation here is that federally chartered and regulated insurance companies continue to participate in the current state-based guaranty systems. These systems have the advantage of basing coverage and participation on the insurance lines sold and the location of policyholders. All but one of the states use post-failure assessments to raise the funds necessary to protect policyholders, and they involve industry representatives in the management of the systems. Both these characteristics encourage industry members to promote effective solvency regulation. Finally, continuing to rely on a state-based guaranty system offers a greater degree of confidence that the resources necessary to protect policyholders will be available in the event of a failure. That could become a problem if the state-chartered and federally chartered insurers are divided into distinct populations providing policy guarantees.

Should federal policymakers decide to establish a separate federal guaranty system, it should also rely on post-failure assessments. Pre-funded systems reduce the incentives of insurance companies to monitor regulatory effectiveness. Furthermore, coverage should remain limited to give policyholders reason to maintain an interest in the financial strength of their individual insurers.

### ***Locating and Financing the Federal Insurance Regulator***

There has also been substantial discussion about the organization and location of a federal insurance regulator. Some observers would create an Office of the Federal Insurance Commissioner in parallel with the Office of the Comptroller of the Currency and the Office of Thrift Supervision, housed within the Treasury Department.<sup>67</sup> Others have argued for an independent agency, along the lines of the Securities and Exchange Commission.<sup>68</sup> Finally, there are those who have suggested that Congress should give the

***The recommendation here, however, is that federally chartered and regulated insurance companies continue to participate in the current state-based guaranty systems. These systems have the advantage of basing coverage and participation on the insurance lines sold and the location of policyholders.***

Federal Reserve System responsibility for regulating federally chartered insurers.

Placing the new federal insurance regulator within the Treasury Department has certain advantages. There would be a single primary insurance regulator—the head of the office—as opposed to a “committee” of regulators like those in the independent regulatory commissions.<sup>69</sup> This could lead to more efficient regulation, assuming a single regulator will be able to act more quickly than a committee of regulators would.<sup>70</sup> Housing the insurance regulator within the Treasury Department along with its banking and thrift counterparts could add to the impact the new regulator would have on policy debates concerning taxes, international agreements, and other similar matters.

Once the location of the new federal insurance regulator is established, the next question likely will be how its operations should be funded. Although some state insurance departments are funded through their states’ general revenues, other state insurance commissions receive dedicated funds, raised through fees and state taxes on insurance company premiums.<sup>71</sup> Even in states where insurance premium taxes do not go automatically to the state insurance commissioner, these funds are still an important source of state revenues. This raises the question: If optional federal chartering is introduced, will these state revenue streams be affected? Will the federal government impose fees to help finance the operations of the federal insurance regulator? If so, will federally imposed fees be in addition to state fees and taxes? Or will federal fees offset (at least to some extent) state levies? Imposing additional fees on federally chartered insurers will discourage firms from leaving the state systems. Reducing states’ revenues will strengthen state opposition to the federal government’s incursion into the arena of insurance regulation. Funding the operations entirely from the general revenues of the federal government will either shift the burden to federal taxpayers or draw financial resources from other federal activities. As with many of the questions discussed, there are no easy answers, but it seems reasonable to expect the primary regulator to collect certain fees paid by insurance companies. Furthermore, adding competition for insurance industry taxes and fees would further enhance regulatory competition between the states and the federal government.

On the surface, the questions about locating and financing a federal insurance regulator do not seem as vital as other questions to the success (however measured) of a dual insurance system. These questions of location and financing may be as politically contentious as any other issue, however, as competing groups vie for political and financial resources. Furthermore, the location of the federal insurance regulator and the financial resources

***Funding the operations entirely from the general revenues of the federal government will either shift the burden to federal taxpayers or draw financial resources from other federal activities.***

available to it may determine the extent of the regulator's influence both within the federal government and in the financial markets.

## Guiding Principles for Optional Federal Insurance Chartering

- The chartering agent, state or federal, should have primary responsibility for all aspects of regulatory oversight, including solvency, consumer protection, and market conduct regulation. Rate regulation and pre-approval of forms and contracts should be deemphasized in favor of consumer education.
- Federally chartered insurance companies should continue to participate in the state-based guaranty systems. Post-failure assessments of surviving insurers to protect creditors coupled with limited coverage for policyholders in the event of a failure provide important incentives for insurance companies and their customers to insist on effective solvency regulation, whatever government entity is providing oversight.
- The new federal insurance regulator should be located within the Treasury Department alongside the OCC and the OTS. This would establish a clear equal footing for the federal regulators of banks, thrift institutions, and insurance companies, while placing the insurance company regulator within the government department responsible for tax policy. Regulatory fees that had been paid to the state insurance commissioners would now be paid by federally chartered insurers to the federal regulator.

## Conclusions

*A man came into a hospital emergency room suffering from snakebite. The doctor asked how he came to be bitten by a snake. The man replied, "I saw a stick lying in the road, and I thought it was a snake."*

*"So where did the snake bite come from?" asked the doctor.*

*"The 'stick' I picked up to kill the snake . . . was a snake!" replied the man.<sup>72</sup>*

The question before the insurance industry and federal policymakers is whether optional federal insurance regulation is a stick . . . or a snake. On the "stick" side of the argument, the creation of a dual insurance system could introduce an important new regulatory competitor, particularly if the new system ties oversight of market conduct and consumer protection to solvency regulation and chartering. Significant cost savings could result for those insurance companies that operate in multiple states, because they could focus their attention on complying with the rules of a single overseer.



Furthermore, for the first time, policyholders could take advantage of regulatory competition (at least potentially), seeking out an insurer who was able to provide a preferred combination of price, contract terms, and stability.<sup>73</sup> Finally, the creation of a dual insurance system would give the entire insurance industry an advocate within the federal government on matters of international trade, regulatory, tax, and economic policy decisions.

On the “snake” side of the question, however, is the possibility that the federal government increasingly will impose a single standard where multiple standards now exist. That is, the introduction of a federal regulator could lead to less regulatory competition over time. Furthermore, there is no way to predict whether federal regulators will prove more or less restrictive in the consumer protection and pricing regulation. Finally, it is important to recognize that regulatory mistakes at the federal level impose costs across the nation, while regulatory mistakes by states are, by their nature, more contained.

As the debates over optional federal insurance regulation unfold, insurance industry and research group advocates will need to pay close attention to the direction taken on several key debates. The introduction of a federal insurance regulator could either injure or benefit all affected parties—the particulars will determine which outcome comes to pass. In short, the devil is in the details.

## Notes

<sup>1</sup> See Scott E. Harrington, “Optional Federal Chartering of Property-Casualty Insurance Companies,” (Downer’s Grover, IL: Alliance of American Insurers, 2002), p. 31.

<sup>2</sup> Under the current guaranty system that protects policyholders of failed insurance companies, states’ premium tax revenues are reduced in the wake of a failure. Therefore, an insurance company failure affects all taxpayers.

<sup>3</sup> See Edward J. Kane, *The Gathering Crisis in Federal Deposit Insurance*, (Cambridge, MA: MIT Press, 1985) and *The S&L Insurance Mess: How Did it Happen?*, (Washington, D.C.: Urban Institute Press, 1989).

<sup>4</sup> The history of insurance regulation in the United States and the judicial and legislative decisions that led to a state-based system of regulation make for interesting reading, but it is not the focus of this paper. For further discussion of this topic, see, for example, Scott E. Harrington, “The History of Federal Involvement in Insurance Regulation,” *Optional Federal Chartering and Regulation of Insurance Companies*, ed. Peter J. Wallison (Washington, D.C.: The American Enterprise Institute, 2000) pp. 21-44.

<sup>5</sup> The extent to which state insurance regulators cooperate and coordinate their efforts has increased significantly during the past 25 years; however, they could do more.

<sup>6</sup> See Peter J. Wallison,, “Optional Federal Chartering for Life Insurance Companies,” *Optional Federal Chartering and Regulation of Insurance Companies*, ed Peter J. Wallison (Washington, DC: American Enterprise Institute, 2000) p. 55.

<sup>7</sup> Joel Wood, “Broker Organizations,” *Optional Federal Chartering and Regulation of Insurance Companies*, ed. Peter J. Wallison (Washington, D.C.: American Enterprise Institute, 2000) p. 173.

<sup>8</sup> See Robert C. Eager and Cantwell F. Muckenfuss, III, “Creating Federal Insurance Regulation: A Zero-Based Approach,” *Optional Federal Chartering and Regulation of Insurance Companies*, ed Peter J. Wallison, (Washington D.C.: American Enterprise Institute, 2000) p. 153, or Congress, Senate, Committee on Commerce, Science, and Transportation *Statement on behalf of the American Council of Life Insurers on “Federal Involvement in Regulation of the Insurance Industry,”* 108<sup>th</sup> Cong, 1<sup>st</sup> sess, 22 October 2003, pp. 4-5. Testimony by Stephen E. Rahn Vice President, Associate General Counsel, and Director of State Relations, Lincoln National Life Insurance Company.

<sup>9</sup> Rahn, 2003.

<sup>10</sup> See Martin F. Grace and Robert W. Klein, “Efficiency Implications of Alternative Regulatory Structures for Insurance,” *Optional Federal Chartering and Regulation of Insurance Companies*, ed. Peter J. Wallison (Washington, D.C.: American Enterprise Institute, 2000) p. 96.

<sup>11</sup> Economists call this the “opportunity cost” of capital. Opportunity cost is what an individual gives up to pursue one course of action over another. If I invest in insurance company securities, those funds are not available to invest in another security offering. The return I could be earning elsewhere is my opportunity cost.

<sup>12</sup> As a general rule, solvency regulation, including determination of capital adequacy, is handled by an insurers' state of domicile (or the state in which it is headquartered). This system of "domestic deference" evolved as a result of earlier criticisms of duplicative, conflicting, and ineffective state solvency oversight. In contrast, consumer regulation, including approval of rates and standardization of contractual terms, is handled by each state in which a firm operates.

<sup>13</sup> For property-casualty insurers, complaints about state oversight often center on rate regulation. See Congress, House, Committee on Financial Services, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, *Statement on "Working with State Regulators to Increase Insurance Choices for Consumers,"* 108<sup>th</sup> Cong, 2<sup>nd</sup> sess, 31 March 2004. Testimony by Roger M. Singer. Life insurers tend to have more problems obtaining state-by-state approval of contractual terms and new insurance products. See Rahn (2003).

<sup>14</sup> Robert J. Hunter, "A Consumer Perspective," pp. 177-87 in *Optional Federal Chartering and Regulation of Insurance Companies*, Peter J. Wallison, ed. (Washington, DC: American Enterprise Institute, 2000) p. 184.

<sup>15</sup> See Eager and Muckenfuss (2000) p. 163 or Rahn (2003) pp. 7-8.

<sup>16</sup> Grace and Klein (2000) p. 115.

<sup>17</sup> The "Gramm-Leach-Bliley Act" or the Financial Modernization Act of 1999 includes provisions to protect consumers' personal financial information held by financial institutions.

<sup>18</sup> See Hunter (2000, p. 185). Note that many consumer advocates oppose federal regulation because they suspect industry advocates of federal oversight are motivated primarily by a desire to eliminate consumer protection regulation and price controls.

<sup>19</sup> Ibid.

<sup>20</sup> Before 1863, each bank issued its own currency backed by gold and other state-approved assets, usually state bonds. The Civil War-era legislation required nationally chartered banks to issue uniform currency backed by gold and U.S. government bonds. Nationally-chartered banks then became a ready market for the government bonds needed to finance the war. State bank notes were taxed, increasing the cost of providing currency and operating state-chartered banks.

<sup>21</sup> See Eager and Muckenfuss (2000) p. 156.

<sup>22</sup> The Office of the Comptroller of the Currency (OCC) is the chartering agent and primary regulator of nationally chartered banks. The Office of Thrift Supervision (OTS) is the chartering agent and primary regulator of federally-chartered thrift institutions.

<sup>23</sup> The Office of Thrift Supervision, within the Treasury Department, was established in 1991 with the Financial Institutions Reform, Recovery, and Enforcement Act. The Federal Home Loan Bank Board, the predecessor of the OTS, had taken a similar approach.

<sup>24</sup> Between 1933 and 1986, the federal government established upper limits on the interest rates banks, and later S&Ls, could pay to depositors. These limits were phased out between 1980 and 1986. Federal regulations still prohibit interest payments on business checking accounts.

<sup>25</sup> See, for example, Jathon Sapsford, “Bank-Cop Fight: Spitzer Takes on U.S. Regulator,” *Wall Street Journal*, March 22, 2004(c), pp. C1, C3.

<sup>26</sup> See Jathon Sapsford, “Eliot Spitzer Takes on the Feds Again, This Time Over Regulation of Banks,” *Wall Street Journal*, January 19, 2004(b), p. C1 and “Critics Cry Foul over New Rules on Bank Review,” *Wall Street Journal*, January 8, 2004(a), pp. C1, C7.

<sup>27</sup> Checkable deposits offered by savings institutions and credit unions are one such example. It was not until the 1980s that non-bank institutions were allowed to offer “checking” accounts, and then it was state regulators who first allowed S&Ls to offer NOW (negotiable orders of withdrawal) accounts and credit unions to offer share drafts.

<sup>28</sup> Bank holding companies (i.e., corporations that own one or more individual banks) were able to acquire banks in different states before 1994. Every individual bank owned by the bank holding company was required to meet applicable state and/or federal regulations, however. Reserve requirements and capital requirements were applied to the individual banks, for example, not to the bank holding company as a whole.

<sup>29</sup> As S&Ls began losing money on their traditional mortgage business during the 1970s and 1980s, state regulators allowed the institutions to pursue new activities in an attempt to regain their financial health. It was, of course, the federal government and taxpayers who paid for the losses resulting from unfamiliar risks associated with many of these new endeavors. As a result, many federal regulations now apply to all federally insured institutions.

<sup>30</sup> The savings and loan and banking industries suffered record numbers of failures during the 1980s. Research has since established a clear link between many of the weaknesses within the industries and the deposit insurance system as it was operated at the time. See, for example, Kane, (1985), Kane (1989), Lawrence J. White, *The S&L Debacle: Public Policy Lessons for Bank and Thrift Regulation*. (New York: Oxford University Press, 1991), or more recently, James R. Barth, Susanne Trimbath, and Glenn Yago, eds. *The Savings and Loan Crisis: Lessons from a Regulatory Failure*. (Norwalk, MA: Kluwer Academic Publishers, 2004).

<sup>31</sup> Hunter (2000) pp. 179-80 and Harrington (2002) p. 6.

<sup>32</sup> Harrington (2002) p. 5.

<sup>33</sup> Grace and Klein (2000) pp. 82-83.

<sup>34</sup> An often-misunderstood fact about insurance company pricing is the forward-looking nature of premiums. It is expected *future* payouts that determine premiums. An insurance company that tries to recoup past losses with higher current premiums risks being undercut by competitors (existing or new entrants) who did not suffer similar losses. Certain events do provide insurance companies with new information that will affect their expectations about future payouts, however. The terrorist attacks of September 2001 caused insurers to reexamine their assumptions about the likelihood and possible nature of terrorist attacks within the United States. On a more mundane level, automobile accidents are not spread evenly across drivers. Individuals involved in an accident are statistically more likely to be involved in a future accident than a driver who has not experienced an accident.

<sup>35</sup> Of course, newly recognized risks are those about which there is the least information. The insurance industry may face a learning curve when attempting to price new risks, like terrorism. As a consequence, early premiums may be too high—or too low.

<sup>36</sup> Hunter (2000) describes what he sees as the shortcomings of an excessively porous antitrust exemption. Most critics of the insurance industry's antitrust exemption understand and accept the fundamental need to share information about past loss costs. The concern is often about the rating bureaus' using past loss costs to project future industry payouts. Insurance companies may then use these projected payouts to establish premiums. Opponents argue that access by all insurers to the same payout projections increases the opportunities for coordinated pricing.

<sup>37</sup> There is a literature arguing that antitrust oversight generally does more harm than good. Because that is unlikely to be a matter seriously pursued in this debate, we will not consider it here.

<sup>38</sup> Hunter (2000) p. 180.

<sup>39</sup> *Ibid*, p. 181.

<sup>40</sup> "Redlining" refers to the presumed practice by some insurers (and bankers) who refuse to write policies for (or lend money to) individuals living or doing business in neighborhoods viewed as "undesirable" or excessively risky. Wood (2000, p. 167) also expresses concern about the need to protect consumers from discriminatory local practices such as redlining.

<sup>41</sup> Harrington (2002) pp. 9-10.

<sup>42</sup> *Ibid*, p. 10.

<sup>43</sup> In the passage quoted above, Harrington points to a link between rate regulation and market conduct problems in the industry. Reduced competition could be the reason.

<sup>44</sup> Imagine, for example, an individual who lives in Pennsylvania but is employed and provided health insurance by a company located in Virginia. Which state's laws apply when disputes arise? Or what about an individual who purchased a life insurance policy in Texas and then moves to Oregon? To whom does the policyholder direct a question? What if the insurer is not licensed in both states?

<sup>45</sup> See Grace and Klein (2000) p. 116, for example.

<sup>46</sup> Wayne White, "Federalizing Insurance Regulation: A Treacherous Road to Reform," *Legal Backgrounder* Vol. 18 No. 8, Washington Legal Foundation, April 4, 2003, p. 3. White is writing generally about federal regulation of any kind, but he echoes arguments made by those urging that consumer protection regulation remain with state overseers.

<sup>47</sup> Certainly, these have been the arguments of New York Attorney General Eliot Spitzer in his battles with the Comptroller's Office over consumer regulation applied to nationally chartered banks. See Sapsford (2004(a), (b), and (c)).

<sup>48</sup> This could be accomplished either by setting an upper limit on premiums, by more generously interpreting the extent of insurance coverage, or by doing both.

<sup>49</sup> See Wood (2000) p. 173 and Hunter (2000) p. 186.

<sup>50</sup> See Wood (2000) p. 167.

<sup>51</sup> Larry LaRocco, “The Banking Industry,” pp. 188-94 in *Optional Federal Chartering and Regulation of Insurance Companies*, Peter J. Wallison, ed. (Washington, DC: American Enterprise Institute, 2000) pp. 192-93. Nasdaq and the New York Stock Exchange are SROs. That is, each of these markets takes primary responsibility for establishing and enforcing the operating rules that protect investors and build confidence in their respective systems. Of course, the Securities and Exchange Commission (SEC) oversees the private regulators of these markets.

<sup>52</sup> Grace and Klein (2000) pp. 105-09.

<sup>53</sup> See, for example, Craig Berrington, “Optional Federal Charter: A Remedy for America’s Antiquated Insurance Regulatory System,” *Legal Backgrounder* Vol. 18 No. 9, Washington Legal Foundation, April 4, 2003.

<sup>54</sup> Depository institutions and insurance companies have long recognized that protecting the customers of failed competitors increases public confidence in all similar institutions. Even before government systems of deposit and policy guarantees, banks and insurance companies in many areas established private agreements whereby surviving institutions provided at least partial protection to the customers of failed firms.

<sup>55</sup> See Bert Ely, “The Fate of the State Guaranty Funds after the Advent of Federal Insurance Chartering,” pp. 135-52 in *Optional Federal Chartering and Regulation of Insurance Companies*, Peter J. Wallison, ed. (Washington, DC: American Enterprise Institute, 2000) pp. 140-41.

<sup>56</sup> The exception to this system of post-failure assessments is New York State. Insurers in New York contribute to a pre-funded insurance guaranty plan run by state officials.

<sup>57</sup> The Federal Deposit Insurance Corporation (FDIC) includes both the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). The National Credit Union Share Insurance Fund (NCUSIF) insures shares (or deposits) for credit unions.

<sup>58</sup> Beginning with this assumption is not meant to presuppose an answer to the more fundamental first and second questions listed above.

<sup>59</sup> Ely (2000, pp. 145-46) identifies many of the following problems.

<sup>60</sup> The FDIC, for example, enjoys a line of credit with the Treasury.

<sup>61</sup> The federal tax authorities determine when insurance companies’ reserves become “too large,” and hence subject to federal income tax.

<sup>62</sup> Harrington (2002) p. 6.

<sup>63</sup> Moral hazard refers to the tendency of individuals to take more risk as they obtain insurance against the undesirable outcomes of their risk-taking. More specifically, when consumers and/or companies stand to lose if their insurance company fails, they will take more care in selecting an insurer. The greater the protection against losses provided by state or federal governments’ guaranty systems, the less concern policyholders need exhibit about the financial health of individual companies.

<sup>64</sup> Of course, when the federal government bears the cost of failures, federal taxpayers ultimately provide the funds. In the short-run, however, an agency's budget could be negatively affected, garnering attention from regulators and Congress.

<sup>65</sup> We will discuss where the federal insurance regulator would be housed below.

<sup>66</sup> Again, the federal government's experience with the savings and loan industry might influence its decision in this case. Until 1989, the Federal Home Loan Bank Board, the chartering and regulatory agency for federally-chartered S&Ls, also operated the Federal Savings and Loan Insurance Corporation (FSLIC). The 1989 legislation dissolved the Bank Board and separated the functions of regulation and deposit guarantees. The regulatory role is now played by the Office of Thrift Supervision housed within the Treasury Department, while deposit guarantees are provided by SAIF within the FDIC.

<sup>67</sup> See LaRocco (2000) p. 190, for example.

<sup>68</sup> See Eager and Muckenfuss (2000) pp. 158-59 for a discussion of some of these other possibilities.

<sup>69</sup> Think of the Securities and Exchange Commission, the Federal Trade Commission, the Commodities Futures Trading Commission, etc.

<sup>70</sup> Of course, "efficient" regulation can cut both ways. Efficient regulators can impose counterproductive regulatory requirements as quickly as they can remove them.

<sup>71</sup> See Grace and Klein (2000) p. 99.

<sup>72</sup> This story was first told to me by Fred Smith, President, Competitive Enterprise Institute.

<sup>73</sup> By contrast, when states establish standard insurance contracts, they eliminate consumer choices.

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