

Regulatory Comments from Eli Lehrer and Michelle Minton

We thank the Department of Treasury for the Opportunity to submit regulatory comments on the forthcoming “Blueprint for an Improved U.S. Financial Regulatory Structure.” The comments that follow speak to only to the questions related to insurance and then only about insurance within the personal lines property and casualty space (essentially automobile and homeowners’ policies.) When we speak about “insurance” in the comments below, we refer only to these types of insurance except where otherwise noted. In the following pages we make four fundamental points:

- *The state-based regulatory system does not work and, indeed, has hampered innovation.*
- *Solving the problems of the state-based system requires measures to encourage “competitive federalism.” An optional federal charter (which must be truly optional) provides the best current option.*
- *Optional Federal Chartering Will Work Best if it is Truly Optional*
- *The government should stay out of the insurance business.*

The state-based regulatory system does not work and, indeed, has hampered innovation.

Even the staunchest defenders of the state-based regulatory system—the people most opposed to the measures we suggest in the following pages--agree that the existing system has serious flaws.¹ Above all else, one thing stands out: America’s insurance companies have stopped innovating. Since 1959 when they started selling homeowners’ insurance American insurance companies have not introduced a single significant new property and casualty insurance product targeted towards individual consumers.² No other industry has remained in total stasis for nearly as long.

No single factor has resulted in this situation. Certainly, cultural factors within the insurance industry and the growth of alternative risk transfer mechanisms that fall outside of the business of insurance as typically defined played roles. But it appears quite likely that state regulation played a major role.

At the moment, forty nine states play a role in controlling the prices that insurers charge. While only three states play a direct role in setting insurance rates, nearly all dictate the sort of information insurers can use in setting rates, and all fifty control the forms that insurers use. In short, the market for insurance is subject to an extensive, inconsistent, burdensome system of political regulation.

This has severe implications for innovation. Any fundamentally new product would need approval from all fifty states and the District of Columbia. Since insurance relies on the

¹ See e.g. J. Robert Hunter, “Testimony before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services of the U.S. House of Representatives: Regarding Additional Perspectives on the Need for Insurance Reform,” Consumer Federation of America, October 30, 2007

² Tom Baker and Jonathan Simon. *Embracing Risk: Toward a Sociology of Insurance and Risk*. Chicago: University of Chicago Press, 2002, 57.

management of sizeable risk pools, furthermore, it is nearly impossible to launch a significant new product in only one or two states. Thus, it appears quite likely that the current, moribund, state system significantly hampers innovation.

This has had severe implications for America's international competitiveness. Although it's impossible to do a strict apples-to-apples comparison across international boundaries it's notable that the Organization for Economic Cooperation and Development finds that American productivity per worker within the "business services" (finance, insurance, and real estate) field is lower than that of many of our chief economic competitors and has grown more slowly since the year 2000.³ Insurance, in short, is a relative drag on American economic productivity.

Solving the problems of the state-based system requires measures to encourage "competitive federalism." An optional federal charter (which must be truly optional) provides the best current option.

The government should promote federalism as a system of competition between states to provide a regulatory environment that best meets the needs of consumers and insurance companies alike.⁴ The federal government should encourage states to "fight" one another to come up with the best system.

A variety of measures could accomplish this. Federal laws permitting the interstate sale of insurance under the laws of the state where an insurance company is domiciled (an approach that has gained some traction in the health insurance arena), interstate compacts (two major ones already exist), optional federal regulation, and the issuance of model laws and accreditation standards through the National Association of Insurance Commissioners and the National Conference of Insurance Legislators can and do all contribute towards creating a better regulatory environment for insurance. Ultimately, a better insurance system could come into existence through a combination of any one of these factors.

A cognizance of political realities and a respect for the limits on federal power, however, indicates that one of these approaches: optional federal regulation, appears to hold the most short term promise. Optional federal regulation would create for insurance the truly national market that currently exists for just about every other product. A Frequently Asked Questions File, which we have written, and have included under a separate cover, may illuminate some points about the merits (and limits) of a proposed optional federal charter.⁵

Optional Federal Chartering Will Work Best if it is Truly Optional

In creating an optional federal chartering system, the federal government should strive to provide an *alternative* rather than imposing its will on all the states. Fulfilling the states' roles as

³ Organization for Economic Cooperation and Development. "Unit Labor Productivity—Annual Indicators," <http://stats.oecd.org/wbos/default.aspx?queryname=346&querytype=view> (Financial Services.)

⁴ For a theoretical basis on Competitive Federalism see e.g. Michael Greve. *Real Federalism: Why it Matters How it Could Happen*. Washington: AEI Press, 1999.

⁵ Eli Lehrer and Michelle Minton. "Optional Federal Chartering: FAQ," Competitive Enterprise Institute, 2007. (www.ofcfaq.org.)

“laboratories of democracy,” indeed, mandates that the federal government not interfere with existing state regulatory systems. Thus, any system of Optional Federal Chartering should be truly optional.

Insurance companies that chose not to participate in it should have no federal oversight beyond the oversight that the federal government exercises with regard to any business enterprise. Insurance companies that opt for federal chartering, likewise, should have no state oversight beyond that which states provide to any other business enterprise. To minimize the consequences for states, furthermore, individual states should retain all premium taxes and all other taxes--except user fees that directly cover the cost of licensing—they currently collect.

Realizing the full potential of the system may eventually require some consideration of legal issues implicit in optional federal chartering. Maintain a truly competitive system would ideally require a separate body of law and, indeed, federal jurisdiction with regard to most issues involving federally regulated insurance companies. A true divide between state and federal regulation will be impossible so long as state courts continue to hear cases involving federally regulated companies. Ultimately, the federal government may wish to investigate the possibility of creating federal jurisdiction over cases involving federally regulated insurance companies.

The government should stay out of the insurance business.

In recent years, many states have inserted themselves directly into the business of insurance. This is almost always a bad idea. To make a broad generalization, government tends to focus on pleasing politically connected groups rather than managing risk in a prudent fashion. Absent a total government takeover of all insurance—something nobody openly supports—furthermore, the limited nature of government intrusions mean that government insurance will have shallower pools and less ability to portfolio risk than private institutions would. Federal windstorm insurance proposals, including the one the House of Representatives passed earlier this year, must be treated with extreme skepticism.⁶

State-based efforts that directly involve the state government insurance the insurance market—most prominently Florida’s Citizens Property Insurance Corporation—also appear to have significant flaws. As one of us has documented, indeed, these arrangements raise a very real specter of state insolvency.⁷ If such insolvency occurs, the federal government will only encourage more bad behavior and foolhardy risk taking if it supports a bailout. Thus, federal policy must set itself firmly against such bailouts.

Finally, the federal government should not guarantee profits to or “backstop” private insurance companies. Many proposals for such backstopping have been forwarded. Ultimately, such proposals will serve largely to subsidize reinsurance for private industry. Private industry should purchase its own reinsurance and pay the costs of its own mistakes.

Concluding Thoughts

⁶ H.R. 920 (included within H.R. 3121).

⁷ Eli Lehrer. “Bankrupting Florida,” *The Weekly Standard*, August 20, 2007.

Property and casualty insurance play a vital role in the American economy. In the proper setting it serves a vital role in improving the lives and livelihoods of Americans. It makes risky activities possible and already safe activities safer. A freer market for insurance will improve America's economic competitiveness around the world, provide more people with security, and make a broader range of insurance options available to American consumers. A properly considered, carefully constructed federal role can and should help provide such a market.