The Future of Insurance Regulation in the United States

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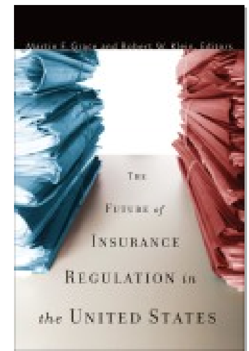

Published by Brookings Institution Press

Grace, F. & Klein, W..
The Future of Insurance Regulation in the United States.
Washington: Brookings Institution Press, 2009.
Project MUSE., https://muse.jhu.edu/.

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An Optional Federal Charter for Insurance: Rationale and Design

Martin F. Grace and Hal S. Scott

Since the early nineteenth century the states have been the principal authority for the regulation of the U.S. insurance industry. In contrast to other financial services such as securities and banking, Congress has not sought to exercise either concurrent or preemptive authority over insurers on a wide scale.[1] Indeed, the McCarran-Ferguson Act of 1945 explicitly found state regulation of insurance to be in the public interest and provided that no federal law should "invalidate, impair, or supersede" any state insurance regulation or tax.[2] Recently, however, and particularly in the wake of the Gramm-Leach-Bliley Act of 1999, many insurers have proposed a system of optional federal chartering (OFC) and regulation of insurance.[3]

In May 2007 Senators John Sununu (R-N.H.) and Tim Johnson (D-S. Dak.) introduced S. 40, the National Insurance Act of 2007 (NIA), which sets forth a scheme for an OFC for life and property-casualty insurers largely modeled on the National Bank Act of 1864. In July 2007 Representatives Melissa Bean (D-Ill.)

1. Congress has preempted state authority, however, in such areas as health and crop insurance. See chapter 2, this volume.

2. P.L. 15, March 9, 1945 (codified at 15 U.S.C., secs. 1101–15).

3. P.L. 106-102, November 12, 1999.

and Ed Royce (R-Calif.) introduced a companion bill, H.R. 3200.[4] In contrast to the state coordination approach taken by the State Modernization and Regulatory Transparency (SMART) Act introduced by Representatives Michael Oxley (R-Ohio) and Richard Baker (R-La.) in March 2004, the NIA would establish a "comprehensive system for the federal regulation and supervision of national insurers and national agencies."[5] State regulation would be preempted except in a few areas, such as taxation and participation of national insurers in state residual market mechanisms and qualified guaranty funds.[6] In March 2008 the U.S. Department of the Treasury endorsed an OFC as part of its blueprint to modernize the federal regulatory structure, much along the lines of the pending bills in Congress.[7]

We first present the arguments for abandoning the status quo and moving toward regulation based on an OFC. We then describe the additional issues that would need to be addressed if the United States adopts an OFC. While the merits of an OFC have been much debated, comparatively little consideration has been given to the matter of how such a system should function if enacted.[8] We consider the proposal by Senators Sununu and Johnson and the issues raised by the need for an appropriate regulatory structure for an OFC. Ultimately, the design of a regulatory structure must turn on the objectives of federal insurance regulation and the areas of insurance to be regulated.

The Economic Rationale for an OFC

Regulatory jurisdictions have strong incentives to utilize their resources efficiently when the benefits of public regulatory services and the public goods they produce are fully internalized within the jurisdiction. In addition to minimizing the social costs of regulation, this further efficiency requirement is added to determine which level of government can best provide insurance regulatory services.[9]

4. H.R. 3200, 110 Cong. 1 sess., July 26, 2007.

5. In June 2006 Representative Ginny Brown-Waite (R-Fla.) introduced part of the SMART Act as H.R. 5637, 109 Cong. 2 sess., June 19, 2006. See National Insurance Act, sec. 2.

6. National Insurance Act, secs. 1125, 1601, 1703.

7. U.S. Department of the Treasury (2008).

8. Harrington (2006) provides an overview of options for federal intervention in insurance regulation. He suggests two alternatives to an OFC: federal minimum standards that would preempt inadequate state regulation; or the creation of a system of "primary state" chartering akin to the current system of corporate chartering.

9. Oates (1972); Inman and Rubenfeld (1997).

Efficiency in provision of public goods can also be enhanced by competition among government agencies for their provision, since government regulators can be monopolists and suffer from principal-agent problems of their own. Further, some consumers may value a different bundle of regulatory services from that valued by other consumers, which would generate demand for services not provided by the monopolist. Thus there may be benefits from regulatory competition.

We see regulatory competition in a number of areas. One area is between state and federal banking regulators (even though this competition has been greatly attenuated by the imposition of federal standards on state regulation, like federal capital requirements). In theory, consumers can choose to purchase their banking services from among several types of banks. With their choice of a particular bank, a bundle of terms, which contains the type of regulatory services provided by the particular government regulator, is automatically included. Indeed, in the banking system state regulators can compete with each other (as state-chartered banks operate interstate) as well as with federal regulators.

We also see the states being able to choose to control a substantive area of federal regulation themselves rather than accept a uniform federal regulatory approach in areas such as occupational health and safety. For example, the Occupational Safety and Health Act allows the states to set up their own regulatory apparatus and regulate at a higher level than the federal government if they desire.[10] This is similar in some respects to the proposed SMART Act, which would set minimal federal guidelines upon which the states could build. In addition, various laws, including state corporation codes, provide incentives for businesses to incorporate within a state's jurisdiction. Thus the states compete among themselves to attract companies to their jurisdiction. This latter case forms the basis for the competitive federalism proposal promoted by Henry Butler and Larry Ribstein, discussed further below.[11]

The Status Quo

The current regulatory system for insurance consists of regulators in each of the fifty states as well as in the District of Columbia and all U.S. commonwealths and territories. Thus some fifty-seven regulators regulate insurance within their jurisdictions. The history of this state-based insurance regulatory system is well

10. Occupational Safety and Health Act (OSH Act), sec. 18, codified at 29 USC 667.
11. Butler and Ribstein (2008).

documented.[12] However, it has not always been assumed that the states should be the exclusive regulators of insurance. There have been numerous proposals for a federal role in insurance regulation since the time of the National Banking Act, which set up the dual-chartering provisions for the banking industry in the 1860s. Current proposals have their roots in the growing interstate presence of the industry and general dissatisfaction with the state regulatory processes. Despite the current proposals, these causal roots have been concerns for some time.[13]

One can view the status quo as a costly system with significant duplication of costs. These costs reduce the demand for insurance to the extent they are passed on to customers. Further, the status quo regulatory apparatus is not designed to move quickly, as all states must agree to a change if it is to have uniform application. The status quo also suffers (or benefits) from the reality that not all states will agree to various policies since they may view their citizens' need for a proposed policy as higher (or lower) than another state's citizens or than an organization seeking state uniformity, such as the National Association of Insurance Commissioners (NAIC). However, this last reality is a critical aspect of the status quo. Each state can represent what it believes is in the best interest of its citizens. By doing so, new knowledge about regulatory policy effectiveness is created. This new knowledge can be spread to other states if it appears beneficial. One aspect of state regulatory powers is that the federalist's vision of the states being laboratories for good policy is theoretically fulfilled in the regulation of insurance. However, the question still arises as to how quickly good policy can spread throughout the states. Further, as pointed out below, states can impose externalities on others by regulating differently from other states. Also, there may be ways to generate new regulatory ideas without creating state laboratories; after all, federal regulation is constantly changing in response to new problems and ideas.

The Case for Abandoning the Status Quo

While a case can be made for maintaining the current state-based system of regulation, there are a number of reasons to favor an alternative framework. Below we discuss the principal problems associated with state insurance regulation and the arguments for establishing an alternative framework (such as an OFC).

12. Day (1970).
13. Randall (1999).

The Inefficiency of State-Based Regulation

Whether one chooses an OFC or a competitive federalist model, it is clear that the states are costly regulators. What is not clear are the benefits that multistate regulation actually produces. Initially, one can examine the costs of state regulation and compare those to the costs of federal regulation. However, a simple cost comparison between current state and federal financial regulatory systems is only partially informative, because each state agency has a slightly different mission. For example, some states expend a great deal of time on rate regulation and issues related to pricing, profitability, and market conduct. Other states have relatively little price regulation but may spend more resources and time on other issues salient to voters in the state. In addition to mission differences at the state level, there is also mission overlap among federal agencies. This makes comparisons of state and federal expenditures on financial service regulation problematic. For example, the Federal Deposit Insurance Corporation (FDIC) has primary solvency regulatory authority as it is the deposit insurer, but the Office of the Comptroller of the Currency (OCC) and the Federal Reserve also have the ability to assess solvency for their separate purposes. Thus it is not really possible to compare regulatory efficiency by looking merely at summary financial or budgetary information. However, these data do show the relative scale of operations of state and federal regulation.[14]

Table 3-1 shows the budget, assets, and number of employees of various financial service regulators in 2006. The budget per employee ranges from $160,000 for the National Credit Union Administration (NCUA) to $305,000 for the Federal Reserve Board. A high ratio of the budget of the NCUA is in assets under its supervision, while for the budget of the Federal Reserve Board this is a relatively low ratio. There is also a great deal of difference among the agencies in budgets per regulated firm under its authority (a high of $292,000 for the OCC and a low of $22,375 for the Federal Reserve Board).

Some of the state insurance regulatory cost indexes are more useful than some of the indexes for federal financial service agencies, but it is difficult to determine based on this information whether regulation should be performed at a higher (federal) level of aggregation. First, it is difficult to make comparisons across financial service regulatory functions. For example, complaints about insurance are likely more numerous than, say, complaints about credit cards or deposits. And

14. This mission overlap is also a type of regulatory competition, as each agency may be able to check the other agency's behavior.

Table 3-1. *Financial Service Regulation, Budgets, Employees, and Assets, 2006*
Units as indicated

Organization	*Budget ($M)*	*Employees*
Office of Thrift Supervision	199,497	918
Federal Reserve Board[a]	173,000	567
Federal Deposit Insurance Corporation[b]	998,000	4,476
National Credit Union Administration	150,800	939
Office of Comptroller of the Currency	579,401	2,886
Securities and Exchange Commission[c]	960,800	3,764
Addendum		
Sum of federal regulators	2,100,698	9,786
State insurance departments + NAIC[d]	1,196,677	12,335

Source: Based on Grace and Klein (2007), table 3.3.

a. Includes the number of state member banks and the number of separate banks belonging to bank holding companies. The FRB has overlapping jurisdiction with the OTS and the OCC.

b. The FDIC has financial regulatory authority over insured banks.

c. SEC budget numbers reflect total program costs. The SEC oversaw approximately 5,300 broker dealers, 5,000 investment companies, and 8,550 investment advisers.

d. Includes property-liability and life, health, and annuity companies.

even if they are not more numerous, the technology and effort needed to resolve the complaints may be different. Second, it appears that closing down a failed insurer is much more expensive than closing down a bank. Some argue that a part of this difference in cost is due to the fact that banks' liabilities are generally easy to determine relative to insurers' liabilities, whose long-tail liabilities take time to resolve. Either way, insurance insolvencies are different from bank insolvencies, as they likely have different costs of resolution.[15] Thus other indicators of cost efficiency are needed in order to discuss which level of regulation is appropriate.

One of the major rationales for federal regulation is the economies resulting from the elimination of duplicate actions by the states: if insurance regulation is aggregated to a higher level of government, it is thought, these duplicate costs would be eliminated. The outcome would be lower regulatory costs to the government and lower compliance costs to the regulated firms. For example, every state undertakes regulation of insurance agents. According to Laureen Regan, the average life agent has about nine state licenses.[16] This cost is borne by the agents, their employers, and their customers. Further, every state licenses the companies

15. Grace, Klein, and Phillips (2007).

16. Regan (2007).

operating within its jurisdiction. In addition, the average property-liability company holds sixteen state licenses and the average life-health company holds twenty-five.[17] Two questions thus arise: Is there a social value for multiple states to undertake similar or identical licensing? And is there an alternative regulatory system that would impose less cost and provide greater benefits?

There is not a great deal of evidence regarding the social value of duplicative regulation, but there is some evidence regarding the costs. Martin Grace and Robert Klein, in their attempt to determine the effect of multiple state licensing requirements on insurers, find that the elasticity between the ratio of total expenses to premiums written and an additional license is about 10 percent.[18] This is fairly significant. Steven Pottier, using a different technique, finds that the total additional costs of having multistate regulation of the life insurance industry is about 1.25 percent of net premiums annually.[19] This translates into approximately $5.7 billion each year. Thus the evidence suggests a large dollar cost to multistate regulation. While these figures are for the life insurance industry, one would expect a similar result for the property-liability industry.

To answer the second question—whether there is an arrangement that will provide a higher social value—we can see whether insurance is regulated at the proper level of political authority. A framework exists for determining whether aggregation of regulatory power is appropriate. The ideal level of regulatory power should be exercised at the jurisdictional level best able to capture all the costs and benefits of regulation within its limits. Thus it is appropriate for county governments, for example, to regulate sanitary conditions at restaurants and swimming pools and for the federal government to regulate the allocation of broadcast frequencies or passenger air routes. This is the essential argument underlying the proper level of regulation. So in addition to cost economies from the aggregation of insurance regulation from the state level to the federal level, one might need to see evidence regarding the interstate nature of the industry or the presence of interstate externalities. The more interstate the business, the stronger the argument is for federal regulation.

Table 3-2 shows the premiums written by domestic and foreign companies in each U.S. state. The data show three facts. First, the domestic market share is small compared to the interstate share: the weighted mean domestic market share for all states for both sectors in 2006 was only 18.93 percent; in other words, out-of-state insurers provided over 80 percent of all insurance.

17. National Association of Insurance Commissioners (2006).

18. Grace and Klein (2000).

19. Pottier (2007).

Table 3-2. *Foreign and Domestic Premiums, Property-Liability and Life and Health, by State, 2006*
Units as indicated

	Property-liability			*Life and health*			*Total industry*	
State	*Direct foreign premiums written ($000)*	*Direct domestic premiums written ($000)*	*Domestic market share (%)*	*Direct foreign premiums written ($000)*	*Direct domestic premiums written ($000)*	*Domestic market share (%)*	*2006 domestic market share (%)*	*1995 domestic market share (%)*
Alabama	5,633,369	960,141	14.56	5,233,207	298,066	5.39	10.38	14.65
Alaska	1,326,310	199,073	13.05	834,761	. . .	0.00	8.43	8.70
Arizona	7,684,470	784,508	9.26	7,818,979	117,100	1.48	5.50	13.94
Arkansas	3,687,606	225,407	5.76	2,779,417	88,050	3.07	4.62	14.99
California	41,325,401	18,476,141	30.90	51,420,394	76,601	0.15	16.67	26.20
Colorado	7,414,151	318,006	4.11	8,353,160	328,631	3.79	3.94	8.34
Connecticut	5,892,576	1,159,682	16.44	6,870,055	8,968,009	56.62	44.24	36.86
Delaware	2,069,795	293,659	12.42	19,148,124	2,041,821	9.64	9.92	15.93
District of Columbia	1,499,298	34,574	2.25	1,824,004	2,917	0.16	1.12	2.06
Florida	28,341,802	10,703,313	27.41	29,349,453	117,188	0.40	15.79	14.71
Georgia	12,380,640	1,525,419	10.97	10,892,022	94,097	0.86	6.51	8.50
Hawaii	1,597,695	727,497	31.29	2,329,903	32,535	1.38	16.21	19.23
Idaho	1,567,678	286,125	15.43	1,804,369	11,343	0.62	8.11	13.11
Illinois	11,874,181	9,279,732	43.87	9,126,798	1,503,516	7.29	25.81	36.72
Indiana	7,150,200	1,363,405	16.01	8,315,297	1,463,280	14.96	15.45	24.98

Iowa	3,425,251	1,146,817	25.08	3,709,343	3,588,079	49.17	39.89	37.95
Kansas	4,052,270	488,023	10.75	6,762,640	271,152	3.85	6.56	20.94
Kentucky	4,821,563	984,111	16.95	4,095,719	40,643	0.98	10.31	11.89
Louisiana	7,090,656	1,661,061	18.98	6,346,595	189,099	2.89	12.10	12.77
Maine	1,515,482	457,457	23.19	1,819,433	20,841	1.13	12.54	15.72
Maryland	7,719,661	1,236,942	13.81	13,559,718	82,954	0.61	5.84	8.46
Massachusetts	6,639,900	5,243,219	44.12	11,917,922	1,256,083	9.53	25.94	31.02
Michigan	8,114,813	7,205,704	47.03	13,784,729	2,227,780	13.91	30.11	25.38
Minnesota	7,745,520	924,741	10.67	8,873,038	1,855,674	17.30	14.33	18.31
Mississippi	3,670,694	502,048	12.03	2,521,008	86,937	3.33	8.69	13.96
Missouri	7,956,991	1,097,600	12.12	8,715,275	274,014	3.05	7.60	13.90
Montana	1,530,070	27,744	1.78	941,543	5	0.00	1.11	1.42
Nebraska	2,789,080	382,762	12.07	3,146,838	482,480	13.29	12.72	26.28
Nevada	4,351,301	243,629	5.30	2,711,937	. . .	0.00	3.33	1.49
New Hampshire	1,877,017	278,221	12.91	2,138,006	3,896	0.18	6.57	8.90
New Jersey	12,339,874	5,017,773	28.91	23,774,434	3,997,113	14.39	19.98	23.90
New Mexico	2,410,956	154,322	6.02	1,822,503	150	0.01	3.52	3.91
New York	26,104,575	8,613,369	24.81	18,763,362	28,191,295	60.04	45.06	36.41
North Carolina	9,977,225	1,836,158	15.54	13,120,640	230,361	1.73	8.21	11.06
North Dakota	1,142,870	163,328	12.50	917,750	10,877	1.17	7.80	11.27
Ohio	8,265,065	5,049,116	37.92	16,121,765	2,078,124	11.42	22.62	28.53
Oklahoma	4,499,132	751,287	14.31	3,803,658	67,781	1.75	8.98	11.12
Oregon	4,052,243	1,380,963	25.42	4,195,542	319,697	7.08	17.09	17.50
Pennsylvania	15,013,048	4,953,342	24.81	21,565,944	451,255	2.05	12.87	15.90
Rhode Island	1,581,235	361,172	18.59	1,707,491	28,845	1.66	10.60	13.97

(continued)

Table 3-2. *Foreign and Domestic Premiums, Property-Liability and Life and Health, by State, 2006 (continued)*
Units as indicated

	Property-liability			*Life and health*			*Total industry*	
State	*Direct foreign premiums written ($000)*	*Direct domestic premiums written ($000)*	*Domestic market share (%)*	*Direct foreign premiums written ($000)*	*Direct domestic premiums written ($000)*	*Domestic market share (%)*	*2006 domestic market share (%)*	*1995 domestic market share (%)*
South Carolina	6,218,784	370,493	5.62	4,969,510	110,068	2.17	4.12	14.87
South Dakota	1,381,122	75,347	5.17	1,105,132	1,131	0.10	2.98	5.10
Tennessee	7,216,199	1,174,449	14.00	8,215,415	319,837	3.75	8.83	10.45
Texas	19,960,335	14,760,142	42.51	25,560,976	3,685,963	12.60	28.84	34.15
Utah	2,846,912	430,184	13.13	3,048,829	228,461	6.97	10.05	16.06
Vermont	988,760	122,421	11.02	953,128	19,632	2.02	6.82	10.50
Virginia	10,287,050	333,919	3.14	10,743,862	2,451,603	18.58	11.70	15.84
Washington	7,198,468	1,629,454	18.46	7,992,753	198,818	2.43	10.74	20.06
West Virginia	2,189,954	892,214	28.95	1,875,780	635	0.03	18.01	1.86
Wisconsin	4,343,890	3,673,437	45.82	8,523,553	789,986	8.48	25.75	31.95
Wyoming	775,488	60,704	7.26	695,591	. . .	0.00	3.96	3.32
Addendum								
Minimum			1.78			0.00	1.11	1.42
Mean			18.13			7.52	13.31	16.57
Weighted mean			24.92			13.33	18.93	22.78
Median			14.31			2.43	10.31	14.71
Maximum			47.03			60.04	45.06	37.95

Source: National Association of Insurance Commissioners (2006); market share calculations by author.

Second, the life insurance business is more interstate than the property-liability business: the average domestic market share is 7.52 percent for life-health insurers and 18.13 percent for property-liability insurers. The same is true for the median state: life-health insurers have much smaller domestic market shares than domestic property-liability companies. Even the overall average (weighted average, or the sum of the domestic markets' premiums in each state over total U.S. premiums written) shows that life-health insurance has a smaller domestic presence relative to property-liability insurance (domestic firms providing only 13.33 percent of life-health insurance).

Determining all of the factors causing this difference is beyond the scope of this chapter, but three factors come to mind. One, life insurance products and risks are more standardized, and thus there is less ability for local firms to have a comparative advantage in the provision of contracts. Two, property-liability policies are more likely to be subject to local restrictions and legal interpretations, which provide local providers with a comparative advantage over national companies. However, even property-liability insurance provided by domestic firms is small, with a weighted mean of 24.92 percent in 2006. Three, between 1995 and 2006 the total industry became more interstate, in the sense that indicators of domestic market share declined over the eleven-year period. Thus life insurance is more interstate than nonlife insurance, and the entire industry has become more interstate over time.

Martin Grace and Richard Phillips, in an effort to assess the cost efficiency aspects of regulatory aggregation, find evidence supporting an increase in efficiency with an increase in the level of regulation.[20] First, they find that the typical state has increasing returns to scale in regulation. The presence of economies of scale means that the average state could undertake the oversight of more producers or firms at lower average costs. This is consistent with the notion that the typical state is too small to regulate efficiently. Surprisingly, the authors also find that the biggest states have decreasing returns to scale. However, upon further investigation they find that the externalities operating among the states varied and that these externalities imposed costs on larger states. Specifically, it appears that larger states were doing the regulatory work of smaller states, as smaller states indirectly imposed their regulatory costs on larger states by relying on them to perform some of the functions belonging to the smaller states. The presence of this externality provides further evidence

20. Grace and Phillips (2007).

that the states are not the proper level of political jurisdictional control over the insurance industry.

Uniformity, Innovation, and Speed to Market

Another problem resulting from state regulation is the effect on product innovation, product approvals (speed to market), and interstate uniformity. If products are approved quickly, then firms can compete more efficiently on product innovation and design. However, if products are approved slowly, the incentive for insurers to develop and market new ideas is reduced. The problem is exacerbated if a product is approved in one state with a certain set of conditions and in another state with a different set of conditions. This differential approval also increases innovation costs. While federal pressure can produce more uniformity, this is not always the case.

Table 3-3 shows five model laws chosen to make specific points. One model law not included on the list is that based on the Risk-Based Capital Model Act.[21] We use it for comparison purposes, as it was adopted by every state within two years of its promulgation—and in almost identical form. This success may have stemmed from federal pressure, such as the criticism of state regulators by the House Commerce Committee for the insurance company failures of the late 1980s and early 1990s. However, federal pressure does not always generate quick adoption and uniformity. For example, the Gramm-Leach-Bliley Act (GLBA) required states to adopt reciprocal agent licensing provisions. The NAIC subsequently proposed a model law regarding producer licensing that would streamline licensing for agents. Table 3-3 shows the states that have adopted a producer licensing law.

21. National Association of Insurance Commissioners (2008). Note that, while the Risk-Based Capital Model Act has been uniformly adopted across the states, it says nothing about minimum initial (or continuing) capitalization requirements. In fact, each state separately sets these initial and continuing capitalization requirements, and they are not uniform. Risk-based capital is the capital requirement adjusted for the risk the company undertakes. It is different from initial or continuing capital requirements, which are unadjusted amounts of capital a company needs to start up or to continue in business. Compare, for example, Florida's initial minimum capital requirement of $5 million with Georgia's initial capital requirement of $1.5 million. In contrast, New York has separate requirements for minimum capital and surplus based on a company's line of business; the range is from $50,000 for glass coverage to $6 million for life insurance. The state would need to look at the risk-based capital law as well as its initial (or continuing) capital requirement statute to determine whether the company can continue to operate. See National Association of Insurance Commissioners (2007).

Table 3-3. *State Adoption of Model Law, Summary Data*[a]

State	Producer licensing		Life insurance disclosure model regulation		Unfair trade practices		Military sales		PC actuarial opinion	
	Law	Related legislation	Law	Related legislation	Law	Related legislation	Law	Related legislation	Law	Related legislation
Alabama	x		x			x				x
Alaska	x	x			x	x				x
Arizona	x		x		x		x			
Arkansas	x	x		x	x	x				
California		x	x		x	x				x
Colorado	x	x			x		x			
Connecticut	x	x	x		x	x				x
Delaware	x		x		x					
D.C.	x				x		x			
Florida	x	x	x		x	x				x
Georgia		x	x		x		x			x
Hawaii	x				x					
Idaho	x				x	x	x		x	
Illinois	x		x			x				
Indiana	x	x	x	x	x					x
Iowa	x	x			x		x			x
Kansas	x	x		x	x		x			
Kentucky	x	x		x	x	x				x
Louisiana	x	x		x	x		x			x
Maine	x	x	x		x					x

(continued)

Table 3-3. *State Adoption of Model Law, Summary Data (continued)*

	Producer licensing		*Life insurance disclosure model regulation*		*Unfair trade practices*		*Military sales*		*PC actuarial opinion*	
State	*Law*	*Related legislation*	*Law*	*Related legislation*	*Law*	*Related legislation*	*Law*	*Related legislation*	*Law*	*Related legislation*
Maryland		x	x		x				x	x
Massachusetts	x	x	x		x					
Michigan	x	x		x	x	x				
Minnesota	x				x					
Mississippi	x				x					
Missouri		x	x	x	x	x				
Montana		x	x		x					
Nebraska	x	x	x		x				x	
Nevada	x	x	x		x					
New Hampshire	x	x	x		x					
New Jersey	x	x	x		x					x
New Mexico		x	x		x		x			
New York		x	x		x		x			
North Carolina	x	x	x		x					
North Dakota	x	x	x		x					

Ohio	x		x		x		x			
Oklahoma	x	x			x		x		x	
Oregon	x	x	x			x	x			x
Pennsylvania	x			x	x	x				
Rhode Island	x	x	x		x		x			
South Carolina	x		x		x	x	x			
South Dakota	x	x	x		x					x
Tennessee	x	x	x		x		x			
Texas		x			x				x	x
Utah		x	x			x	x			
Vermont	x		x	x	x					x
Virginia		x			x		x		x	
Washington		x	x		x				x	x
West Virginia	x			x	x					
Wisconsin		x	x			x				x
Wyoming	x				x	x			x	

Source: National Association of Insurance Commissioners (2008).

a. States identified in the column labeled “Law” have adopted the law in a “uniform and substantially similar manner.” “Related legislation” means that the states have not adopted the law in a “uniform or substantially similar manner.” These states may have an older version of the law or a law derived from other sources.

Although the GLBA was passed in 2000, nine years later not all of the states have adopted the law. In addition, states have adopted other measures or other rules that reduce the effect of uniformity among the states. In addition, state judges, in interpreting the law consistent with how the states' legal systems have evolved, can make conflicting interpretations of the same statute. Finally, certain large and important insurance states such as Texas and New York have not yet passed the model law. The Government Accountability Office (GAO) asserted in congressional testimony that the holdout states may believe that their standards are superior and do not desire to lower them.[22] However, no cost-benefit analysis supports this assertion. And even if such an analysis did support it, it would not likely account for the costs imposed on others outside the state. Thus by holding out, these states impose compliance costs on owners and policyholders of companies operating nationwide.

The life insurance disclosure model provides "rules for life insurance policy illustrations that will protect consumers and foster consumer education."[23] Policy illustrations are part of the marketing process for life insurance, as they provide information about expected investment returns or credited interest rates on policies. For example, if the previous twenty-year return credited to policies was 5 percent, a policy illustration might have a projected 8 percent return rather than the historic 5 percent return. This model law was proposed in 1976 in light of a wave of creative illustrations that promised high returns on investment performance. As of 2008 only thirty-two states had adopted it. Nonuniform disclosure regulations are costly. In contrast, all but five states have adopted the NAIC's unfair trade practices rule. This model act was proposed in 1947.

The table also shows the military sales model, proposed in 2007 as a result of a law enacted by Congress.[24] This regulation is designed to protect young soldiers, sailors, marines, and airmen from aggressive sales tactics directed at military personnel. To date only eighteen states have adopted it. Presumably, this was an important issue for Congress, yet it had not been adopted by a majority of states in its first two years.

The PC actuarial opinion model law, adopted in 2005, is designed to require an actuary to issue an opinion regarding the financial state of an insurance company and provides that the opinion must be based on the actuary's best estimate

22. U.S. Government Accountability Office (2002).

23. National Association of Insurance Commissioners (2008).

24. Military Personnel Financial Services Protection Act, P.L. 109-290 (2006). See also "NAIC Adopts Model Regulation on Military Sales" (www.naic.org/Releases/2007_docs/Military_sales.htm [May 2008]).

or a range of acceptable estimates. The law also requires certain documentation to be part of the opinion. This law was designed to increase the underlying analysis and accuracy of the annual reports of property-liability companies. The law has been adopted by eight states, while another nineteen have adopted other related (and possibly different) rules.

In addition to concerns about a lack of uniformity (which increases costs), a typical complaint about the current state system concerns delays between product development and approval. This is also an issue of uniformity, as each state must approve a product before it can be sold in a state. The NAIC has attempted to respond to insurers' concerns about product approval delays. The costs of getting products to market nationally are allegedly high; hence the NAIC's apparent desire to deal with the issue. The GAO testified that the initial attempt to streamline product approval was not, in fact, streamlined enough for insurers to obtain value. In fact, there were too many additional individual state requirements.[25] The NAIC has again tried to improve the process by the formation of the Interstate Insurance Product Regulation Commission (IIPRC) for life insurance, an interstate compact.[26]

Horizontal Equity with Other Financial Services Industries

Permanent or cash value life insurance and many types of annuities have significant savings components. If these products are generally viewed as savings vehicles, then a number of potential banking or financial institution substitutes exist, ranging from bank accounts to individual stock portfolios. Federally regulated banks have a potentially significant advantage compared to insurance companies and nonbank annuity providers. Financial institutions can ask their regulators for nationwide approval of a product and receive an answer within a relatively short period of time, compared to the time it takes for insurers to obtain state approval. This provides a financial institution with a significant advantage over insurers for the marketing of similar products.[27]

Further, the states have rules regulating insurers' investments that may put them at a further disadvantage vis-à-vis federally regulated financial institutions. According to Grace and Klein, federally regulated financial institutions are

25. U.S. Government Accountability Office (2002).

26. According to information on the IIPRC, thirty-three states and related jurisdictions were members as of December 2008. However, five large insurance states are missing from the compact: New York, California, Illinois, Florida, and Connecticut. New York, Illinois, and California have proposed legislation (www.insurancecompact.org [November 2008]).

27. Kelly Greene, "Mutual Funds Pitch Alternative to Annuities," *Wall Street Journal,* June 9, 2008, p. D8.

permitted to use relatively aggressive hedging strategies, whereas insurers typically are not.[28] The market is quickly and dramatically changing, yet states typically resist allowing insurers to use the strategies commonly applied by other financial institutions. It may be that state regulators are apprehensive because they lack the resources to monitor and evaluate these strategies. A federal regulator with better analytical resources could permit life insurers to engage in investment and hedging strategies that would be more appropriate, more efficient, and more consistent with the rules governing other financial institutions.

The Costs and Benefits of an OFC

Consider the costs of an OFC. First, there are the costs of regulation at two levels of government. Even if there were significant change to a federal charter by many insurers, there still would be many insurers left to be regulated by the states. It would be ideal if there were a reduction in state expenditures exactly offset by the increase in federal expenditures, but this is not likely to occur, as bureaucracies are difficult to eliminate even if their mission changes significantly. Thus federal insurance regulatory expenses are likely to go up more than any reduction in state regulatory expenses.

A second source of costs is the imperfection of the federal-state charter competition. While there is the potential for competition, there is the problem of stickiness. Once a national insurer obtains a federal charter, returning it to a state charter would be costly. Depending on how substantial these costs are, insurers could be "held up," in the sense that it would be so costly to quit the federal charter that the federal government could extract concessions on tangential issues. Congress could also significantly expand its authority over the industry. In fact, this has historically been one of the reasons trotted out as a critique of past federal regulatory proposals.[29] It is also important to understand that, even with a holdup problem, overall efficiency could still be improved by the regulatory competition that would be induced by an OFC.

A third potential cost is less consumer protection. There is a concern that consumers would find it more difficult to have their complaints resolved at the federal level. This can be dealt with by adequate federal resources and consumer education. Most consumer complaints are resolved over the telephone and not in

28. Grace and Klein (2007).

29. Hanson (1977); Sara Hansard, "Will Optional Federal Charter Lead to More Regulation?" *Investment News,* May 26, 2008, p. 3.

person. It just as easy to call the toll-free number of a federal regulator as it is to call the number of a state regulator. It is possible, however, that state regulators may be more responsive to local complaints due to the political consequences of not doing so.

A fourth cost issue arises from the difficulties of maintaining state guaranty funds and federal regulation.[30] As discussed at more length below (under the general subject of guaranty funds), this cost suggests that the OFC should include a federal guaranty fund and allow insurers to opt out of state guaranty funds.

These costs can be compared to a number of benefits that would arise from an OFC. These include cost reductions resulting from regulatory streamlining. In a competitive environment, these reductions are passed on in terms of lower prices for consumers. Grace and Klein suggest that there are also benefits to competition by increasing the size of the market. To the extent that state licensing is costly, it acts as a barrier to competitive entry. Removal of such barriers would increase competition. In addition, increased competition would increase efficiency-inducing mergers and acquisitions, which would be a gain in an industry with relatively low average efficiency levels.[31] Increased competition would also bring about product innovation and economic growth.[32] Finally, an OFC would reduce the negative externalities imposed on out-of-state customers and insurers resulting from the current state regulatory system.

Competitive Federalism

Henry Butler and Larry Ribstein argue for a framework that would allow an insurer to choose one state to be its regulator; the insurer would then be able to operate nationwide under the laws of its home state.[33] This model of single-state regulation is akin to how state corporate law is employed in an interstate market. Butler and Ribstein try to counter potential "race to the bottom" critiques to their proposal. They argue that with perfect information consumers presumably would shun insurers from states with known lax regulation. Given, however, that there would likely be some residual consumer uncertainty over the insurer's home state's consumer protection law, Butler and Ribstein suggest that the home state's laws require the insurer to disclose which level of consumer protection would be

30. National Association of Mutual Insurance Companies (2008).
31. Yuengert (1993); Cummins and Weiss (1993).
32. Jayaratne and Strahan (1996).
33. Butler and Ribstein (2008).

granted: that of the insurer's home state or that of the consumer's state. This information disclosure would help the consumer shop for appropriate coverage from a company warranting a given level of consumer protection.

This is not convincing. As we have explained, a key reason for insurance regulation is consumers' asymmetric and imperfect information. A disclosure document (which many consumers may not read or comprehend) is not a credible solution. A key feature of the current system is strong insurance regulation by most states. Those states (and Congress) will not accept the possibility of their consumers being exposed to lax regulation by another state. There is also the issue of enforcement. Indeed, for an OFC to have any political traction it will have to assure Congress that it will not lessen current state consumer protection.

The status quo is costly and will never realistically result in a reduction in compliance costs. This is because the states have no real incentive to work together. Even though states occasionally work together, as with their quick and universal adoption of risk-based capital requirements, this is not a likely scenario in other areas. State adoption of risk-based capital requirements was likely prompted by regulators' fear of federal intervention if they did not strengthen solvency standards. However, the agency licensing requirements of the GLBA have not been accomplished. If the states were going to work together, they would have done so by now. Further, there is evidence that even a congressional mandate requiring a certain level of market conduct regulation for military personnel has not been adopted quickly.

The insurance industry has become more of an interstate business over its entire history, and this trend is still continuing. In addition, as the industry becomes more interstate in nature, the ability of the states to impose externalities on consumers in other states is increasing. Because of this, the industry needs a new style of regulation. The banking industry, the mutual fund industry, and parts of the insurance industry compete for the savings dollars of consumers. New products become approved quickly in the noninsurance arena, but innovations in the insurance industry require a long and ponderous review. This puts the insurance industry at a competitive disadvantage.

While there is evidence of interstate externalities in regulation, there are also those caused by differing state polices. A model of competitive federalism could bring about a reduction in compliance costs and may have the ability to increase efficiency by internalizing costs and benefits to its virtual jurisdiction; we think that an OFC approach also has merit. An OFC law would internalize the costs and benefits of insurance regulation. In addition, a model, which has existed since

the 1860s in the banking industry, shows how the system would work. However, while an OFC presents some potential advantages in the sense that it can internalize costs and benefits of regulation, the current law has some problems that need clarification.

The External Structure

With these considerations in mind, we now turn to options for how to design a federal insurance regulator to fit within the federal regulatory structure. Certain key issues must be considered: independence from the president, characteristics of the chief official, legislative jurisdiction, ad hoc oversight, funding, and lessons from state insurance regulation.

Independence

Some regulatory agencies, such as the Federal Reserve Board, are independent of the president. Others, such as the OCC, are instead housed within a cabinet department (Treasury, in the OCC's case, albeit with significant insulation from the secretary of the Treasury). The more independence, the less exposure there is to political pressure, but there is also the greater difficulty of coordinating policy among regulators, short of regulatory consolidation in an independent agency.

The federal insurance regulator could be part of a broader supervising agency. For example, the United Kingdom's Financial Services Authority (FSA) is an independent, consolidated agency encompassing the regulation of accounting, asset management, banking, securities, insurance, and other segments of the financial services industry, with separate "sector leaders" for each.[34] It operates as a company limited by guaranty and financed by the financial services industry, with a board selected by the United Kingdom's Treasury.[35]

There is also a difference between being exposed to political pressure and being political. For example, the five commissioners of the Securities and Exchange Commission (SEC) are split three to two along party lines, with the party in power having the majority. In practice, the commissioners from each party, while independent, have a natural tendency to coordinate their positions with their political benefactors (those who nominated them).

34. See www.fsa.gov.uk/Pages/About/Who/Management/Leaders/index.shtml.
35. See www.fsa.gov.uk/Pages/About/Who/index.shtml.

Chief Official

What should be the characteristics of the insurance regulator's chief official? Chief officials (and by implication agencies themselves) may operate with different degrees of insulation from the president. The most insulated model would involve a multimember chief official body, with characteristics such as staggered terms, bipartisan composition, and for-cause removal. The SEC and the Federal Reserve Board offer examples of this approach. Next, the agency might have one chief official with some sort of for-cause removal. An example is the Social Security Administration. Finally, the agency might have one chief official who serves at the pleasure of the president. An example here is the director of the Federal Bureau of Investigation. Often, agencies that are independent (as described above) also have chief officials who are more insulated. However, this is not always the case: although the Environmental Protection Agency is independent of any cabinet agency, the administrator serves at the pleasure of the president.

Legislative Jurisdiction

Every federal regulator is overseen by a particular congressional committee. For instance, the OCC and SEC report to the Senate Committee on Banking, Housing, and Urban Affairs, whereas the Federal Trade Commission reports to the Senate Committee on Commerce, Science, and Transportation. Which congressional committee should have jurisdiction over a federal insurance regulator? The banking committees seem appropriate to ensure parity of treatment with the treatment of financial institutions and to address the concerns raised above.

Ad Hoc Oversight

Quite separate from questions of oversight resulting from congressional committee jurisdiction, the formal organizational relationship with the president, appointment and removal of chief officials, and consolidation with other agencies, a federal insurance regulator may also be overseen by ad hoc institutions composed of various executive officials. Perhaps the most relevant group for an insurance regulator is the President's Working Group on Financial Markets, which currently includes the secretary of the Treasury, the chairman of the Federal Reserve, the chairman of the SEC, and the chairman of the Commodity Futures Trading Commission (CFTC). The new insurance regulator would be added to the mix.

Funding

Some regulators, such as the SEC, receive substantial amounts of their funding from congressional appropriations. Others, such as the FDIC and the OCC,

receive no appropriations and are entirely funded by premiums, assessments, other fees, and earnings on investments. Reliance upon appropriations increases accountability to Congress but at the cost of independence from Congress.

Lessons from State Insurance Regulation

In considering what a federal regulator might look like, it is useful consider how state insurance regulators are organized and funded. The typical state insurance regulator is constituted as an autonomous agency, formally part of the executive branch, with one chief official appointed by the governor. An example of this paradigm is the New York State Insurance Department. It is headed by a superintendent, who is appointed by the governor. No state insurance regulator appears to operate through a multimember commission. Within state legislatures, insurance regulation is often through committee, the most common three being a committee on banking and financial regulation (twenty-one states), a committee on commerce or consumer protection (twelve states), and a committee on insurance specifically (eleven states). A minority of states has an elected chief official for insurance; these states often grant this official more formal independence from the executive than that granted to a committee. Delaware has an elected insurance commissioner, who is subject to removal only for "reasonable cause."[36] This structure cannot be constitutionally replicated within the federal administrative structure. In and of itself, this means that a federal regulator may be more responsive to popular political pressure.

Another minority of states brings insurance regulation within another executive department, which is usually devoted either to commerce and consumer affairs or to banking and other financial services. Most of these states go further by consolidating regulation within this department, such that the insurance regulator merely is a division of a larger regulator, akin to the U.K.'s FSA.[37] Michigan uses this option. Its insurance regulation is one of the functions of the Office of Financial and Insurance Services, which also oversees banking and securities. This office is itself a part of the Department of Labor and Economic Growth.

Oversight by an ad hoc authority is highly uncommon. The only significant example might be Florida, where the commissioner of the Office of Insurance

36. 18 Del. C. secs. 301, 303.

37. Sixteen states have consolidated financial supervision for insurance, banking, and securities; twelve states have consolidated supervision for banking and securities; one state (New Jersey) has consolidated supervision for banking and insurance; one state (Tennessee) has consolidated supervision for insurance and securities; and twenty-two states have separate supervision for all three sectors. Brown (2005).

Regulation is appointed and overseen by the Financial Services Commission. The Financial Services Commission is itself composed of the governor and the cabinet. This commission also appoints and oversees the head of the Office of Financial Regulation, which oversees banking and securities. Both the Office of Insurance Regulation and the Office of Financial Regulation are within the larger Department of Financial Services, which is headed by a constitutional officer and also has regulatory jurisdiction over Florida's state accounting and auditing, state funds, and workers' compensation system.

State insurance departments may take their operating revenue from a variety of sources, including premium taxes, fees and assessments, appropriations, and penalties.[38] There is considerable diversity among the states. In California, the Department of Insurance collects fees for licensing and examination of insurance companies and agents and deposits them into a dedicated fund; fines and penalties are deposited into the state's general fund. In Maine the Bureau of Insurance gathers operating revenue by making an annual assessment against all licensed insurers in proportion to each company's direct gross premium. In Nevada the legislature appropriates monies for the Department of Insurance from the general fund. Nevertheless, the most common approach gives the state insurance department considerable freedom to collect fees for service, allowing for a degree of independence and self-funding.

Summary

Some characteristics of state regulation are so prevalent that they may seem to be presumptively worthy of replication at the federal level, for a couple of reasons. First, multimember insurance commissions are entirely absent among the states, which suggests that a Federal Reserve or an SEC approach would not be appropriate at the federal level. However, state insurance regulators are not independent from the political process, perhaps because some of the consumer issues they deal with are so highly political. Multimember setups may be more appropriate for independent regulators, to ensure that the independent agency has political balance and is a substitute for more active political control. Second, the latitude given to state insurance departments in the setting and collecting of fees suggests that a national insurance regulator should be self-funding, at least in part. Self-funding would allow the regulator a degree of independence from the political process, akin to that enjoyed by the Federal Reserve system. However, the creation

38. NAIC (2007).

of another independent federal agency with its own source of funds may not be a desirable result.

The Treasury blueprint contemplates the creation, in the medium term, of an Office of National Insurance (ONI) within the Treasury to license and oversee federally chartered insurance companies. The office would be headed by a commissioner and would be self-funded by assessments on federally chartered firms. In the longer term, the blueprint contemplates splitting the function of this office, like the functions of other existing regulatory agencies, among a market stability regulator (the Federal Reserve), a prudential financial regulator (within the Treasury), and a business conduct regulator (apparently an independent agency). These three regulators would join the existing FDIC, together with a new independent corporate finance regulator, to form a federal regulatory structure with five peaks.

In our view, it would be preferable to create an OFC now and not wait for the medium term. Further, we believe that it would be a mistake to create an independent agency to regulate insurance. Such an agency would further fragment federal regulation, a step in the wrong direction. However, it would also not be wise to merge insurance and banking regulators, because banking considerations are likely to be dominant, given history and the public concern with systemic risk. Insurance would be a poor stepchild.[39] The best approach would be to create a separate insurance regulator but use that occasion to strengthen the powers and resources of the President's Working Group on Financial Markets. The Treasury blueprint contemplates strengthening these powers, and it is expected that an executive order to this effect will be issued. Such an arrangement might replicate the benefits of oversight provided by Florida's Financial Services Commission.

As an overall matter, in the medium term (not the long term, as contemplated by the Treasury) the federal government should pursue a more integrated regulatory structure. Rather than the Treasury's five-peak plan, it should create a structure similar to the U.K.'s twin peaks: a central bank (the Bank of England) and one overall financial regulator and supervisor (the FSA).[40] While the Bank of England has no supervisory authority, one could well envision giving the Federal Reserve such power, either exclusively or concurrently with authority of a U.S. version of the FSA. These twin peaks would supervise and regulate federally

39. Chesson (2000, p. 74), remarks of the NAIC: "The bank regulators would not be suitable . . . as we know from the savings and loan experience, the regulators had no trouble subordinating regulation and disclosure to their primary function of protecting the banks."

40. Hal Scott, statement in response to the blueprint (www.capmktsreg.org/pdfs/4-4-08_hal_s_scott_press_release.pdf).

chartered insurance firms, along with the other financial institutions. While some, like Elizabeth Brown, argue that we should no longer regulate by labels and that it is hard to identify exactly what "insurance" is, it should be noted that the U.K.'s FSA organizes its regulatory efforts across nine sectors, including insurance.[41] Indeed, given the unique aspects of insurance, there should be a division of insurance within a U.S. FSA. This FSA would be an independent body, so that all supervision of financial institutions, including insurance, would be outside of the Treasury.

As the failure of Northern Rock in the United Kingdom demonstrates, even twin peaks can have coordination problems. A memorandum of understanding currently governs the relationship of the Bank of England, the FSA, and the U.K.'s Treasury in dealing with financial system issues. Going forward, the United Kingdom envisions the need for stronger coordination.[42] Any revamping of U.S. regulation should include a similar memorandum among U.S. regulators.

Consolidated regulation could increase efficiency and allow coordination between insurance regulators and financial regulators. This coordination is important for ensuring fair competition between insurance institutions and those financial institutions that offer similar products. Such coordination is also important in dealing with foreign states, as it ensures a unified voice for U.S. regulation and allows for a more rapid response to changing international events. According to Brown, other virtues of consolidated regulation may include better handling of issues unique to financial conglomerates (such as conflicts of interest), greater resistance to capture by a particular sector in financial services, and reduced confusion for consumers seeking information or to file a complaint.[43] And as the subprime crisis has taught us, coordination may prevent issues from falling through the jurisdictional cracks. On the other hand, a consolidated regulator might become large and unwieldy and unresponsive to the needs of small firms.

The Internal Structure

The design of the federal chartering agency's internal structure raises a number of issues. As demonstrated below, there is considerable harmony across lines in terms of solvency regulation. This is not surprising, given the fact that solvency is a firm-based, rather than a product-based, phenomenon—and given as well the trend toward convergence across product lines. Further, the major differences among

41. Brown (2005).
42. See for example Bank of England (2008).
43. Brown (2005).

lines arise in the area of consumer protection regulation. Since commercial insurance for sophisticated purchasers does not require market conduct regulation or examination and since it is a competitive business, the arguments for its regulation are lessened compared to personal lines or life insurance. The ultimate questions, then, are whether and how the whole or partial integration of auto (and other retail property-casualty) insurance may be effected.

The following three sections consider the internal structure of the federal chartering agency for three categories of insurance: life insurance, private passenger automobile insurance, and commercial general liability insurance.[44] No state has a distinct set of rules for each area, nor would such regulatory tailoring be sensible given the existence of common issues and the fact that many insurers offer multiple lines of insurance.

Currently, insurance companies are organized and chartered as life-health companies, as property-liability companies, or as specialty companies such as title insurers. Legally, a life-health insurer can offer various lines or products within its general area, such as term life policies, whole life policies, and annuities. Similarly, a property-casualty insurer may offer personal auto and homeowners as well as commercial lines like commercial multiperil and workers' compensation. It is common for a number of affiliated insurance companies to belong to a group owned by a parent or holding company. The companies within a group are divided along various dimensions, such as lines of insurance or products, geography, and underwriting standards. To some extent, the creation and focus of specific insurance companies within a group may be influenced by regulation. However, the formation of companies within a group also often reflects how a group wishes to organize its operations from a business perspective. The structure of insurance companies affects the way they might be regulated under an OFC.

The principal rationale for states to retain solvency regulation is their concern for consumer protection (such as for life insurance policyholders or for the maintenance of guaranty funds). However, maximum cost savings are achievable only if all these functions are regulated at the federal level. Further, any split of functions between the states and the federal government will be difficult to design and administer.

44. The insurance industry is essentially divided among three principal sectors: life insurance and annuities, accident and health insurance, and property-casualty insurance. Within each of these sectors, there are a number of lines of insurance, which constitute specific markets in which particular products or types of coverage are offered. For example, in the property-casualty sector, there are many lines of insurance, including private passenger auto, homeowners, workers' compensation, medical malpractice, and commercial general liability, among others.

Nonetheless, the Treasury blueprint apparently contemplates that there would be federal chartering by sector. Health insurance is explicitly excluded from the OFC. Thus for a given insurance holding company or parent firm, some of its companies and products could be regulated at the federal level and others at the state level. Another approach might be the licensing of types of regulation. Thus it would be possible but not optimal for firms to have the choice of being regulated at the federal level for aspects of regulation that do not vary by sector, with the states regulating areas that do vary.[45] However, the cleanest and most efficient solution would be to license firms, rather than sectors, lines, or functions. Indeed, we have no historic experience with federal licensing of financial products: the entire national bank experience is based on the chartering of firms.

Each insurance product may be sold in a more or less competitive market, face different noninsurance competitors, and give rise to more or less concern for consumer protection. As a result, state regulators have taken different approaches to the regulation of life, individual auto, and commercial insurance.

Life Insurance

Life insurance companies offer life insurance contracts and other financial products (such as annuities) to retail customers, businesses, and groups. The market for life insurance products is highly competitive, a situation enhanced by increasing competition from banking and securities products. As industry executives and observers note, this is not simply a matter of banks offering life insurance in the wake of the Gramm-Leach-Bliley Act but of a more fundamental convergence taking place in the financial services industry. Life insurance companies have been among those most interested in an OFC.[46]

45. Minimum capitalization requirements vary by line and by state. During the 1990s the National Association of Insurance Commissioners (NAIC) sought to harmonize state regulation by adopting model minimum risk-based capitalization (RBC) requirements for most lines (including life and property-casualty). See for example N.Y. Ins. L. sec. 4103; see also Ettlinger, Hamilton, and Krohm (1995). A multistate, multiline insurer generally must meet the greater of its minimum RBC requirements or the minimum capital requirements of each state in which it is licensed to do business. There is no reason that a federal regulator could not promulgate solvency regulations that would be not only equally sensitive to the different risks posed by different product lines but also more uniform.

46. See Grace and Klein (2007) for a discussion of competition in life insurance markets; also see chapter 7, this volume, for a more detailed discussion of the implications of the convergence of financial services markets.

Solvency Regulation

Life insurers are subject to solvency regulation in each of the states and territories in which they do business. Solvency regulation encompasses chartering and licensing and involves periodic financial reporting and examination requirements. An insurer chartered as either a life-health insurance company or a property-casualty company will be licensed to issue one or more lines within these broad categories.[47] In order to be chartered and licensed, insurers must meet minimum capital and surplus requirements, which vary by sector and line. Considerable uniformity already has been imposed upon states' capital and surplus by their adoption of the Risk-Based Capital Model Act promulgated by the NAIC. However, almost every state has retained its own fixed minimum capital and surplus requirements. A multistate, multiline insurer generally must meet the greater of NAIC's minimum risk-based capital requirements or the minimum capital requirements of each state in which it is licensed to do business.[48] In addition to minimum capital requirements, states regulate market entry through seasoning and other requirements. After becoming licensed, both life-health and property-casualty insurers must file annual and quarterly financial reports and submit to periodic full-scope, and occasional targeted, financial examinations.

Because the underwriting risks faced by life insurers are distinct (for example, the long time frame of life insurance contracts), state regulators have subjected these companies to chartering and licensing requirements and accounting standards that differ from those applied either to property-casualty insurers or to banks. Life insurers are subject to investment restrictions that differ from those imposed upon property-casualty insurers and are required to account differently for their policy reserves. Moreover, both life and property-casualty insurers must comply with accounting principles that are more conservative than those applied to banks. Insurers are required to file financial reports in keeping with statutory accounting principles (SAP) rather than generally accepted accounting principles (GAAP). SAP differs from GAAP in terms of the valuation, realization, and continuity issues imposed on reporting companies (SAP generally takes a liquidation rather than going-concern perspective). Otherwise,

47. The separation between life and property-casualty insurers seems to be the historical legacy of "monoline" insurance regulation, which began with the New York legislature's 1849 decision to require each insurance company to issue only a single line. Insurers began offering multiple lines during the early twentieth century; however, legislation providing for the licensing of multiline insurers was not adopted by the states until after 1945.

48. Capital requirements for insurance companies are explained in greater detail by Klein (2005).

the financial reporting and examination requirements imposed upon the life insurance industry by state regulators are similar to those imposed upon the banking industry by the OCC.

Many states already base their financial reporting requirements upon universal standards prescribed by the NAIC and accept zone examinations of multistate insurers; therefore, insurers and the federal regulator will reap limited (though welcome) cost savings from a single federal reporting and examination system.[49] However, federal regulatory oversight of insurer solvency could further enhance the efficiency of the insurance industry. A federal regulator could abolish the traditional division of solvency regulation between life and property-casualty insurance. While these types of insurance face distinct risks, so do the different individual sublines of property-casualty insurance, which nevertheless may be offered by a single insurer.[50] Following state regulators' shift to a risk-based capital model, the federal regulator may contemplate chartering consolidated federal insurance companies authorized to do business in any sector or line of insurance, provided they have adequate risk-adjusted capital and surplus.[51]

In addition, a federal regulator could consider either the elimination of capital or surplus requirements for life insurance companies or a convergence with banking capital requirements and accounting standards. To the extent that the capital requirements of life insurers are more conservative than those of banks and securities firms offering similar products, insurers will be at a competitive disadvantage. The reconciliation of SAP and GAAP would eliminate those inconsistencies that may give either insurers or their competitors an advantage in the market for financial services and would provide regulatory efficiencies (consistency and comparability) as financial services converge. Finally, a federal regulator should ensure relative ease of entry and exit.

Rates, Policy Forms, and Consumer Protection

Life insurance rates generally are lightly regulated or unregulated by the states. However, this light touch is significantly offset by requirements in most states that

49. The federal regulator may reduce costs by conducting financial examination on an as-needed or prioritized basis (that is, in response to a complaint or lawbreaking) rather than on a strictly periodic basis. The current proposal would require the commissioner to conduct an on-site examination of each federally chartered insurance company at least once every three years; however, insurance agencies would be subject to examination only in response to a complaint or lawbreaking. See NIA sec. 1125.

50. See for example N.Y. Ins. L. secs. 4101–02.

51. The current proposal would not allow a national insurer to hold licenses for both life and property-casualty insurance. See NIA sec. 1203.

policy forms be subject to prior approval by the state insurance department. Thus in order to introduce a new product a life insurer must seek the approval of the insurance regulator in each state in which it does business. Life insurers also are subject to state market conduct regulation and examination (such as advertising restrictions).

Life insurers report significant direct and indirect costs arising from this contradictory and fragmented mélange of state regulation.[52] For example, life insurers may have to create different versions of products, tailored to the regulations of particular states, and may employ multiple state-based compliance staffs. This puts life insurers at a competitive disadvantage vis-à-vis banks and securities firms.

Unification of the regulation of rates and policy forms in a single federal regulator obviously would reduce compliance costs to life insurers; elimination of prior approval of rates and policy forms would be a further boon, enabling life insurers to compete with banks and securities firms on a more even playing field.[53] Because the market for life insurance products is highly competitive, the main consumer protection issue facing the federal regulator will be that of retail consumers' informational inadequacy. This consumer protection should take the form of simple regulations regarding market conduct, along with efforts to inform retail consumers.

Commercial Insurance

Property-casualty companies offer commercial general liability insurance to businesses, often along with other lines like commercial auto and workers' compensation insurance. The market for commercial insurance is highly competitive. The buyers of commercial insurance vary greatly in size and in terms of their needs for insurance coverage. Small businesses tend to purchase standardized insurance policies, while larger firms are more likely to arrange customized insurance contracts to meet their specific needs. The sophistication of commercial insurance buyers also varies directly with their size; large firms are relatively sophisticated and benefit little if at all from regulatory protections.

Solvency Regulation

Like life insurers, commercial property-casualty insurers are subject to minimum capital and surplus requirements for chartering and licensing as well as to periodic

52. See ACLI (2005) for the industry's view of this problem.

53. As noted above, the NIA would establish a file-and-use system for life insurance policy forms and allow the commissioner to exempt particular categories from the filing requirement. Life insurers would be allowed to classify policyholders and set rates freely. NIA sec. 1213.

financial reporting and examination by state insurance regulators. The rationale for these requirements obviously is to ensure the solvency of insurers, who have promised to deliver future contingent benefits to policyholders or their beneficiaries. A federal insurance regulator could lower regulatory costs through more uniform and consistent chartering, licensing, and financial reporting requirements. And competition may be enhanced by a consolidated federal insurance company option.

Insofar as these products are sold in competitive markets to presumptively sophisticated buyers, a federal insurance regulator may decide to eliminate capital and surplus requirements altogether for commercial insurers. Commercial insurers face increased competition from the growing market in alternative risk-transfer mechanisms, such as credit derivatives. To the extent that suppliers of alternative risk-transfer products are subject to lower (or no) capital requirements, prices and consumer choice may be distorted in the market for commercial lines. Minimum capital and surplus requirements also hamper the entry of new commercial insurers, whose products might find willing, sophisticated buyers. Financial reporting and examination may be justified insofar as it cost-effectively reduces the risk of insolvency, in part by eliminating duplicative diligence costs undertaken by customers.

Rates, Policy Forms, and Consumer Protection

Like life insurance, commercial insurance enjoys de facto rate deregulation but (rather surprisingly) remains subject to considerable policy form regulation.[54] Over time, many states have deregulated commercial insurance for larger buyers, but the pattern of deregulation is inconsistent and subject to state-specific criteria.[55] Prior approval of policy forms increases commercial insurers' time to market, disadvantaging them vis-à-vis securities firms offering alternative risk-transfer products. As with life insurance, it is not clear what purpose prior approval of policy forms serves when rates are deregulated.[56] Other than fraud investigation, consumer protection issues are not implicated by commercial general liability insurance.

54. See Butler (2002).

55. For example, the states employ different criteria for determining how "large" or "sophisticated" a firm must be in order for it to purchase insurance that is not subject to the rate and form regulation that applies to insurance purchased by smaller firms.

56. As noted above, the NIA would establish a use-and-file system for property-casualty insurers and would prohibit the commissioner from requiring property-casualty insurers to use "any particular rate, rating element, price, or form." NIA sec. 1214.

Automobile Insurance

Property-casualty insurers also offer voluntary auto insurance to retail consumers in strictly regulated markets. Universal coverage often is mandated or encouraged by regulators, and residual market mechanisms have been created to provide insurance to individuals who cannot obtain coverage from a private carrier. Consumer groups have objected to the extension of federal chartering to auto insurance and other retail property-casualty insurance on the grounds that the federal regulator would be unable or unwilling to provide adequate consumer protection.

Solvency Regulation

Retail auto insurance, like other lines, is subject to minimum capital and surplus requirements for chartering and licensing and to periodic financial reporting and examination by state insurance regulators. The rationale for such supervision is strong in the case of auto insurance, where it may be necessary to protect consumers with limited information and monitoring capacity from unscrupulous insurers. The basic contours of federal solvency regulation and its benefits are substantially the same as those discussed above. The need for clear communication between financial supervision and consumer affairs bureaus is greatest for proper solvency regulation of auto insurers.

Rates, Policy Forms, and Consumer Protection

Auto insurance regulation touches all aspects of consumer protection, including rates, policy forms, market conduct, consumer education, and consumer complaints. Some states strictly regulate rates and policy forms. For example, until 2008 Massachusetts set uniform rates and rating classes for insurance companies. It still requires prior approval of rates. However, rate and policy form regulation differs greatly among states. Two prior approval states may even impose different burdens upon insurers, depending upon the stringency and speed of review as well as the use of such regulation to suppress rates.[57] Moreover, rate and policy form regulation is intimately tied to state policies favoring universal coverage. State regulators are strict in enforcing market conduct regulation and swift in responding to consumer complaints.

The variety of rate and policy form regulations among states imposes considerable direct and indirect costs upon auto insurers and results in various cross-subsidies among consumers with different risk profiles. Even if a federal regulator

57. See Harrington (2000).

required prior approval of rates and policy forms, regulatory costs would be lowered. However, because the market for voluntary auto insurance in most states is highly competitive, a federal regulator may choose to deregulate rates or policy forms. Illinois completely deregulated rates for voluntary auto insurance in 1971 (it still regulates insolvency, market conduct, and other areas). Observers report that in Illinois auto insurance is widely available and rates are competitive; moreover, deregulation seems to have had no adverse effect upon loss ratios, the size of the uninsured and residual market, or insurer solvency. Competition in a deregulated rate environment may be buttressed by modification of the federal antitrust exemption for national insurers, although it is not clear that this would have any material effect on markets that are already highly competitive.[58]

Even in a competitive, rate-deregulated national auto insurance market, the federal insurance regulator may desire to regulate market conduct for the protection of consumers. Such an initiative may require a distinct division of market conduct and consumer protection dedicated to retail policyholders and beneficiaries. The more lines that can be regulated at the federal level that raise such consumer concerns, the more justification there would be for a separate division.

Residual Market Mechanisms

To guarantee the availability of auto insurance, every state has a residual market facility (for example, an assigned risk pool) for drivers unable to secure voluntary auto insurance. Like state guaranty plans (discussed below), auto insurers doing business in a state participate in its residual market mechanism on a pro rata basis. State workers' compensation insurance generally has a similar mechanism. The NIA would not create a national residual market mechanism. Instead, federally chartered insurers would remain subject to applicable state law relating to participation in a residual market mechanism. The Treasury blueprint seems to take the same approach.

If auto insurance were offered an OFC, the internal structure of the federal regulator would be affected greatly by the legislative decision regarding the creation of a national residual market mechanism. If national insurers were required to participate in state residual market facilities, regulatory supervision would be divided between the federal government (solvency and consumer protection) and state governments (residual market compliance), which may raise not only direct com-

58. California's Proposition 103 did this at a state level. In chapter 5 Martin Grace and Robert Klein argue that the industry's current limited antitrust exemption has not promoted anticompetitive behavior.

pliance costs to insurers but also indirect costs related to increased time to market for new products.

There are two other alternatives: the creation of a national residual market mechanism and the preemption of state residual market mechanisms without the creation of a new one. Obviously, a national residual market mechanism would require national administration of a regulatory function unique to this kind of insurance. More important, national pooling would alter the spread of the costs of underwriting losses among insurers. If broader spreading of risks were to result in cost savings to national insurers, presumably they (and their policyholders) would benefit, to the detriment of state-chartered insurers. On the other hand, those insurance companies that predominantly insure policies in states with safer drivers might believe that wider risk spreading would raise costs. Abolishing all residual risk insurance would not be a practical alternative.

Guaranty Funds

The state guaranty fund system, an important facet of insurance regulation, has been a cause of concern for federal chartering. These funds are in place to compensate for the losses suffered by third parties and policyholders due to insurance company insolvency. Since insurance regulators are responsible for preventing this insolvency, guaranty funds may be framed as a sort of product warranty for the quality of regulation.[59] The general perception is that the administration of state guaranty funds has been one of the most effective components of state insurance regulation. The proposed federal legislation and the Treasury blueprint would keep the state guaranty system intact and require federally chartered insurance firms to participate in the system.

States began to create these funds in 1969, at the behest of insurance companies and perhaps in response to pressure for federal regulation. The first wave of funds provided protection for life-health insurers, with subsequent waves spreading coverage to property-casualty insurers. These product divisions remain today and often include subdivisions, or accounts, for particular lines of insurance. Assessments for policyholders' claims against insolvent insurers are made against the appropriate account. The funds typically are organized as compulsory membership, nonprofit associations of all insurance companies licensed in the state. They are administered by a board composed of representatives from insurance companies and the state insurance regulator, with some states including representatives of the

59. Ely (2000).

public as well. Most state guaranty assessments are not risk sensitive, which has been a source of criticism. Also, some states allow insurers, especially life-health insurers, to offset the taxes they pay on premiums by the amount of guaranty fund assessments paid. As a result, some of the cost of insolvency losses is passed along to taxpayers, who must make up for any shortfall in taxation created by these offsets.

The two most often praised features of the state guaranty fund system are its basis for assessments and its level of coverage. With the exception of New York, every state administers its guaranty fund on a postassessment basis. That means that member insurance companies do not pay into a fund until around the end of the year—and only to the extent necessary to compensate for losses. This may be contrasted with funding on a preassessment basis, wherein companies would pay into the fund before losses are known, as is the case with the FDIC fund for banks. In 2007 the New York state legislature took advantage of its state's preassessment fund by siphoning off the fund's resources for general spending. This suggests that any prefunding mechanism needs to be highly insulated from the political process.

Additionally, state guaranty funds generally have low coverage limits. Commentators hail these limits as promoting efficient behavior by insurance companies. Due to the low limits, companies have incentives to self-insure by controlling their risk of insolvency. These incentives tend to minimize losses. Were coverage limits to be higher, insurance companies would be more likely to engage in risky behavior, such as writing more high-risk policies, due to moral hazard. These are the same issues encountered in setting the level of FDIC insurance for banks.

Owing to this positive appraisal of state guaranty funds, many commentators have adopted an approach along the lines of, If it ain't broke, don't fix it. Indeed, postassessment funding and low coverage limits suggest that state guaranty funds do not suffer from the same weaknesses of overregulation and inefficiency that might justify more general reform of insurance regulation. Of course, postassessment funding and low coverage could also be implemented at the federal level.

If it is assumed that state guaranty funds operate well and should continue in operation, then the question is whether an OFC might impair the effectiveness of the state guaranty system. There are a few reasons to think that such impairment might occur. First, federal regulators might worry about relying upon state funds in the case of insolvency. If a large national insurance company were to fail, then some state funds might have insufficient assessment resources to compensate for the losses of third parties and policyholders within that state's jurisdiction. Second, state funds do not exhibit a uniform level of protection, which means that different federally chartered insurers would have different insolvency protection,

depending upon where they operate.[60] Federal regulators might insist upon uniform minimum standards for the operation of state guaranty funds. Unsurprisingly, the insurance industry and state regulators have generally supported the state guaranty approach.[61]

However, federal regulation with state guarantees necessitates severing the link between regulation and guaranty that is the backbone of the idea of guaranty as product warranty. This idea is premised upon the notion that regulators will act more effectively if they must bear the cost of poor regulation. This efficacy will not obtain if state funds bear the costs of poor federal regulation. It was precisely this concern that led to federal involvement in safety and soundness regulation for state-chartered banks using federal deposit insurance.[62]

Concerns about the potentially adverse impact of federal regulation upon the state guaranty system might be grounds for installing a federal guaranty fund for federally chartered insurers. Such a fund would successfully tie federal regulation to a federal guaranty, thereby satisfying the product warranty rationale. There might also be some subsidiary benefits of a federal fund. It would imply uniformity of protection for federally chartered insurers. If a diverse group of insurers choose to operate under federal charter, then there might be better pooling of risk as compared with state funds, which have a more limited geographic base from which to draw members.

Additionally, there would be no passing off of externalities from one state to another.[63] Currently, state regulators have less incentive to regulate multistate insurers because other states' funds share the costs of insolvency. A federal fund would eliminate this practice for federally chartered insurers, because the federal fund would not be able to pass the buck of insolvency on to other funds. On the other hand, some argue that the possibility of externalities to insolvency actually improves state regulation because it gives state regulators an incentive to monitor the quality of regulation in domiciliary states.[64]

Were legislators to opt for establishing a federal guaranty fund, then there are a number of structural concerns they would need to address. As discussed earlier, most state funds have divisions and subdivisions keyed to different insurance products. The presence and extent of such divisions in a federal fund would be

60. "Coverage limits vary from state to state, up to $500,000, by type of insurance product and by type of liability (prepaid premiums versus actual loss, cash values versus life insurance death benefits, and so forth)." Ely (2000, p. 142).

61. See Harrington (2000).

62. Ely (2000).

63. See, for example, Grace and Phillips (2007).

64. Macey and Miller (2003).

something to be decided. Further, legislators would have to consider whether state-chartered insurers would be eligible for the fund, just as state-chartered banks are eligible for federal deposit insurance. Another question is how premiums would be assessed. Risk-based premiums seem ideal, even though they are difficult to implement. If the federal guaranty fund is structured like federal deposit insurance, then it might even make sense for the FDIC to administer the fund. Regardless, the relationship between the fund and federal regulators, possibly including a federal insurance regulator, should be clarified. Additionally, a number of unique concerns would arise during the transition by insurers from membership in state funds to membership in a federal fund.[65]

If, as contemplated by the blueprint, lines and not firms were federally chartered, the administration of the guaranty funds would become even more complicated. The same firm could be engaged in state-chartered and federally chartered activities, and the states would obviously have an interest in the solvency of state activities. Under this scenario, state guaranty funds could guarantee state lines, while the federal guaranty fund would guaranty federal lines.

Conclusions

Several important issues need to be considered in designing a regulatory structure for an OFC. First and foremost, the objectives of insurance regulation and the rationale for an OFC must guide regulatory design. Second, lessons learned from existing federal and state financial services regulators regarding the external structure of such an agency must be borne in mind. Chief among these lessons is the disjunction between the accelerating convergence of financial services and the current fragmentation of our regulatory system. Third, it would be preferable to charter firms, rather than lines or regulatory functions, at the federal level. The extent of federal chartering of lines would be a major factor in designing the internal structure of the federal agency. Fourth, the participation of national insurers in state residual market mechanisms and guaranty funds must be determined, with reference to both consumer protection and efficiency goals. Finally, in the medium term, insurance supervision and regulation should be part of a new twin-peak regulatory function, consisting of the Federal Reserve and a new U.S. FSA.

In the shorter term, while the federal government should have primacy in the regulation of insurance, it would be a mistake to establish an independent Office

65. Examples include need for exit fees to prevent exodus from state to federal regulation in lieu of an assessment due to failure of a large company and for a mechanism for dealing with insolvency of newly chartered federal companies (Broome, 2002).

of National Insurance (as contemplated by the NIA), which would further fragment federal regulation of financial services. Neither would it be wise to consolidate federal regulation of banking and insurance under a single agency (a point upon which both the NAIC and multistate insurance companies agree). In our view, the optimal external structure would involve the establishment of a distinct insurance regulator subject to oversight by the President's Working Group on Financial Markets. This approach is most likely to provide the greatest benefits arising from an OFC—cost savings from uniformity, economies of scale, and appropriate deregulation, along with the benefits of coordinated financial services regulation—at the lowest cost. It also would combine regulatory expertise and independence with strong political oversight and accountability. Finally, it might serve as a first step toward consolidated federal financial services regulation, beginning with the reconciliation of capital requirements and accounting standards for all financial services firms.

The federal regulator of insurance should provide a true federal option: national insurers should be subject only to federal regulation of their solvency and product offerings and should be able to offer many lines of insurance. A federal regulator would be well situated to set and enforce appropriate risk-based capital requirements for national insurers, based upon their product lines and other relevant risk factors. Indeed, a federal regulator could consider removing the traditional barrier between life and property-casualty insurers. The benefits of an OFC would be maximized—and the potential for duplicative and conflicting regulation reduced—by allowing national insurers to offer as many lines of insurance as possible. Retaining state policy form regulation for national auto and workers' compensation insurance (as contemplated by the NIA) would reduce greatly the benefits of rate deregulation for these lines, as we have seen from states' "deregulation" of commercial insurance. Alternatively, limiting national property-casualty insurers to commercial insurance would require them to charter separate workers' compensation companies in each state in order to provide "full service."

Clearly, licensing national insurers to offer certain lines, such as auto insurance, would implicate important consumer protection issues. Generally speaking, the regulation of insurers, like that of banks, should be prudential in approach and effected through examination. However, the more "retail" lines offered by a national insurer, the more a federal regulator would be required to promulgate market conduct regulation, investigate consumer complaints, enforce penalties for violations, and provide for consumer education. If such lines are offered, the federal regulator should create a distinct division of market conduct and consumer protection dedicated to retail policyholders and beneficiaries.

Furthermore, the relationship of national insurers to state residual market mechanisms and guaranty funds must be determined. The creation of a national residual market mechanism and a national guaranty fund would require federal administration of regulatory functions unique to insurance—and historically the province of the states. However, federal administration of these functions would enable national pooling of residual and insolvency risks and would allow for regulatory innovations (for example, risk-based premiums for the national guaranty fund). Indeed, either or both pools could be open to the participation of state-chartered insurers, allowing them to enjoy any economies of scale provided by federal administration. An important issue to consider is that allowing national insurers to participate in state residual market mechanisms and guaranty funds, however well administered, might lead to different or even contradictory regulation of federally chartered insurers. In contrast, a national guaranty fund would allow the federal government to consolidate solvency regulation from "cradle to grave," albeit at some cost and risk.

To sum up, the design of a regulatory structure for an OFC for insurance should provide for strong and efficient federal regulation of what is a national and international financial service activity. Insofar as is possible, the federal option should give insurers the choice to be subject only to federal, rather than state, regulation and law enforcement. And insofar as the convergence of financial services is accelerating, the creation of a federal option should be a first step toward more complete consolidation of federal financial services regulation. Such a system would level the playing field both nationally and internationally and provide consumers with the most efficient and transparent options.

The discussion here assumes that federal chartering would be optional. However, it may well be that federal regulation, if not chartering, will become mandatory for the systemically important insurance companies, given the Federal Reserve's $85 billion loan to AIG in September 2008 (accompanied by a 79.9 percent equity interest), later supplemented by an additional loan of $37.8 billion in October, and still a third round of net additional funding by the Treasury of $25 billion in November (Treasury bought $40 billion of preferred stock, while the Federal Reserve reduced its September loan by $15 billion). On top of this actual funding, two new credit facilities established in November, totaling $52.5 billion, further increased the Federal Reserve's potential exposure. One should also note that insurance companies are generally eligible for Treasury assistance under the Troubled Asset Relief Program (TARP).[66] As the AIG case

66. Emergency Economic Stabilization Act of 2008, H.R. 1424, sec. 3(5) specifically includes a state regulated insurance company as a "financial institution" eligible for assistance under sec. 101.

shows, there are large insurers that have a potential for imposing systemic risk to the economy. If such firms are to be rescued by the federal government, it seems reasonable to insist that the federal government have supervisory and regulatory powers over such firms. This issue is outside the scope of this chapter but is illustrative of the continuing evolution of regulatory issues facing the financial services industries.

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