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Insurance Regulation: Optional Federal Charter Legislation

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Summary

Insurance is one of three primary pillars of the financial services industry. Unlike the other two, banks and securities, insurance is primarily regulated at the state, rather than federal, level. The primacy of state regulation dates back to 1868 when the Supreme Court found in *Paul v. Virginia* (75 U.S. (8 Wall.) 168 (1868)) that insurance did not constitute interstate commerce, and thus did not fall under the powers granted the federal government in the Constitution. In 1944, however, the Court cast doubt on this finding in *United States v. South-Eastern Underwriters Association* (322 U.S. 533 (1944)). Preferring to leave the state regulatory system intact in the aftermath of this decision, Congress enacted the McCarran-Ferguson Act of 1945 (P.L. 79-15, 59 Stat. 33), which reaffirmed the states as principal regulators of insurance. Over the years since 1945, congressional interest in the possibility of repealing McCarran-Ferguson and reclaiming authority over insurance regulation has waxed and waned.

In past years, particularly since the Gramm-Leach Bliley Act of 1999 (GLBA, P.L. 106-102, 113 Stat. 1338), the financial services industry has seen increased competition among U.S. banks, insurers, and securities firms and on the global scale. Complaints that the 50 state regulatory system puts insurers at a competitive disadvantage in the marketplace have been rising. Whereas the insurance industry had previously been united in preferring the state regulatory system, it has now splintered, with larger insurers tending to argue for a federal system and smaller insurers tending to favor the state system. The recent financial crisis, particularly the effects of the failures of insurance giant AIG and various monoline bond insurers, has given greater urgency to calls for federal oversight of insurance.

Some Members of Congress have responded since the 107th Congress with different proposals ranging from a complete federalization of the interstate insurance industry, to leaving the state system intact with limited federal standards and preemptions. The most common proposal has been for an Optional Federal Charter (OFC) for the insurance industry. This idea borrows the idea of a dual regulatory system from the banking system. Both the states and the federal government would offer a chartering system for insurers, with the insurers having the choice between the two. The proposed National Insurance Act of 2007 (S. 40 and H.R. 3200) was the only OFC legislation offered in the 110th Congress. Similar legislation has yet to be offered in the 111th Congress.

Proponents of OFC legislation typically cite the efficiencies that could be gained from a uniform system, along with the ability of a federal regulator to better address the complexities of the current insurance market and ongoing financial crisis as well as the need for a single federal voice for the insurance industry in international negotiations. Opponents of OFC legislation are typically concerned with the inability of a federal regulator to take into account local conditions, the lack of consumer service that would result from a faraway bureaucracy in Washington, DC, and the overall deregulation contained in some of the OFC proposals. This report offers a brief analysis of the forces prompting OFC legislation, followed by a discussion of the arguments for and against an OFC, and summaries of various OFC legislation that has been proposed. It will be updated as legislative events warrant.

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Background

Insurance is one of three pillars of the financial services industry. Unlike the other two, banks and securities, insurance is primarily regulated at the state, rather than federal, level. The primacy of state regulation dates back to 1868 when the Supreme Court found that insurance did not constitute interstate commerce, and thus did not fall under the powers granted the federal government in the Constitution.[1] In 1944, however, the Court cast doubt on this finding.[2] Preferring to leave the state regulatory system intact in the aftermath of this decision, Congress enacted the McCarran-Ferguson Act of 1945,[3] which reaffirmed the states as principal regulators of insurance. Over the years since 1945, congressional interest in the possibility of repealing McCarran-Ferguson and reclaiming authority over insurance regulation has waxed and waned.

In 1974, Congress enacted the Employee Retirement Income Security Act[4] (ERISA) preempting state laws governing many health benefit plans offered by employers, thus essentially federalizing much of the regulation of health insurance. In 1980, the Congress curtailed the authority of the Federal Trade Commission (FTC) to investigate the insurance industry, reducing a small avenue of federal oversight on insurance.[5] In the early 1990s, a bill[6] to repeal the limited antitrust exemption granted insurers in McCarran-Ferguson, and thus expand federal oversight of insurance, was reported out of committee in the House, but never reached the House floor. In 1999, Congress enacted the Gramm-Leach-Bliley Act[7] (GLBA), which specifically reaffirmed the states as the functional regulators of insurance.

GLBA may have statutorily reaffirmed the primacy of state regulation of insurance, but it also unleashed market forces that were already encouraging a greater federal role. GLBA removed legal barriers between securities firms, banks, and insurers, which, along with improved technology, have been an important factor in creating more direct competition among the three groups. Many financial products have converged, so that products with similar economic outcomes may be available from different financial services firms with dramatically different regulators. Insurers face 50 different state regulators and state laws, many of which differ on some particulars of insurance regulation. This has lead to industry complaints of overlapping, and sometimes contradictory, regulatory edicts driving up the cost of compliance and increasing the time necessary to bring new products to market. These complaints existed prior to GLBA, but the insurance industry generally resisted federalization of insurance regulation at the time. Facing a new world of competition, however, the industry split, with larger insurers tending to favor some form of federal regulation, and smaller insurers tending to favor a continuation of the state regulatory system. Life insurers tend to more directly compete with banks and securities firms, so they tend to favor some form of federal charter more than property/casualty insurers.

Some Members of Congress have responded to the changing environment in the financial services industry with a variety of legislation. In the 108th Congress, Senator Ernest Hollings

[1] *Paul v. Virginia* (75 U.S. (8 Wall.) 168 (1868)).

[2] *United States v. South-Eastern Underwriters Association* (322 U.S. 533 (1944)).

[3] P.L. 79-15, 59 Stat. 33,15 U.S.C. Sec. 1011 *et seq*.

[4] P.L. 93-406, 88 Stat. 829.

[5] The Federal Trade Commission Improvement Act of 1980, P.L. 96-252, 94 Stat. 374.

[6] H.R. 9, The Insurance Competitive Pricing Act of 1994, by Representative Jack Brooks.

[7] P.L. 106-102, 113 Stat. 1338.

introduced S. 1373 to create a mandatory federal charter for insurance. In the 108th and 109th Congresses, Representative Richard Baker drafted, but never introduced, the SMART Act[8] that would have left the states the primary regulators, but harmonized the system through various federal preemptions. The most consistent response has been the introduction of legislation calling for an Optional Federal Charter (OFC) for insurance.

OFC legislation was first introduced in the 107th Congress, with bills being introduced in the 109th and 110th Congresses as well. Specifics of OFC legislation can vary widely, but the common thread is the creation of a dual regulatory system, inspired by the current banking regulatory system. OFC bills generally would create a federal insurance regulator that would operate concurrently with the present state system. Insurers would be able to choose whether to take out a federal charter, which would exempt them from most state insurance regulations, or to continue under a state charter and the 50 state system of insurance regulation. Given the greater uniformity of life insurance products and the greater competition faced by life insurers, some have suggested the possibility of OFC legislation that would apply only to life insurers, but no such bills have been introduced.

Arguments for a Dual Regulatory System

In addition to the principal argument that the regulation of insurance companies needs to be modernized at the federal level to make insurers more competitive with other federally regulated financial institutions in the post-GLBA environment, other arguments advanced for dual chartering have included the following:

- The recent financial crisis has shown that some insurers present systemic risk and should be regulated by a regulator with a broad, systemic outlook.
- The need to have a federal insurance regulator who could have a knowledgeable voice and be an insurance advocate in Washington, DC.
- The success of the Comptroller of the Currency (OCC) in expanding bank products through preemption of state laws.
- The need for "speed to market" for product approval so insurers will not be at a distinct disadvantage in product creation and delivery.
- The creation of a more accommodating regulatory environment as a result of competition between federal and state regulators, as in the case of banks.
- The ability to achieve national treatment, so that a single charter would allow insurers to do business in all states and avoid higher costs of state regulation due to the need to comply with 50 state regulators.
- The difficulty insurers have in expanding abroad without a regulator at the national level.
- Greater supply of insurance and lower cost to consumers as insurance companies are forced to compete on a national scale.

[8] This act was the subject of a June 16, 2005, hearing in the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises entitled "SMART Insurance Reform."

Arguments Against a Dual System and for State Regulation

The arguments of those who oppose any federal regulation of insurance companies, but prefer that the state insurance regulatory system be maintained, have included the following:

- State regulated insurers have performed relatively well through the financial crisis, underscoring the quality of state regulation.
- State insurance regulators' unique knowledge of local markets and conditions.
- The flexibility and adaptability of state regulation to local conditions.
- The diversity of state regulation, which reduces the impact of bad regulation and promotes innovation and good regulation.
- The reduced risk that a regulator who pursues bad policies will be able to affect large numbers of insurers.
- The existence of strong incentives, such as direct election, for state regulators to do the job effectively at the state level.
- The danger of a costly overlay of a new federal bureaucracy.
- Fiscal damage to the states should state premium taxes be reduced by the federal system.[9]
- The fragmentation of the overall insurance regulatory system that could result from dual chartering and state/federal oversight.
- The possibility of a "race to the bottom" as state and federal regulators compete to give insurers more favorable treatment and thus secure greater oversight authority and budget.

In the abstract, the OFC question could be simply about the "who" of regulation. Should it be the federal government, the states, or some combination of the two? In practice, however, OFC legislation has had much to say about the "how" of regulation. Should the government continue the same fine degree of industry oversight that states have practiced in the past? The OFC bills that have been introduced to this point have tended to answer the latter question negatively—the federal regulator that they would create would exercise less regulatory oversight than most state regulators. This deregulatory aspect of past and present OFC bills can be as great a source of controversy as the introduction of federal regulation itself.

[9] Premium taxes on insurance are a significant source of revenue for states' general funds. In 2007, states collected approximately $15.3 billion in premium taxes. "2007 State Government Tax Collections" U.S. Census website http://www.census.gov/govs/www/statetax07.html.

Optional Federal Chartering Legislation

110th Congress

The National Insurance Act of 2007

Senators John Sununu and Tim Johnson introduced S. 40 on May 24, 2007, whereas Representatives Melissa Bean and Edward Royce introduced H.R. 3200 on July 26, 2007. The bills were referred to the relevant committees (Senate Banking, Housing, and Urban Affairs, House Financial Services, and House Judiciary), but neither was the specific subject of hearings or markups. Two general hearings on insurance regulatory reform, however, were held by the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises in October 2007, and the possibility of an optional federal charter was a major topic of discussion in the subcommittee.

S. 40 and H.R. 3200 were very similar, but not identical bills. Both would have created the option of a federal charter for the insurance industry, including insurers, insurance agencies, and independent insurance producers. The bills would have created a federal regulatory and supervisory apparatus, including an Office of National Insurance and a National Insurance Commissioner. This federal regulator would generally have been overseen by the Secretary of the Treasury, but the secretary would have been forbidden from interfering in specific matters before the commissioner. The budget for the office would have been paid for by fees and assessments on insurers. The commissioner would have been appointed by the President, and confirmed by the Senate for a five-year term. Holders of a national license would have been exempt from most state insurance laws. Thus, nationally licensed insurers, agencies, and producers would have been able to operate in the entire United States without fulfilling the requirements of the 50 states' insurance laws. Some significant aspects of the bills included the following:

- The federal system would have applied to property/casualty and life insurance, except for title insurance and including surplus lines insurance.[10]
- Rate regulation would not have been applicable to national insurers.
- Form regulation, the ability of the regulator to control what will and will not be included in an insurance policy, would have been reduced substantially compared to most states.
- Fees covering the cost of the system would have been assessed on those operating under the federal system.
- National insurers would have continued to pay state premium taxes, so there should be no loss of premium tax revenue to the states.
- National insurers would have continued to be subject to state laws requiring participation in residual market entities, but only if rates charged by the residual

[10] Surplus lines insurance is insurance sold by insurers who are not licensed to sell insurance in particular state. See CRS Report RS22506, *Surplus Lines Insurance: Background and Current Legislation*, by Baird Webel, for more information on this insurance.

market entity covers all costs incurred, and only if there were no rate and form requirements concurrent with participation.

- Reform of the state regulation of surplus lines insurance—only the state in which the insured resides or does business would be allowed to tax surplus lines insurance.
- National insurance producers would have been allowed to sell surplus lines insurance.
- Would have applied federal antitrust laws to national insurers, except to the extent that state laws continue to apply to them.

Differences between S. 40 and H.R. 3200 are relatively minor, including the following:

- H.R. 3200 would have specifically allowed non-U.S. reinsurers to file financial data in accordance with International Financial Reporting Standards.
- H.R. 3200 would have limited jurisdiction over non-U.S. reinsurers to federal courts, rather than including state and local courts.
- H.R. 3200 would have broadened slightly and clarify anti-fraud language.

Beyond the general aspects inherent in the OFC concept, such as the dual, competing regulatory structures and uniform regulation across the country, the most striking specific aspect of S. 40 and H.R. 3200 was the lessening of the rate and form regulation under these bills as compared to the current system. Currently every state has some measure of rate and form regulation.[11] In some states, insurers must get specific prior approval for changes to rates and forms, while in others insurers may have some freedom to change rates and forms with the possibility that the state insurance commissioner could disallow the change after the fact. S. 40 and H.R. 3200 specifically disallowed rate and form regulation for national property/casualty insurers. Such insurers would have been required only to maintain copies of the policy forms that they use. National life insurers would have been subject to general standards and a requirement to file forms with the commissioner before these forms would have been used.

109th Congress

The National Insurance Act of 2006

Senators John Sununu and Tim Johnson introduced S. 2509 on April 5, 2006. The House companion, H.R. 6225 was introduced on October 18, 2006. Neither bill saw direct committee action, although S. 2509 was repeatedly discussed at a hearing on "Perspectives in Insurance Regulation," held by the Senate Banking, Housing, and Urban Affairs Committee on July 18, 2006. These bills were very similar to the bills of the same name introduced in the 110th Congress and discussed above. Differences between the bills in the two Congresses included the following:

[11] A chart of various state regulations can be found at the website of the Insurance Information Institute, a property/casualty insurer organization. http://www.iii.org/media/hottopics/insurance/ratereg/?table_sort_575580=3,.

- The 2006 bills did not address surplus lines insurance.
- The 2007 bills added language requiring national insurer compliance with anti-money laundering laws.
- The 2007 bills specifically exclude national insurers from offering title insurance.
- The 2007 bills included new guaranty fund language, changing the focus from a qualified state, to a qualified association or fund. If a state's guaranty fund is not qualified, then the national insurers operating in that state must join the national guaranty fund to be established by the National Insurance Commissioner.

107th Congress

The Insurance Industry Modernization and Consumer Protection Act

H.R. 3766 was introduced on February 14, 2002, by Representative John LaFalce. It would also have created an optional federal charter for "national insurers," but not for insurance agencies, brokers, or agents. It would have created a new federal agency within the Treasury Department, known as the Office of National Insurers and headed by a director, rather than a commissioner. Other significant aspects of H.R. 3766 included the following:

- The federal charter could provide for a national insurer to underwrite both life insurance and property/casualty insurance.
- The director would have had general regulatory authority over national insurers, including solvency oversight and policy forms, but rate regulation would have been left with state insurance regulators.
- Even though the legislation had no provision for the licensing of insurance producers, the director would have had the authority to enforce unfair and deceptive practices rules against state-licensed producers with respect to the sale of insurance products issued by national insurers, and all states would have been subject to federal minimum standards.
- National insurers would have been encouraged to invest in the communities in which they sell policies.
- National insurers would have been required to file reports containing community sales data for use by federal regulators in combating insurance redlining. Further, national insurers would have been prohibited from refusing to insure, or limiting coverage on a property, based solely on its geographic location.

The National Insurance Chartering and Supervision Act

This proposal was reportedly introduced late in 2001 by Senator Charles Schumer, but was never assigned a number, nor referred to either the Senate Commerce Committee or the Senate Banking, Housing, and Urban Affairs Committee.[12] A draft of this proposal[13] provided that the

[12] See, for example, "Chartering Bill Introduced; Industry Divided on Federal Proposal," *Business Insurance*, Jan. 7, 2002, p. 1 and "Schumer working on Federal Regulation and Terrorism Backstop Bills in the Senate," *BestWire*, Mar. 13, 2002.

chartering, supervision, and regulation of National Insurance Companies and National Insurance Agencies be administered by the federal government in a newly created federal agency within the Treasury Department. The proposed agency, the Office of the National Insurance Commissioner, would have been headed by the National Insurance Commissioner, appointed for a five-year term by the President and subject to Senate confirmation. National insurers and agents would have been exempt from most state insurance law. Significant aspects of the bill included

- application to all lines of insurance, including life, health, and property/casualty;
- imposition of fees as necessary to cover the expenses of the federal apparatus; and
- requirement that NICs participate in "qualified" state insurance guaranty associations and establishment of a federal backup guaranty association to cover "non-qualifying" states.

The broad powers granted to the National Insurance Commissioner were not to include the authority to regulate rates or policy forms. Nor would the Schumer proposal have exempted federally chartered NICs from anti-trust laws, except for purposes of preparing policy forms and participating in state residual market programs such as assigned risk pools in automobile insurance. The federal license would have specified the line or lines of insurance a NIC could underwrite, and no single NIC could be licensed to underwrite both life/health insurance and property/casualty insurance, although an affiliated group of insurance companies (state and/or federally chartered) could have included separate companies writing those different lines of insurance.

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[13] Draft Language can be found under "Testimony" at http://www.aba.com/ABIA/ABIA_Reg_Mod_Page.htm.