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Insurance Regulation and Competition: Background and Issues

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SUMMARY

Insurance companies make up a major segment of the U.S. financial services industry. However, unlike banks and other financial institutions that are regulated primarily at the federal level, insurance companies are regulated by the states. As financial services have converged in response to globalization and other market factors, the seemingly arbitrary distinctions separating various financial products and services, as well as their providers, have broken down.

In 1999 Congress passed the Gramm-Leach-Bliley Act (GLBA) to reflect marketplace changes and to overhaul the laws governing financial institutions. Rather than changing the regulatory structures in place for the various financial institutions, GLBA embraced the concept of "functional" regulation. In the process it specifically reaffirmed the regulation of insurance by the states as granted by the 1945 McCarran-Ferguson Act. Since 1945 Congress has reviewed the jurisdictional stewardship entrusted to the states under McCarran-Ferguson on various occasions. However, until recently efforts to transfer insurance regulatory authority back to the federal government were opposed by both the states and a united insurance industry.

Some insurers now claim that in view of the growing convergence of financial services and products, they find themselves at a competitive disadvantage because of the inefficiencies associated with being regulated by the states. For example, life insurers selling products aimed at retirement and asset accumulation must now compete with similar bank products. While banks can roll out their new products nationwide in a matter of weeks, it sometimes takes 2 years or more for an insurer to obtain the necessary state approvals for a national launch of a similar product. As a result, many insurers selling such products are calling upon Congress to pass legislation reinstating the federal government's insurance regulatory role.

The House Financial Services Committee has been looking into the current state insurance regulatory structure, and during the 107th Congress its subcommittees held six hearings. The first three hearings focused on the inefficiencies and lack of uniformity in current state insurance regulation, and the second three hearings reviewed various proposals for reform, including optional federal chartering and regulation of insurers. The insurance industry is divided on the issue of whether the federal government should assume any regulatory role. Major trade groups of some of the largest insurers and brokers are actively advocating a dual state/federal insurance regulatory system that would allow an insurer the option of obtaining a federal charter and being regulated at the federal level. Other segments of the insurance industry would prefer to see the states modernize the current system, rather than establish any federal system.

Legislation in the House and Senate is modeled on the dual state/federal regulation that now exists for the banking industry, but most consider it very unlikely that the 107th Congress will address either measure. It is anticipated that additional proposals for a dual state/federal regulatory system, including additional optional federal chartering proposals, will garner more consideration by the 108th Congress.

Most Recent Developments

During June 2002, the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services, chaired by Representative Richard Baker, held a series of three hearings on "Insurance Regulation and Competition for the 21st Century." The June 2002 hearings followed three previous hearings in 2001 on the current structure of state insurance regulation, and reviewed various proposals for insurance regulatory reform, including optional chartering of insurers at the federal level. Legislation providing for optional federal chartering has been introduced in the House (H.R. 3766), and also in the Senate, though the latter has not yet been assigned a number. Representative Baker has announced that he intends to unveil legislation early in 2003 to modernize and streamline insurance regulation. Various insurance interests are also currently working on updating their own competing proposals to revamp and modernize the regulation of insurance.

Background and Analysis

Present Regulatory Structure

Insurance companies comprise a major segment of the U.S. financial services industry. However, unlike banks and other financial institutions that are regulated primarily at the federal level, insurance companies have been regulated by the states for the past 150 years. The legal basis for insurance regulation by the states goes back to an 1868 decision of the U.S. Supreme Court which held that insurance was not interstate commerce, and thus not subject to regulation by the federal government under the Commerce Clause of the U.S. Constitution. Courts followed that precedent for the next 75 years. Then, in 1944, the U.S. Supreme Court reversed its 1868 ruling and held that insurance is, in fact, interstate commerce, and subject to federal oversight. By that time, however, the state insurance regulatory structure was well established, and a joint effort led by state regulators and insurance industry leaders to overturn the decision legislatively led to the passage of the McCarran-Ferguson Act of 1945. That act suspended federal powers to regulate insurance, subject to "effective" insurance regulation by the states, and granted a limited federal antitrust exemption to the insurance industry.

After 1945, the jurisdictional stewardship entrusted to the states under McCarran-Ferguson was reviewed by Congress on various occasions. Each time proposals were made to transfer insurance regulatory authority back to the federal government, they were met by opposition from the states as well as from a united insurance industry. Generally, such proposals for federal oversight spurred a series of regulatory reform efforts at the state level and by the National Association of Insurance Commissioners (NAIC). Such efforts were directed at correcting perceived deficiencies in state regulation in order to forestall a federal regulatory takeover, and were generally accompanied by pledges from state regulators to work for more uniformity and efficiency in the state regulatory process.

A major effort to transfer insurance regulatory authority to the federal government was undertaken in the mid 1980s, following insolvencies of several large insurance companies. Representative John Dingell, who at that time chaired the House Commerce Committee which had jurisdiction over insurance, questioned whether state regulation was up to the task of overseeing such a large and diversified industry. He conducted several hearings on the state regulatory structure and also proposed legislation that would have created a federal insurance regulatory agency modeled upon the Securities and Exchange Commission (SEC). State insurance regulators and the insurance industry opposed his proposal and worked together on a series of reforms at the state level and at the NAIC, including a new state Accreditation Program setting baseline standards for state solvency regulation. Under such baseline standards, each state must have adequate statutory and administrative authority to regulate an insurer's corporate and financial affairs, and must also have the necessary resources to carry out that authority. In spite of such reforms, however, another breach in the state regulatory system occurred in the late 1990s, when Martin Frankel slipped through the oversight of several states and effectively "looted" a group of small life insurance companies of some $200 million. Such a breach was a major embarrassment to state regulation, but it did not have a long-term impact or bring additional calls for a federal regulatory system.

Factors Promoting Change

In 1999, Congress passed the Gramm-Leach-Bliley Act (GLBA – P.L. 106-102), an historic piece of legislation, which instituted a massive overhaul of the federal laws governing U.S. financial institutions. Support for the measure came largely as a result of changes in market forces, frequently referred to as "convergence." Convergence in the financial services context refers to the breakdown of distinctions separating different types of financial products and services, as well as the providers of once discreetly separate products. Drivers of such convergence are generally considered to be such emerging market forces as globalization, new technology, e-commerce, deregulation, market liberalization, increased competition, tighter profit margins, and the growing number of sophisticated consumers. The goals behind these driving forces, in turn, appear to be the increasing efforts of all financial services providers to find growth, gain market share, create new revenue streams, and enter new markets. For example, U.S. banks have looked to adjunct non-banking products such as insurance and pension products to increase their profitability, pointing to European "bancassurers" that generate 20% to 30% of their profits from the sale of insurance and investment products integrated into core retail banking businesses.

GLBA repealed federal laws that seemed inconsistent with the way that financial services products were actually being delivered, and removed many barriers that kept banks or securities firms from competing with insurance companies. The result was the creation of a new competitive paradigm in which insurance companies now find themselves in direct competition with brokerages, mutual funds, and commercial banks. GLBA did not, however, change the basic regulatory structure for insurance or other financial products. Instead, it specifically reaffirmed the 1945 McCarran-Ferguson Act which had granted insurance regulatory authority to the states, thereby recognizing state insurance regulators as the "functional" regulators of insurance products and those who sell them. Some insurance companies believe that in this new environment, state regulation places them at a competitive marketplace disadvantage. They maintain that their new non-insurer competitors in certain lines of products have far more efficient federally based systems of regulation, while they are subject to the perceived inefficiencies of state insurance regulation, such as the regulation of rates and forms as well as other delays in getting their products to market. For example, life insurers with products aimed at retirement and asset accumulation must now compete with similar bank products; however, banks can roll out such new products nationwide in a matter of weeks, while some insurers maintain that it can take as long as 2 years or more to obtain all the necessary state approvals for a similar national insurance product launch.

GLBA also addressed the issue of modernizing state laws dealing with the licensing of insurance agents and brokers and made provision for a federal licensing agency, the National Association of Registered Agents and Brokers (NARAB), which would come into existence only if the states failed to enact the necessary legislation for state uniformity or reciprocity.

State Regulatory Response

Following the passage of GLBA, state insurance regulators working through the NAIC embarked on an ambitious regulatory modernization program in response to both the mounting criticisms of state insurance regulation and the recognition of the growing convergence of financial services and financial services products. In early 2000, NAIC members signed a *Statement of Intent: The Future of Insurance Regulation*, in which they pledged "to modernize insurance regulation to meet the realities of the new financial services marketplace" and "to work cooperatively with all our partners – governors, state legislators, federal officials, consumers, companies, agents and other interested parties – to facilitate and enhance this new and evolving market place as we begin the 21st Century." New NAIC Working Groups were formed and charged with addressing the various changes needed to implement those provisions of GLBA requiring regulatory action such as that needed to prevent NARAB from coming into existence, and also to update and modernize state regulation in other ways not required by GLBA but needed to deter growing industry support for federal oversight. The NAIC's new groups addressed such key issues as state privacy protections, reciprocity of state producer licensing laws, promotion of "speed to market" of new insurance products, development of state-based uniform standards for policy form filings, and other proposed improvements to state rate and form filing requirements.

According to NAIC, the states are now well underway in their efforts to modernize state regulation in those areas where improvements are needed. NAIC maintains that states are better positioned than the federal government to serve the interests of American insurance consumers, emphasizing that state regulators are better able to make sure that the personal interests of consumers are not lost in the arena of commercial competition. To support this position, the NAIC points out that during 2000, a total of some 12,500 state insurance regulatory personnel were employed by the states at a cost of $880 million, and the states handled approximately 4.5 million consumer inquiries and complaints regarding their policies and their treatment by insurance companies and agents. The NAIC reports that as to GLBA's NARAB provision on producer licensing reform, 46 states had enacted legislation as of June 2002, and subsequently at least 35 were preliminarily certified as having full reciprocity – far more than the 29 states needed under GLBA to prevent the establishment of NARAB. Even though state regulatory uniformity has always been one goal of the NAIC, it does concede that in view of differing state legal systems, complete uniformity may be an illusory goal in many lines of insurance products, and not necessarily required to maintain the degree of effective state regulation required by McCarran-Ferguson. However, in the area of life insurance, the NAIC acknowledges that the more national nature of life insurance products argues for true uniformity. As a result, the NAIC is currently drafting an interstate compact requiring such uniformity for certain life insurance products, believing that such a compact is the best mechanism to achieve it.

State regulators, in carrying out their pledge to modernize state insurance regulation by instituting the reforms needed in the state regulatory structure, hope to satisfy those within the insurance industry who feel that their needs would be better served by a federal regulatory structure, or by a dual regulatory structure where insurance companies could choose to be regulated either at the state or federal level. One distinguishing feature of this latest effort by the states to improve state insurance regulation and maintain their jurisdiction over it is that this time the insurance industry itself is not united in its support of state regulation.

Instead, the industry is sharply divided, with some segments committed to an improved state-based regulatory structure, and others firmly in support of obtaining from Congress the option to be regulated at the federal level. Three industry trade groups, the American Council of Life Insurers (ACLI), the American Insurance Association (AIA), and the American Bankers Insurance Association (ABIA), have released draft legislative proposals for the creation of an optional federal charter for insurance companies. Other industry groups, including the Alliance of American Insurers (AII), the National Association of Independent Insurers (NAII), and the National Association of Mutual Insurance Companies (NAMIC), are opposed to any federal legislation, preferring that the needed regulatory improvements be made by the states.

Congressional Response

In the wake of the passage of GLBA, the U.S. House of Representatives in the 107th Congress reorganized its committee structure to reflect the convergence in the financial services arena. Jurisdiction over most insurance matters was transferred to the newly formed Financial Services Committee, which incorporated in its Oversight Plan or agenda, several insurance-related issues that it intended to look into, including the following:

- Insurance Marketing: "...examine a number of consumer protection issues...including the churning of life insurance, sales and marketing representation, coercion and pressure tactics, product bundling, excessive premium charges for credit insurance and mortgage insurance, and Internet marketing of insurance products."

- Insurance Solvency Regulation: "...examine the current accreditation program of the NAIC that judges the adequacy of state insurance regulatory systems."

- Insurance Fraud: "...examine the efforts by the States, the NAIC, and other entities, to locate and fight insurance fraud, particularly in implementing reforms developed after the Martin Frankel scandal."

- NARAB Implementation: "...determine whether a sufficient number of States are implementing uniform or reciprocal insurance agency licensing rules as required under the NARAB Title of GLBA, and what further measures are necessary to promote uniformity in insurance licensing."

- Insurance Product Approval: "...review the 50 State approval process for allowing new insurance products and forms to be admitted into the insurance markets."

- National Insurance Uniformity: "...review various alternatives for modernizing the regulation of insurance, including reform efforts by the NAIC, development of interstate and regional regulatory compacts, facilitation of nationwide state – run insurance regulation programs, proposals for an optional federal insurance charter, and other reforms for improving the efficiency and effectiveness of insurance regulation."

Legislation in the 107th Congress

Senate

Legislation first presented on December 20, 2001, by Senator Schumer to provide for an optional federal charter for insurers has not been assigned a number. It is entitled "The National Insurance Chartering and Supervision Act" (NICSA), and is modeled on the dual state/federal regulation that now exists for the banking industry and would enable insurance companies and agencies to choose between state or federal regulation. It provides that the chartering, supervision, and regulation of National Insurance Companies(NICs) and National Insurance Agencies (NIAs) be administered by the federal government in a newly created federal agency within the Treasury Department. The new agency would be known as the Office of the National Insurance Commissioner (ONIC), and it would be headed by the National Insurance Commissioner, who would be appointed for a 5-year term by the President, subject to Senate confirmation. In addition to chartering new NICs and approving conversions of current state chartered insurers into NICs, NICSA provides that the National Insurance Commissioner would have regulatory and supervisory powers that would include the following:

- Regulation of all lines of insurance, including life, health, and property/casualty;
- Establishment of a main office in Washington, DC, and six regional offices;
- Imposition of fees as necessary to cover the expenses of the ONIC;
- Establishment of insurance policy standards;
- Establishment of capital, reserve, and accounting standards for insurance policies;
- Enforcement of financial and market conduct standards;
- Approval of any changes in control of NICs, and any merger and consolidation if the NIC is the surviving entity;
- General enforcement authority, including license revocation or suspension, cease and desist orders, and the imposition of civil money penalties;
- Licensing and regulation of NIAs and agents (producers) who sell insurance for NICs;
- Licensing and regulation of federally qualified reinsurers; and

- Requiring NICs to participate in "qualified" state insurance guaranty associations and creating a federal backup guaranty association to cover "non-qualifying" states.

The broad powers granted to the National Insurance Commissioner would not include the authority to regulate rates or policy forms. Nor would the Schumer proposal exempt 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.

NICSA provides that a NIC could be organized as a stock, mutual, or fraternal company, allows the conversion of mutual companies to stock companies, and contains provisions for the regulation of insurance holding companies. However, regardless of a NIC's form, it would not be able to engage in any underwriting activities until it received a license from the National Insurance Commissioner. The license would specify the line or lines of insurance the 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 separate companies writing those different lines of insurance. Receivership provisions for NICs are also included and provide that the venue for receivership proceedings would be the U.S. District Court that has jurisdiction over the NIC's main office.

House of Representatives

H.R. 3766 was introduced on February 14, 2002, by Representative LaFalce, and is entitled "The Insurance Industry Modernization and Consumer Protection Act" (IIMCPA). It would also create an optional federal charter for National Insurers (NIs), but not for insurance agencies, brokers, or agents. Like the Schumer proposal, it would create a new federal agency within the Treasury Department, but the agency would be known as the Office of National Insurers (ONI) and would be headed by a Director, rather than a Commissioner. Although H.R.3766 is similar in some respects to the Schumer bill and the ACLI draft proposal, H.R. 3766 has some significant differences, including the following:

- The charter could provide for a NI to underwrite both life insurance and property/casualty insurance;
- The Director would have general regulatory authority over NIs, including solvency oversight and policy forms, but rate regulation would be left with state insurance regulators;
- Even though the legislation has no provision for the licensing of insurance producers, the Director would have the authority to enforce unfair and deceptive practices rules against state-licensed producers with respect to the sale of insurance products issued by NIs, and all states would be subject to federal minimum standards;
- NIs would be encouraged to invest in the communities in which they sell policies;
- NIs would be required to file reports containing community sales data that could be used by federal regulators to combat insurance redlining, and could not refuse to insure, or limit coverage on, a property based solely on its geographic location.

Congressional Hearings During the 107th Congress

During the 1st Session of the 107th Congress, subcommittees of the Financial Services Committee held three hearings to examine the current structure of insurance regulation and assess its current inefficiencies. In May 2001, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing on state efforts to comply with the NARAB Title of GLBA, which requires a minimum of 29 states to institute producer licensing reciprocity or face activation of a federal licensing agency, known as the National Association of Registered Agents and Brokers (NARAB). In June 2001, the same subcommittee held a hearing to review the state regulatory approval process for new insurance products, referred to as "speed to market." In August 2001, a third hearing to review whether "over-regulation" of automobile insurance denies consumers choice and competition was held by the Subcommittee on Oversight and Investigations. The committee had originally planned for additional hearings to be held during 2001, but those plans were put on hold following the events of September 11.

During the 2nd Session of the 107th Congress, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises transitioned from examining state regulatory inefficiencies considered during the 1st Session to reviewing various proposals for reform. It held a series of three hearings under the heading of "*Insurance Regulation and Competition for the 21st Century*." A brief summary of the highlights from those hearings follows.

June 4, 2002 Hearing.. Representative Richard Baker, chairman of the subcommittee, indicated in his opening remarks that the hearings were to be the first step toward legislative recommendations for action on insurance regulatory reform. He said that it is clear that some sort of regulatory reform is in order because insurance products that are not labeled as such can enter the marketplace more freely than those labeled as insurance. Two panels of witnesses representing banking and insurance companies and agents agreed that insurance regulation needs to be reformed, but they were divided over whether the best way to accomplish the needed reform would be to establish an optional federal charter and regulatory system, or to reform the current state regulatory system. Chairman Baker emphasized that if states believe that they can adequately reform the existing state system, they should be given a reasonable time limit in which to do so before Congress determines that it must act. He also added that the hearings would be a "first step" toward his drafting some type of proposed legislation to reform and streamline insurance regulation that could be unveiled in 2003, but that he had no preconceived ideas as to any specific legislation at this time.

June 11, 2002 Hearing. Representative Michael Oxley, chairman of the full committee, gave an opening statement urging a "go-slow" approach to the task of reforming insurance regulation, and expressing his hope that the necessary state-based reforms could be set in place so that no federal action would be necessary. The witnesses, representing individual insurers and various trade associations, again expressed differing opinions as to whether Congress should pass optional federal chartering legislation, or take any action to require the states to make specific reforms in order to improve the position of insurers in competition with other financial institutions. Subcommittee Chairman Baker repeatedly attempted to get witnesses to recommend a "time-line" during which the states would have to make the reforms necessary to obtain the goal of modernizing state regulation and create a more level playing field for insurers in the financial services marketplace.

June 18, 2002 Hearing. Most of the witnesses at this hearing were again representatives of insurance industry groups with definite positions for or against dual chartering. However, one agent group announced it was developing a "middle ground" approach under which the states would continue to regulate insurance, but under certain federally mandated standards. The president of a small life insurance company gave concrete examples of problems his company has experienced with the current state regulatory system and asked that if Congress does enact federal chartering legislation, small companies like his not be excluded by high capital or revenue minimums. The president of the NAIC testified that state regulators are well on their way in their efforts to modernize state regulation, and that any federal legislation dealing with insurance regulation would carry the risk of undermining state consumer protections due to unintended or unnecessary preemption of state laws and regulations.

Two other hearing-related events took place that had a bearing on the issues considered at the June 18 hearing. First, the General Accounting Office (GAO) released a statement for the record (GAO-02-842T) in which it concluded that even though the NAIC has made a concerted effort in promoting more uniform regulatory processes and requirements, it may not be able to achieve uniformity in certain areas, and that "... ongoing federal oversight and, possibly, federal intervention may be needed to provide impetus for positive change and continuing improvement in state regulation of insurance." Second, a group of some of the largest financial services trade groups favoring optional federal charter legislation (Financial Services Coordinating Council, American Bankers Insurance Association, American Council of Life Insurers, American Insurance Association, Council of Insurance Agents and Brokers, and Financial Services Roundtable) announced prior to the hearing that they had formed a coalition dedicated to establishment of "...a chartering system for insurers that mirrors the existing dual banking system, which allows banks to choose between state and federal regulators."

For Additional Reading

For additional information on the background of state insurance regulation and proposals before Congress, see CRS Report RS21153, *Optional Federal Chartering for Insurers: Legislation and Viewpoints*, by S. Roy Woodall, Jr.

For additional information on the major insurance industry groups and how they differ in their positions on federal chartering of insurers, as well other organizations with an interest in federal chartering and regulation of the insurance industry, see CRS Report RS21172, *Optional Federal Chartering for Insurers: Major Interest Groups*, by S. Roy Woodall, Jr.

For additiional information on P.L. 106-102, see CRS Report RL30375, *Major Financial Services legislation, The Gramm-Leach-Bliley Act: An Overview*, by William D. Jackson and F. Jean Wells.