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Insurance Regulation: Background and Issues

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Contents

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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 for the various financial institutions, GLBA embraced the concept of "functional" regulation. 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. Until recently, however, 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.

Legislation presented in the 107th Congress was modeled on the dual state/federal regulation that now exists for the banking industry. The 107th Congress did not address either measure, but it is anticipated that proposals for increased federal involvement in insurance will garner some consideration in the 108th Congress. Such consideration is expected by some observers to be informed by analysis of the perceived effectiveness, or ineffectiveness, of the states assuming the duties conferred on them in the Terrorism Risk Insurance Act of 2002.

Finally, the sunset of the Fair Credit Reporting Act's preemption of state laws on sharing credit information among affiliates will likely lead to a debate over who should regulate insurers' use of medical and financial information. Insurers' use of credit scoring in underwriting homeowners and automobile insurance may be a part of that debate, as may the absence of uniform privacy protections among the states. Critics of GLBA's privacy provisions will also join the discussion. At issue will likely be the both the effectiveness and efficiency of state regulation.

Most Recent Developments

A series of hearings on insurance in the House Financial Services Committee has begun with subcommittee hearings on April 10 and May 6, 2003. In an effort mandated by Congress in the Terrorism Risk Insurance Act of 2002, federal and state regulators continue to cooperate closely to make the marketplace for terrorism insurance work for businesses, consumers, and insurers. During the 107th Congress, legislation providing for optional federal chartering was introduced in the House and presented in the Senate, but neither piece of legislation was acted upon. Various insurance interests are currently working on updating their own proposals to 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, insurance companies have been regulated solely by the states for the past 150 years. This stems from a 1868 decision of the U.S. Supreme Court 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 was 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 relinquished to the states federal authority 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 they 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 chaired the House Commerce Committee that 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 on 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 those standards, in order to obtain and retain its accreditation, each state must have adequate statutory and administrative authority to regulate an insurer's corporate and financial affairs and 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 looted a number 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) 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. NAIC maintains that states are better positioned than the federal government to serve the interests of American insurance consumers, emphasizing that state regulators are more 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. Also, it reports that as of May 2003 it had certified 38 states as reciprocal jurisdictions – substantially more than the 29 states needed under GLBA to prevent the establishment of NARAB. Critics note, however, that several large states, notably California, New York, and Florida are not among this number.

The NAIC does concede that, in view of differing state legal systems, complete uniformity may be an illusory goal, but state regulators believe that uniformity is not required to maintain the level of effectiveness required by McCarran-Ferguson. The NAIC has acknowledged, however, that the more national nature of life insurance products argues for true uniformity. As a result, the NAIC recently endorsed an interstate compact to promote regulatory uniformity for certain life insurance products, believing that such a compact is the best mechanism to achieve uniformity within a state framework.

State regulators, in carrying out their pledge to modernize state insurance regulation, 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. The insurance industry itself is divided, with smaller insurers committed to improving the state-based regulatory structure, and larger insurers to supporting a dual regulatory system. Three industry trade groups, the American Council of Life Insurers (ACLI), the American Insurance Association (AIA), and the American Bankers Insurance Association (ABIA), have each released draft legislation creating an optional federal charter for insurance companies. They have recognized similarities among their proposals and interests and are now working together to reach a common position. Other industry groups, including the Alliance of American Insurers (the Alliance), 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.

Recent Legislative Activity

Formal Proposals

Legislation substantially changing the current regulatory structure for insurance has yet to be introduced in the 108th Congress, although two far-reaching pieces of legislation were proposed in the previous Congress.

Senator Schumer presented legislation in December 2001 to provide for an optional federal charter for insurers; it was not assigned a number during the 107th Congress. The legislation was modeled on the dual state/federal regulation that now exists for the banking industry and would have enabled insurance companies and agencies to choose between state and federal regulation. It would have created a new federal agency within the Treasury Department to charter, license, supervise, and regulate insurers and agents electing federal regulation. The new agency would also have had the powers to impose fees to fund its operations, to establish solvency and accounting standards, to enforce market conduct standards, to approve changes in control, and to license and regulate reinsurers. The legislation would also have required all insurers electing federal regulation to participate in either state insurance guaranty associations or a federal backup guaranty association. It would not have given the new agency authority to regulate insurance rates or policy content, nor would it have exempted federally regulated insurers from antitrust laws, except for very limited purposes.

Representative LaFalce introduced H.R. 3766 in February 2002. It would have created an optional federal charter for insurers, but not for insurance agents or brokers. Like Senator Schumer's proposal, it would have created a new federal agency within the Treasury Department. It was generally similar to Senator Schumer's proposal, but it differed in these ways:

- H.R. 3766 would have allowed a federally regulated insurer to underwrite both life insurance and property/casualty insurance in the same company.
- Though the new agency would have had general regulatory authority over insurers electing federal regulation, only state insurance regulators would have had authority to regulate rates.
- Though H.R. 3766 had no provision for the licensing of insurance producers, the new agency would have had the authority to enforce rules on

unfair and deceptive practices against state-licensed agents selling insurance for federally regulated insurers.

- It would have encouraged federally regulated insurers to invest in the communities where they sell policies.
- It would have required federally regulated insurers to file reports with community sales data to combat insurance redlining.

There were no hearings, markups, or committee reports on either Senator Schumer's proposal or on Representative LaFalce's H.R. 3766 during the 107th Congress.

Hearings

Continuing previous interest from the 107th Congress, the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held its first hearing on insurance issues during the 108th Congress on April 10, 2003, entitled: "*The Effectiveness of State Regulation: Why Some Consumers Can't Get Insurance*." Witnesses at the hearing addressed the general financial challenges facing the insurance industry as well as specific states' market experiences. A particular focus was on various states' regulatory policies. Positive experiences were highlighted in states, such as Illinois and South Carolina, which have less regulation, especially less direct regulation of rates. Negative experiences were highlighted in states, such as Louisiana and New Jersey, which have a greater amount of regulation and generally require prior approval for insurance rates.

Much of the questioning revolved around what sort of role the federal government might play in this area that has traditionally been left to the states. General support was expressed for continuing a state role in regulation of insurance, but various ideas for federal intervention were mentioned, including an optional federal charter, direct federal preemption of some state regulation, and a NARAB-like approach where threatened federal preemption might lead to changes by the states themselves. Chairman Baker closed the hearing by indicating that he did feel that modifications to the current system were in order, but that the shape of these modifications are yet to be determined.

The House Financial Services Subcommittee on Oversight and Investigations also held a hearing addressing insurance issues. The May 6, 2003 hearing was entitled "*Increasing the Effectiveness of State Consumer Protections.*" This hearing focused on market conduct examinations, which are exhaustive reviews by state insurance regulators of individual insurance companies' business practices and policies. The General Accounting Office (GAO) and the National Council of Insurance Legislators (NCOIL) separately have been studying issues relating to market conduct regulation and both presented preliminary findings of their studies at this hearing. There was general agreement among the witnesses that the current system of market conduct regulation needs improvement. Of particular concern was the lack of uniform standards and coordination between the states in how and when the examinations are conducted. Both NCOIL and NAIC are undertaking efforts to improve the current system. Questions were raised by GAO, however, as to the effectiveness and speed of these efforts; even when NCOIL or NAIC produce model legislation or practices, these must be then adopted by each state individually. Continued state regulation was strongly defended, but it was suggested that continuing congressional pressure might be necessary to encourage adoption of suggested changes.

Possible Future Legislative Activity

The Terrorism Risk Insurance Act of 2002 (TRIA), which created a federal backstop for insured terrorism losses, offers a new challenge for state regulation and may affect the debate over the effectiveness of state regulation. Under TRIA, the Secretary of the Treasury will administer the backstop program but states will continue to regulate the business of insurance. Some advocates of optional federal regulation of insurers anticipate that state regulation may fail to provide uniformly available and affordable terrorism insurance. Proponents of exclusive state jurisdiction anticipate that state regulation will prove adaptive to local circumstances and therefore successful in providing coverage for terrorism insurance. This debate may surface once Treasury completes its studies due under TRIA.

Other issues may arise during the 108th Congress that insurers favoring an optional federal charter will present as support for their position. These include privacy of medical and financial information generally, the lack of uniform protection among the states for that information, and insurers' use of credit scoring in underwriting automobile and homeowners insurance. It is likely that all these issues – including the effectiveness of state insurance regulation – will be raised during the oncoming debate over whether to renew the preemption in the Fair Credit Reporting Act for sharing credit information among affiliates.

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 additional 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.

For additional information on insurance scoring see CRS Report RS21341, *Credit Scores: Credit-Based Insurance Scores*, by S. Roy Woodall, Jr.

For additional information on financial privacy laws and the Fair Credit Reporting Act, see CRS Report RS21427, *Financial Privacy Laws Affecting Sharing of Customer Information Among Affiliated Institutions*, by M. Maureen Murphy.