

Insurance

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# Options remain open for federal insurance regulation

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There has been recurring support both in the US Congress and Treasury for an Optional Federal Charter (OFC), which would create a single federal insurance regulator as an alternative to the current state regulatory system. Barbara Law reviews the arguments for and against an OFC, provides updates on the status of the debate, and shares insight into what the future may hold.

OPTIONS REMAIN OPEN FOR FEDERAL INSURANCE REGULATION

Recent discussions about the federal government's role in insurance regulation are not novel. US lawmakers and judges have periodically evaluated the appropriate level of insurer oversight. However, the tradition of state insurance regulation, with the National Association of Insurance Commissioners (NAIC) facilitating the regulation of multistate insurers and industry support, has endured without significant challenges since the mid-part of the twentieth century.

**Calls for a federal charter**

In 1999, the Gramm-Leach-Bliley Act (GLBA) paved the way for US banks to own and operate securities firms and insurance companies. The emergence of a consolidated financial services industry highlighted the high cost of insurance regulatory compliance compared to other financial services sectors which operate pursuant to federal authority. Since then, multistate insurers – particularly life insurers whose products are most akin to securities and other financial products – have been increasingly in favor of federal regulation.

There has been recurring, bipartisan support in Congress for federal insurance regulation in the form of an Optional Federal

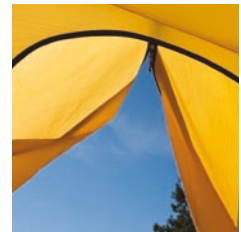
In 1945 Congress enacted the McCarran-Ferguson Act, which created a reverse pre-emption allowing states to primarily regulate insurance in most instances. Specifically, the Act states that, 'No act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance' ... unless such Act specifically relates to the business of insurance. 15 USC § 102(b). McCarran-Ferguson was a significant step in establishing the dominant role of states in this area and creating the environment for the current insurance regulatory framework.

Charter (OFC), which would create a single federal jurisdiction to regulate the financial condition and operations of chartered life and property and casualty insurers as an alternative to the current state regulatory system. The US Treasury also recommended an OFC in its March 31, 2008 'Blueprint for a Modernized Financial Regulatory Structure' (Blueprint). Recent legislation calling for an OFC includes:

- A single point of entry for company and producer licensing;
- Federal financial and market conduct exams;
- Utilization of statutory accounting for financial reporting;

- A five-year transition period, during which the Commissioner would monitor solvency utilizing the NAIC's financial regulation models and blanks;
- A reduction or elimination of product, underwriting and rate controls;
- Holding company provisions consistent with state provisions; and
- National consumer protection through consumer affairs, an insurance fraud division and an ombudsman.

Despite these suggested changes, there have been no apparent proposals to preempt state tax law, which uses state-based statutory accounting as a basis. In addition, state P&C laws that mandate access to



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certain coverages and require residual market participation would continue.

OFC proponents seek above all to minimize the costs of multijurisdictional compliance. Even those who strongly believe that state governments are the appropriate supervisors of insurers recognize the need to promote and achieve some level of uniformity across US jurisdictions. State commissioners, acting through the NAIC, coordinate regulatory efforts by establishing and administering accreditation programs for financial regulation, promoting model laws and regulations, standardizing financial reporting blanks, proscribing statutory accounting and risk-based capital standards, proscribing common procedures for financial and market conduct exams, and utilizing single-site electronic filing. However, as long as each jurisdiction ultimately remains autonomous in its domestic market, regulatory inconsistencies and redundancies will persist and compliance costs will remain high. Simply put, uniform insurance regulation has been no state's priority.

**The pros and cons of a federal charter**

Market and regulatory efficiencies resulting from an OFC may provide opportunities for both reduced expenses and increased revenue. Moreover, there is the potential for cost savings in licensing, distribution channel management, product development, and IT. There also

**US jurisdictions**

There are 56 insurance jurisdictions in the United States in all, including each of the 50 states, the District of Columbia, and the five US territories. Insurance Commissioner is an appointed position in the majority of jurisdictions. Commissioners are elected to office in eleven states.

Resources available to state insurance departments vary, as do the departments' approaches to regulation. Thanks to the NAIC financial accreditation program, there is a relatively high degree of uniformity among state laws and regulations that affect holding company transactions, financial solvency, and financial exams, but the degree of regulation in other areas that affect insurer operations is more disparate. This is particularly true with licensing and product development, including rate and policy form approvals, and the market conduct examination process. Moreover, while insurers are generally subject to financial examination solely by their domiciliary state, an insurer may be called upon to submit to a targeted or comprehensive market conduct examination at any time by any state in which it is licensed to transact business.

could be cost savings resulting from holding company and legal entity efficiencies if a single regulator oversees all transactions affecting affiliated legal entities. In turn, the insurance-buying public would enjoy cost savings through premium reductions.

Moreover, in addition to being costly, state regulation has been criticized for stifling product innovation and economic growth. This is due in large part to the unpredictable outcome and length of time associated with the launch of a new policy or contract. Accordingly, many industry participants and observers believe an OFC would increase product speed-to-market and spur competition and new product offerings.

Despite the likely advantages of an OFC, industry support has not been universal and state regulators strongly oppose any attempt to introduce a federal counterpart. Arguments in favor of the status quo and against an OFC or federal insurance regulation generally include:

- The fact that state-based regulation has been effective, and is responsive to local markets and consumers;
- An OFC or other federal regime would confuse consumers and simply create another layer of bureaucracy;
- A general lack of insurance expertise at the federal level compared to the state level;



- A federal regulator might not have the resources or expertise to respond to the volume or needs of consumers; and
- The suggestion that dual regulation would promote regulatory arbitrage, spur harmful competition (a 'race to the bottom') among jurisdictions, and serve to disadvantage local and regional insurers.

#### The status of a federal charter

Despite the often vigorous debate about it, OFC enactment is not imminent. In fact, the OFC remains little more than a concept. Even so, bipartisan support appears to have endured numerous Congressional hearings that have vetted interested parties' competing positions. Until very recently, there had been a growing sense even among opponents that the implementation of an OFC would occur during a future legislative session. Familiarity and confidence in the banking system suggested that the enactment of an OFC would not be a radical step for federal lawmakers. This sentiment was reinforced by the Bush administration with the release of the Blueprint and its endorsement of an OFC.

However, in the wake of recent market turmoil and a change in the US political landscape, the future of an OFC is now far from clear. Market events during the second half of 2008 have fueled continued discussion on the merits of federal versus state insurance oversight, but the

context of the debate has changed. Even if the Obama administration and the incoming Congress accept the virtues of centralized insurance regulation, their attention will likely be focused on shoring up financial markets and enhancing consumer protections. It is not clear what this might mean for the prospects of an OFC or insurance regulatory reform generally.

#### Debate continues

An OFC remains a viable mechanism to introduce a single US insurance regulatory framework, while preserving the current infrastructure for companies that would prefer to continue the relationship they have with their local insurance departments. However, for an OFC to gain acceptance, changes to past proposals may be inevitable. Future OFC legislation may expand sections related to consumer protections and omit provisions that may be construed as deregulation, such as the removal of existing rate and product controls. Even though economists strongly maintain that price restrictions drive up the cost of insurance, it is highly unlikely that Congress would move forward with any measures that might be construed as being anti-consumer. A change such as this, particularly as it affects the P&C industry, might stall any serious consideration of an OFC or invite the consideration of alternative approaches. To date, federal legislators have not been eager to take on regulatory

responsibilities at the level necessary to oversee insurer operations like the states do.

OFC alternatives include:

- A mandatory federal regulator for multistate insurers that would replicate the role currently served by state departments of insurance;
- Introducing federal regulation of solvency and/or holding company matters while preserving state regulation for consumer and market conduct issues;
- National standards for regulating certain areas of insurance, to be administered and enforced by state regulators, including financial and market conduct regulation, rate and policy forms, licensing, reinsurance, surplus lines, and insurer receiverships;
- Preserving state regulation but establishing federal minimal standards from which states could deviate to a limited degree; and
- Allowing insurers to elect a single US jurisdiction as a primarily licensing authority whose laws would then be held to govern that insurer's national operations regardless of other local standards.

These structures have various levels of support among stakeholders, and some have already been rejected in the past. Yet, it is doubtful that any option would be off the table if the

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federal government is persuaded that some degree of regulatory insurance reform is necessary, and that such reform is best implanted on an institutional or industry basis.

State insurance regulators hope this will not be the case. Amidst bank takeovers and liquidity shortfalls at federally regulated entities, state insurance regulators are pointing to the relative stability of the insurance industry as proof that monitoring solvency at the state level has been very successful. This appears to be a valid point, but to what extent have recent developments reframed the debate beyond traditional turf wars?

Crediting state regulation as a success would be an acknowledgement of the effectiveness of current solvency monitoring mechanisms, such as statutory financial reporting, reliance on risk-based capital formulas, insurer investment provisions, dividend restrictions, and the role of the SVO in asset valuation. But, there is nothing to prevent a federal insurance regulator from permanently adopting the states' approach under an OFC or other federal regulatory system. Ideally, effective insurance regulation will

not be dependent on the identity or the government level of the administrator or enforcer.

Future discussions regarding the prospect of federal insurance regulation, which may or may not involve an OFC, are likely to be in the context of broad regulatory reforms to the financial services industry as a whole. If reform aims to consolidate and eliminate potentially redundant administrative agencies, reforms may extend beyond state-based regulation or an OFC. As distinctions between financial service products and firms continue to erode, advocates of state insurance regulation may find it increasingly difficult to shield the insurance sector from efforts to streamline regulation.

The modernization of financial services regulation may very well entail a transition away from product or industry-based regulation to a risk-based regulatory scheme where a regulator or regulators would safeguard against market failures across FS sectors. A consolidated form of financial services regulation might take a 'peaks' approach, which the Blueprint recommendation recommends and which had been discussed favorably by Paul

Volcker, President Obama's Economic Recovery Advisory Board chairman. This type of structure delegates regulatory authority based on objective. For example, under a twin peaks approach a single regulator would monitor the financial condition of financial services companies and another would focus on market conduct and consumer protection matters.

All told, there is still considerable uncertainty about the best resolution to the federalism debate in what is a global insurance market. Whatever does (or does not) result, it is fundamental that regulators across financial services share and publically stress the same goals: monitoring solvency and protecting consumers. Attaining these objectives in an environment that maximizes efficiencies and avoids unnecessary costs provides a compelling focus for any regulatory reforms, regardless of government level, or whether insurance-specific or applicable to the financial services industry as a whole. Only when all of this is attained will a regulatory framework fully realize its potential to effectively balance the interests of consumers, investors, and industry. □

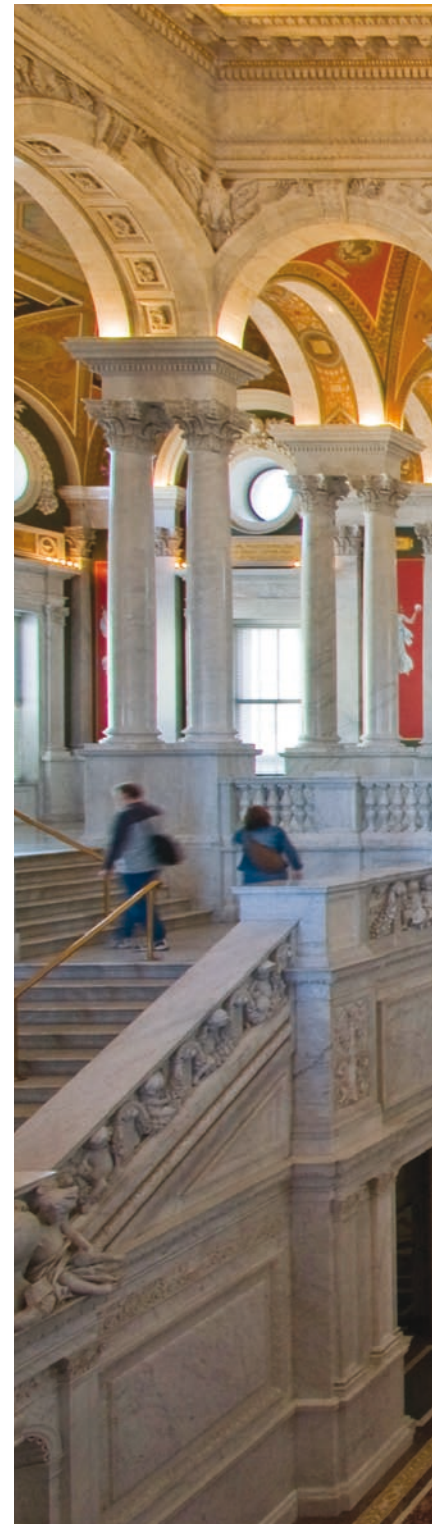
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OPTIONS REMAIN OPEN FOR FEDERAL INSURANCE REGULATION continued



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