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Insurance Regulation and Competition: Background and Issues

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Carolyn Cobb, Insurance Consultant
Government and Finance Division

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Insurance Regulation and Competition: Background and Issues

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. Though the 107th Congress did not 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.

Analogies to the perceived effectiveness of state regulation of insurance in assuming the duties conferred in the Terrorism Risk Insurance Act of 2002 will likely infuse discussions of optional federal chartering during the 108th Congress. Some insurers may argue that the Act's implementation presented a test case for state insurance regulation, which they may say has failed. State regulators and other insurers will likely view the states' implementation of the Act as successful.

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

Most Recent Developments

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. In an unprecedented effort mandated by Congress in the Terrorism Risk Insurance Act of 2002, federal and state regulators are cooperating closely to make the marketplace for terrorism insurance work for businesses, consumers, and insurers.

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. That 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 and 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 some 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. Most financial institutions supported the overhaul because market forces had broken down the distinctions among financial products and services, as well as the providers of once discreet products. Those market forces – such as globalization, new technology, e-commerce, deregulation, market liberalization, increased competition, tighter profit margins, and the growing number of sophisticated consumers – had been driving all financial services providers to find growth, gain market share, create new revenue streams, and enter new markets. U.S. banks looked to non-banking products such as insurance and pension products to increase their profitability. They pointed, for example, 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. It ushered in 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 disadvantage. They maintain that their new non-insurer competitors have far more efficient federally based systems of regulation, while they are subject to the perceived inefficiencies of state insurance regulation, such as the multi-state prior approval of policy forms. Life insurers with products aimed at retirement and asset accumulation 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 2 years to obtain all the necessary state approvals for a similar national insurance product launch.

GLBA also addressed the issue of modernizing state laws on licensing insurance agents and brokers by creating 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 within the time limit Congress specified.

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 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 marketplace as we begin the 21st Century." They formed new working groups to implement GLBA, to prevent NARAB from coming into existence, and to modernize state regulation in other ways to deter growing industry support for federal oversight. The 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 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. Also, it reports that as of December 2002 it had certified 38 states as reciprocal jurisdictions – far more than the 29 states needed under GLBA to prevent the establishment of NARAB. 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.

Legislative Activity in the 107th Congress

Proposals

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 during the second session. 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

The House of the 107th Congress reorganized its committee structure to reflect GLBA's enactment and convergence in financial services. Jurisdiction over most insurance matters was transferred to the newly formed Financial Services Committee, which incorporated into its agenda several insurance-related issues, including agent licensing, states' approval processes for new insurance products, and a review of alternatives for improving the efficiency, uniformity, and effectiveness of state regulation.

During 2001, subcommittees of the Financial Services Committee held three hearings to examine the current structure of insurance regulation and assess its current inefficiencies. The Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises held a hearing on state efforts to comply with the GLBA requirement that at least 29 states institute producer licensing reciprocity or face activation of a federal licensing agency known as NARAB. The same subcommittee later held a hearing to review the state regulatory approval process for new insurance products, referred to as "speed to market." The Subcommittee on Oversight and Investigations held a third hearing to review whether "over-regulation" of automobile insurance denies consumers choice and competition. 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 June 2002, the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises reviewed various proposals for reform, holding a series of three hearings on "*Insurance Regulation and Competition for the 21st Century*." At the first hearing, Representative Richard Baker, chairman of the subcommittee, said that some sort of insurance regulatory reform was in order because insurance products that are not labeled as such can enter the marketplace more freely than those labeled as insurance. Witnesses representing banks, insurers, and agents agreed that insurance regulation needed to be reformed, but they disagreed about whether the best way to accomplish that would be to create an optional federal regulatory system or to reform the current state regulatory system. Chairman Baker emphasized that if states believe that they can adequately reform their existing system, they should be given a reasonable time limit in which to do so. He added that the hearings would be a "first step" toward his drafting legislation to reform and streamline insurance regulation that could be unveiled in 2003, but that he had no preconceived ideas about its specific content.

At the second hearing, Representative Michael Oxley, chairman of the full committee, urged a "go-slow" approach to reforming insurance regulation and expressed his hope that the necessary state-based reforms could be made so that no federal action would be necessary. The witnesses, representing individual insurers and various trade associations, again expressed differing opinions on whether Congress should pass optional federal chartering legislation or require the states to make specific reforms to improve the competitive position of insurers. Subcommittee Chairman Baker repeatedly attempted to get witnesses to recommend a "time-line" for the states to make the reforms necessary to modernize state regulation and create a more level playing field for insurers in the financial services marketplace.

At the third hearing, most of the witnesses were again representatives of insurance industry groups with definite positions for or against dual chartering. One agent group

announced, however, that it was developing a "middle ground" approach under which the states would continue to regulate insurance, subject to 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 were to 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 were well on their way in their efforts to modernize state regulation, and that any federal legislation dealing with insurance regulation risked undermining state consumer protections by unintentionally or unnecessarily preempting state insurance laws and regulations.

Other

Two other events bore on the issues considered at the hearings. First, the General Accounting Office (GAO) had 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 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."

In September, following these events, Representative Baker conducted an open roundtable discussion on the general subject of insurance regulatory reform. It involved various members of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, along with two panels of industry spokespersons. The first panel favored state insurance regulation, and the second panel preferred an optional federal charter and a dual federal/state regulatory structure. Most of the panelists were somewhat flexible as to the details of needed insurance regulatory reform, but all were in agreement that the status quo is not acceptable. Representative Richard Baker repeated his admonition that the "clock is running" on the states' efforts to modernize state insurance regulation.

Possible Legislative Activity in the 108th Congress

The Terrorism Risk Insurance Act of 2002 (TRIA) may affect the coming debate over the effectiveness of state regulation. In the aftermath of the World Trade Center attacks, insurance for terrorism risk became unavailable or unaffordable. A coalition of business interests – including construction, real estate, entertainment, manufacturing, retailing and transportation sectors – began working with the 107th Congress and the insurance industry to create a federal backstop for insured terrorism losses. When the TRIA backstop became law in November, a new test for state regulation emerged. 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 is likely to surface in any hearings that Congress may have on TRIA, on its implementation, or on optional federal chartering. It will be difficult, however, to assess the marketplace – much less the effectiveness of state regulation – for some time.

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.