

FEDERALIZING INSURANCE REGULATION: A TREACHEROUS ROAD TO REFORM

by

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Throughout its history, the insurance industry has thrived, offering consumers an impressive array of products. State regulation is a critical element in this success. As is true of every regulatory structure, there are problems. However, replacing or intruding upon state regulation should only be done in extraordinary circumstances, after overcoming a significant burden of proof. This burden may not be met simply by pointing to today's problems. Rather, those advocating an increased federal role must show that the state system cannot adapt to today's challenges, *and* that the federal government can. Comparing the challenges created by the September 11, 2001 terrorist attacks, with the need for uniform regulation between the states, it is immediately obvious that the Terrorism Risk Insurance Act of 2002 was necessary, but that a federal charter is not.

The insurance industry has historically been regulated by the states. This arrangement has been reexamined on a number of occasions, and is currently under review. The ongoing debate began in 1999 with the elimination of depression era barriers between financial services entities by the Gramm Leach Bliley Act, 15 U.S.C. § 6807 (GLBA). This led to competition between federally chartered businesses who are regulated by one entity, and insurers who must obtain licenses and product approvals in each state where they do business.

In 2001, the House Financial Services Committee began a series of hearings on the status of this convergence, with federal involvement in the regulation of insurance clearly on the table. These hearings were interrupted by the terrorist attacks of September 11, 2001, which intensified review of the current regulatory balance. Due to concerns about the availability of commercial insurance, and the insurance industry's ability to withstand another attack of this magnitude, Congress passed the Terrorism Risk Insurance Act of 2002 (TRIA). 15 U.S.C. § 6701. TRIA fills a critical need, requiring the federal government to act as a reinsurer for commercial insurance in the event of another attack. TRIA is narrowly tailored to accomplish its objective. Consider the following limitations:

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- Substantive state insurance law remains intact unless specifically preempted. One of the most prominent preemptions, prior approval of rates for terrorism premiums, is only valid through the end of 2003.
- Congress relied heavily on state insurance regulation for TRIA's implementation.
- TRIA is designed to provide critically needed support while the insurance industry develops the ability to respond to this threat. At the latest, it expires on December 31, 2005.

An Appropriate Federal Role. TRIA is appropriate because terrorism presents a unique and extraordinary risk. Terrorists want to inflict significant damage in unpredictable ways. The complex element of malicious human intent means that insurers do not know when, where, or how terrorists will strike. Assessing this risk is further complicated by the fact that the most predictive data is intelligence information, which is properly classified. Historically, insurers provided terrorism coverage, believing that the risk was minimal. September 11th changed that perception, requiring the insurance industry to address this massive and grave challenge for the first time. Due to the need for immediate action, the absence of relevant predictive information, the national nature of the terrorism risk, and the potential devastating magnitude of terrorist attacks, the federal government is currently the only entity capable of providing stability as insurers develop a means of addressing this risk.

State-based Solutions to Today's Challenges. By contrast, the challenges faced by state-licensed insurers doing business in multiple states do not present the unique and extraordinary circumstances that would justify a federal role. While it is true that insurers must negotiate a system requiring license and product approvals in each state to sell one product, and be subjected to examinations of their practices in each state, a federal solution is not necessary or desirable. Unlike terrorism, state-based solutions are available, and efforts are underway to improve regulatory uniformity between the states. Further, these solutions go beyond theory in that many are being developed and implemented, including the following:

- **Washington D.C.'s License Reciprocity Initiative.** Washington D.C.'s Insurance Commissioner, Lawrence Mirel, has undertaken a reciprocity initiative allowing a non-domestic insurer to quickly obtain an insurance license in the District if they meet certain criteria. For example, if the insurer does more than 20% of its business in the District and its domestic jurisdiction is accredited by the National Association of Insurance Commissioners (NAIC), it may obtain an insurance license in the District. This revolutionary step, if widely adopted, has the potential to dramatically change the face of state insurance regulation, eliminating one of the most problematic jurisdictional hurdles currently faced by insurers.
- **The System for Electronic Rate and Form Filing (SERFF).** SERFF was designed to speed the process of insurance rate and form filing. Under this system, multi-state insurers may make required regulatory filings with insurance departments. One immediate consequence of the SERFF implementation process has been the significant reduction of "desk drawer rules." These are rules imposed by individuals or departments that lack statutory authority. As desk drawer rules are exposed to review and eliminated, the process of filing the same product in each state will continue to improve on this electronically streamlined system.
- **Uniform examination pilot.** The NAIC's Market Regulation and Consumer Affairs (D) Committee, in cooperation with members of the insurance industry, is developing a refocused and improved examination process. Currently, each individual state has the authority to conduct in-depth examinations of an insurer licensed in that state. It is common

to place companies on a rotating list and conduct an examination when their turn comes up. The new process would create a baseline of company conduct, and would allow the regulator to focus on companies that fall below the baseline. This process has the potential to be used on a multi-state basis, and can improve the efficiency and effectiveness of the examination process.

- **Possible use of Memorandums of Understanding (MOU).** As is evidenced by the above examples, the NAIC has recognized that state-based insurance regulation must become more unified and uniform. It has also been recognized that many of the more significant efforts will take several years to fully develop. As a result, the use of MOUs is under consideration as an intermediate measure. While not a panacea, the use of MOUs can greatly accelerate the process of obtaining improved uniformity.

The above list provides examples of the efforts underway by state regulators to address the problems created by a lack of uniformity. State regulation is not a static system unwilling to change. While the challenge is real, it can be met successfully in the states.

A Federal Alternative Is Not the Answer. The one advantage of federal regulation is how it would allow insurers to do business in multiple states with one license. This one advantage aside, there are many valid questions about the ability of a federal regulator to solve the insurance industry's regulatory challenges. Consider the following:

1. **Unique needs can be addressed in each state.** A federal license places all insurers in the same class. The result is that it might be difficult for one regulator to resolve a situation in one state that results in a benefit to people in that state without giving that benefit in another state even when it does not make sense. In this respect, a federal regulator might actually be less able to address a unique need in a state.
2. **Each state's tort system is different, and the courts have shown significant deference to state tort law throughout our national history.** Because the U.S. Supreme Court has held that tort law does not constitute the regulation of insurance, it is not clear that federal regulation could offer uniformity. Further, state tort systems reflect the choices and cultures of the citizens in each state.
3. **The variety of state laws offer regulators facing a particular problem the ability to review numerous tried and tested approaches before deciding on a course of action.** The federal regulation of insurance may force uniformity, but in doing so it will also eliminate the ability of states to provide this vital function.
4. **Guaranty funds are both a cause of concern in the event of regulation, and proof that the states may adapt to problems.** These structures were put in place by the states to help address insurance company insolvencies. They are funded by the other licensed insurers in the state and provide policyholders with some assurance that their claims on an insolvent insurer will be paid. It is unclear how this highly successful mechanism will be impacted by a federal regulatory process. With the federal government's history of "borrowing" from funds intended to protect citizens, the ability of a federal guaranty fund system is suspect at best.
5. **Some members of the insurance industry are now advocating an *optional* federal charter.** Under their construct, those who wish to have one license may obtain a federal license, and those who prefer state regulation would theoretically remain unaffected. While

this approach has superficial appeal, deeper consideration raises significant questions. The impact of fracturing the unity of the current regulatory structure is unclear. Two regulatory systems require two tax structures. States already charge premium taxes to support state regulatory systems. How will the federal government fund the necessary and inevitable regulatory bureaucracy? Will policyholders be forced to pay twice?

6. **A review of Congress's performance to date does not provide proof that the federal government can correct the industry's problems.** Despite the fact that the insurance industry was struggling with terrorism, which was imposing broader economic ramifications, it took Congress over a year to pass TRIA. While this effort was ultimately successful, there have been failures. One of the most notable is represented by HR 1408. This legislation, introduced in the 107th Congress would have provided state insurance regulators with access to federal criminal information databases so that regulators would be able to detect license applicants who have been convicted of serious felonies in other states. Despite the obvious need for this critical information, this legislation never made it out of the Senate.

The Burden of Proof Has Not Been Met. Those advocating federal regulation of insurance have not met their burden of proof. While the challenge of obtaining regulatory uniformity between the states is significant, it is not so extraordinary as to justify a federal presence in insurance regulation. This is particularly true in light of the many state-generated initiatives underway to address this problem. Even if the states were not responding, advocates of federal regulation would still have to establish that the federal government would be capable of regulating insurance. There is no assurance that the federal government could do this, or could provide the necessary uniformity. Advocates of federal regulation have said that the federal regulatory structure will be free from unnecessary, archaic, and burdensome regulation. There is no doubt that this is their sincere desire, but there is also no guarantee that this will be the outcome. It is just as likely that federally-licensed insurers will face a maze of complex, inconsistent, and unnecessary federal regulations — many of which may be more focused on social regulation than on ensuring a healthy and competitive business environment.

The insurance industry is working with the NAIC to establish uniformity. While they can accomplish much, uniformity must be supported by state legislatures. Both industry and the NAIC have undertaken efforts that will result in the necessary uniformity through legislative action. The supporters of a federal charter argue that this will not work because the NAIC and the insurance industry do not entirely agree on the structure of legislative remedies. This argument fails as well. This kind of disagreement has been a constant in our nation since its founding, and will not be a barrier to success. With this in mind, and considering that a federal charter will most probably never look like the product its advocates envision, it is clear that reforming state regulation is the real road to uniformity.