State vs. Federal Regulation of Insurance
An Analysis

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Overview

The fundamental purpose of the regulation of insurance is to protect the insured, who purchases a product in good faith with the promise of future protection, from being exposed to insurers no longer being able to fulfill their obligations (known as an insolvent insurer). Due to the complexity of the insurance industry and the product it sells, the consumer is exposed to a much larger risk than is presented by normal consumer products/goods/services. Fairness to all policyholders, within the bounds that insurance naturally must be somewhat discriminatory, is also a vital concern when one looks at the insurance regulations. Insurance, which has existed in the United States since the very beginning of its history, has been established as the regulation territory of the state governments. This, as one may surmise with the presence of fifty state governments, has led to a very complex system of regulatory standards that differ from state to state.

While an attempt to standardize the various insurance departments that each state government has established, some critics of the current system argue that this effort do not extend deep enough to fully solve the problem. Still others argue that the state regulation is desirable because the local needs of consumers would be ignored by a national institution and that the transition to a different regulatory form would be costly and create chaos inside of the industry. In short, the question as to whether or not the industry should be regulated nationally or by state has yet to be put to rest and, most likely, will continue on into the distant future. Both sides of the argument certainly have their merits, but neither side can completely
dominate the discussion as fault can also be pointed out for both sides. But before any judgment can be ascertained through careful examination of the two arguments, it is important for one to understand the historical events that created the state regulatory administrations that currently dominate the realm of insurance regulation.

**History**

The current system of regulation developed in the years following 1868 after Samuel Paul of Virginia brought a state law, which required the licensure of foreign insurers and a bond submitted to the state government, to the Supreme Court on the grounds of it being a federal regulatory issue as the states were not regulate interstate commerce (Justia Supreme Court Center). This attempt to avoid the fine, and subsequent deposit of the expensive bond with the state government, was denied by the Supreme Court of the grounds that insurance was not interstate commerce and subject to state regulation. The Court argued that, because the transaction occurred solely within state lines, that no interstate commerce occurred and the Virginia law was upheld.

After the Paul decision every state began to draft independently different versions of insurance regulation. This quickly led to a scenario where insurance companies that wished to operate in more than one state were subjected to widely varying terms and conditions in order to obtain a license to operate. This naturally led to increased costs to the companies themselves but also to the consumer as the increased operating expenses were passed to the consumer (as well as lack of coverage due to companies being unable to fulfill state requirements to conduct business).
This growing problem was addressed when the commissioners of all the state insurance departments came together to establish a regulatory support organization known as the NAIC (National Association of Insurance Commissioners). This organization was meant to bring together representatives from every state in order to create solidarity and uniformity necessary for insurance companies to successfully conduct business across different regions. This need was further demonstrated as the insurance industry was evolving and branching out into different products as well as protection against a wider range of perils (National Association of Insurance Commissioners). This was the initial step towards the creation of large, single entity of regulatory power despite the association only possessing advisory powers.

Another challenge to state regulation of insurance was presented to the Supreme Court when the federal government brought legal action against an insurance organization known as the Southeastern Underwriters. The federal government, which argued that this organization represented clients across many state lines and were operating using illegal (unfair) business practices, made the claim that insurance companies were engaging in interstate commerce and were breaking federal anti-trust legislation (Justia U.S. Supreme Court Center). The court overturned their previous ruling when they agreed with the federal government and brought the insurance industry back under the definition of interstate commerce and federal regulation.

This sudden reversal of the overall regulatory environment led to chaos in the industry as the federal government had failed to develop any sort of comparable insurance regulatory agency that would fill the void left from the dissolution of the state departments. This regulatory void was filled when the federal government, in the public’s best interest,
determined that it was preferable for the states to continue the regulation of the insurance industry (National Association of Insurance Commissioners). Subsequent acts such as the Gram-Leach act of 1999 further solidified the power of state regulation by removing federal regulations in the financial operations of insurance companies.

Now that the precedence of the regulation of the insurance companies has been firmly established, it is now vital for one to gain an understanding into the exact activities and practices that are monitored in the industry. The scope of regulation pervades every facet of an insurance company’s operations and must be broken down into its individual parts for better understanding.

**Regulatory Scope**

**State Legislators/NAIC**

State legislatures are the makers of public policy that establish the parameters from which the state insurance departments operate. While they normally do not go into the specific details of the insurance industry, it is the state legislatures that hold considerable power in regulatory efforts as they control the funding to the various departments. Legislatures also delegate authority to the insurance commissioners which then operate the regulatory efforts in the direction set forth by the legislature.

The NAIC, which brings together all of the individual insurance departments, is a standard-setting entity that also conduct peer oversight for the specific departments. This organization is vital for insurance department officials to maintain a limited form of...
cohesiveness when determining regulatory standards as well as policy forms. This entity, while outside of the bounds of federal power, represents the national efforts to standardize insurance regulation.

**Product Licensing/Regulation**

Individual agents and brokers must be licensed inside the state that they operate in so that they can conduct business legally. The states perform educational activities that are meant to ensure that all producers of insurance are held to a high, professional standard. The insurance departments coordinate their efforts to prevent multiple attempts of fraud or regulatory violations by the maintenance of a database to report such activities (National Association of Insurance Commissioners).

Insurance companies are required to file their policy provisions and rates in order to determine whether or not the policies conform to local statutes. The policies are also checked for major coverage gaps and the rates are examined to ensure that unreasonably high (or low) rates are not charged. Most states require property casualty insurers to file their policies and rates prior to using them but this is not the case in life insurance or annuities. Health insurance, prior to the Affordable Care Act, generally was permitted to file and use their rates until the insurance agency reviewed them (The ACA changed this to where health insurance rates must be reviewed before usage similar to property and casualty (National Association of Insurance Commissioners)).
Financial/Market Regulation

The states are responsible for ensuring not only the financial preparations of insurance companies (such as reserve funds), but also the manner in which these assets are reported to the public. The state insurance departments run audits of the insurance companies to determine the financial strength of each to handle their obligations as well as the accuracy of their financial statements (National Association of Insurance Commissioners). If an insurance company is not in compliance with the various regulations (such as not having enough reserves for policy liabilities), they are taken over by the state department until they are deemed financially secure.

State insurance departments are charged with ensuring that rates are applied fairly to all consumers as well as do not provide for excessively high profits at the consumer’s expense. The state departments also respond to various complaints made against insurance companies to ensure that adequate consumer protection policies and procedures are in place. The insurance departments have established many avenues of communication for the consumer to voice their comments/questions/concerns such as hotlines and websites to improve the reaction time between problems and regulatory response.

Whether it be a question of terms and conditions or a review of the financial strength of an insurance company, regulatory efforts are vital for the continued success of the insurance industry. Due to the vital importance of the regulatory efforts, it is essential that the most efficient method of achieving these regulations in order to best serve the consumers. An
analysis of the advantages and disadvantage of both state and federal regulation is necessary to achieve this objective.

**State Regulation**

**Advantages**

State regulation, for over one hundred fifty years, has been the primary form of regulatory model that this country has known. This model, though possessing various flaws, does have the advantage of many years of amendments and changes to adapt to new industry conditions. A federal agency would have to be created without any sort of precedent and it would be likely that the industry would have to undergo years of uncertainty in the regulatory environment if the change was made.

State regulation allows for more localized concerns to be heard by the people who possess the power to address the situation. State insurance departments, which reside in the same area and witness the same insurance needs as the consumers, are much more likely to address the concerns of local groups than a large bureaucracy is (National Association of Insurance Commissioners). Individual consumers also have more direct access to these state departments as the physical locations of the regulators will be much closer and the consumers, through state politics/elections, will have more power over the insurance departments. A significant minority inside of a state is much more likely to influence a state election (the winner of which determines who is in the insurance department) than a national one.
State regulation of insurance has already proved moderately successful in handling the issue of lack of uniformity in policy conditions/rates charged/etc. While it is true that a federal entity would be able to solve this issue in a more efficient manner, the “one size fits all” approach to insurance is not appropriate for a population and environment as diverse as that of the United States (National Association of Insurance Commissioners). Some variation in the policy terms and conditions are necessary in order to best protect the consumer’s, and insurer’s interests, over a wide range of physical locations and policyholders.

State governments collect a significant amount of revenues from their collections on insurance regulations. In 2010 alone state agencies collected 1.24 billion dollars of revenue from regulatory efforts and provided 11,600 jobs to state economies (National Association of Insurance Commissioners). These revenues and jobs are significant boosts for the economies of the various states and, as a result, improve the national economy as well.

**Disadvantages**

State insurance regulation, if the recommendations of the NAIC are not followed, can lead to an overly complex system that damages the efficiency of insurance company operations. By requiring small differences in regulations (and subsequent different form filing requirements), the insurance regulatory system adds more to the amount of red tape that insurance company must go through before it can offer its product. The increased costs can, and are, passed along to the consumers.

The increasing frequency of international transactions in the United States economy calls for a more uniform code of regulations that are better supplied by a single, federal entity.
The federal government is better able to understand, and address, the requirements that foreign governments and international organizations require insurance companies to adhere to. State government agencies may be better at responding to the local needs, but they are not as successful when addressing the concerns of a globalized economy.

The state governments, by spreading the amount of insurance experts around fifty departments, “water down” that concentration of administrative talent. Rather than the consolidation of all the great insurance minds into one entity that has the power to make regulations, the state system creates inefficiency as the knowledge is diluted from the decision making process. State governments cannot provide the expertise as a nationwide entity can as they have many more positions to fill and less people to do it with.

**Federal Regulation**

**Advantages**

Federal regulation of insurance would allow the federal government to create a standard method of filing rates and policy provisions nationwide. The insurance companies would no longer have to review each rate and policy by state nor would they be forced to file with fifty different departments. This system would result in a more efficient introduction of policies to the market as well as reduced administrative costs that could be passed on to the consumer.

Federal regulation allows the federal government to gather all of the expertise and resources of insurance to one centralized location. With the increased levels of communication
and coordination that would arise from a single entity, the federal regulation would be composed with better insight (at least in theory). The federal entity would also have access to the larger federal revenues in order to maintain higher reserves as well as provide more funds for research and regulatory enforcement (Bloomberg Business).

The federal regulatory agency would have a better understanding of the economy at large as well as the international community. The federal government understands the requirements of foreign governments and would be better able to draft regulations that would enable companies to better compete outside of the United States. The federal government also has greater access to economic studies that would better prepare the insurance industry for economic trends and consumer needs (Bloomberg Business).

**Disadvantages**

Federal regulation of insurance would further separate the regulatory official from the needs of the individual consumer. In a market as diverse as the insurance industry, the regulatory efforts must be shaped to where each, and every, one of these concerns is addressed properly to ensure consumer protection. A bureaucrat in a large office will never be able to stay informed on local issues as well as a state employee with connections to the area.

No precedence exists for the creation of a federal regulatory agency of insurance and any effort to do so would cause considerable disruption in this industry that is vital for the American economy. This new agency certainly would not perform very well at first and the resulting damage could be catastrophic to the overall economy. A large risk exists to completely
dismantle an existing establishment such as state regulatory agencies that have been developed over a number of years.

The federal government, in an effort to standardize all insurance products, could easily fall victim to a significant problem for any bureaucracy: the end product of its process will be much more complicated and difficult to put into practice than the current model. The federal model, because it must be standard for all fifty states, would have to account for every local variation of insurance practice into one long and complex form (National Association of Insurance Commissioners). This form would prove impractical and would cost the American taxpayer millions for an agency that does not fulfill its purpose.

**Conclusion**

Overall the regulation of insurance has been, and will continue to be, of vital importance to the consumers and the industry itself. The modern economic conditions of this nation require that insurance be integrated into almost every activity and consumers have come to rely on it as a basic necessity. It is in the defense of these consumers that the state insurance regulators continue to mold and adapt their regulatory efforts to better serve their needs. Just as insurance is always looking to better serve the consumer through constant innovation and product development, the regulatory efforts of state governments continue to evolve and adapt to market demands. While federal regulations will continue to be offered as a better alternative to the current system, it is likely that the large initial costs and disruption in the operations of the insurance industry will be significant enough to prevent any sort of major structural changes in the near future.
Bibliography

