

# Insurance Regulation: State vs Federal

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## Executive Summary

Both State and federal chartered regulation of insurance bring advantages and disadvantages. The debate over how we should go forward with government regulation in the post Gram-Leach-Baily era has been a hot topic in the insurance industry since the early 2000s.

There are three ways to proceed with regulation: completely state; completely federal; or a combination thereof, most commonly referred to as a dual charter system. There is not much support for a dual charter system because, in the eyes of most, it would substantially increase cost while providing little improvement.

Supporters for federal regulation argue that states are currently doing a poor job of regulating market conduct and handling complaints from consumers. They claim that the federal government could do a better job by implementing a single set of laws and standards administered by a single unified entity or a few closely interconnected government agencies.

State supporters claim they already have uniform laws and standards through model laws provided by the National Association of Insurance Commissioners and that the option to adopt laws gives them a major advantage over a unified system of regulation because the needs of individuals from different states vary widely.

While unified laws and regulators offer simplicity and efficacy, the state model offers innovation and effectiveness. When the primary function of insurance regulation is to protect consumers a unified system is not the answer.

## **Introduction**

Advantages and disadvantages exist with both state and federal chartered regulation of insurance. Supporters of federal regulation argue that a more uniform system would make regulation more efficient by achieving economics of scale, and the federal government can offer more competent regulation. Supporters of federal regulation also point out that the current system has the following faults: inadequate protection of consumers, ineffectiveness while handling complaints, and lenient market conduct examinations.

Supporters of state regulation argue that individually they offer responsiveness to local needs, greater opportunities for innovation, decentralization of political power, and that adequate uniformity can be attained by model laws and proposals from the National Association of Insurance Commissioners (Rejda, 2011 & "State insurance regulation:", 2013).

## **Purpose of the Study**

The purpose of this study was to discuss in-depth the benefits and short-comings of both state and federal regulation of insurance from a property and casualty perspective.

## **Methods and Procedures**

A knowledge base on insurance regulation was developed by studying chapter eight of George E Rejda's Principles of Risk Management and Insurance. Scholarly articles were then consulted to supplement what was covered by the textbook, and then statements and opinions from experts were added to the study.

## **The Reason for Regulation**

The fundamental reason for regulating insurers is to protect the consumer. With respect to the most tangible products, comparing different insurance products can become very difficult. It is assumed that the majority of people know too little about insurance to make adequate decisions. Inadequate consumer knowledge can reduce the influence consumers have over quality and price, so limitations and regulations are imposed on insurance companies to sustain a competitive market for consumers (Rejda, 2011; "State insurance regulation," 2013).

Insurance companies are regulated on ability to pay claims so state insurance departments ensure that adequate funds are reserved to pay potential claims incurred by the insurer.

Lastly, state insurance departments assist in making insurance available to consumers. For example, a person can be too high of a risk to be desirable to standard insurance providers. State governments work with insurers to offer programs that can provide insurance for these individuals. One such program is the Kentucky Fair Plan. The Kentucky Fair Plan is a nonprofit association that provides dwelling fire, commercial fire, and farm fire homeowners insurance to property owners in Kentucky who cannot get coverage directly from insurers ("Kentucky fair plan," 2014).

## **Insurance Regulation Historically**

Insurance regulation in the United States began when state legislatures started passing laws that required insurers to provide limited financial information to the public. "In 1851 New

Hampshire became the first state to create a separate insurance commission to regulate insurers" (Rejda, 2011). The other states established similar systems.

In the first 100 years of insurance regulation, the deciding factor on who was to regulate the affairs of insurance companies was whether or not the insurance was, or was not, considered interstate commerce (Rafferty, 2013; Rejda, 2011).

An extension of the notion regarding the free flow of trade between states started when the Civil Rights Act of 1964, dealing with discriminatory practices in public accommodations, was upheld by the Supreme Court. The court decided that "A business, although operating within a single state, could affect interstate commerce with its restrictive laws and was, therefore, at odds with the federal legislation." This decision provided the enabling of the Constitution's commerce clause, giving the federal government regulatory right to the companies that operated in more than one state (Rafferty, 2013).

The court's decisions on insurance being interstate commerce went one way and then another, in such cases as Paul v. The State of Virginia and The United States v. SEUA until 1945. In 1945, the McCarran-Ferguson Act deemed that, interstate commerce or otherwise, the continued regulation and taxation of insurance by the states is in the public's best interest. State regulation was again confirmed by the Gram-Leach-Baily Act of 1999 (Rejda, 2011; "State insurance regulation," 2013).

## **National Association of Insurance Commissioners**

When thinking of insurance regulation by state one must realize that most states work together when trying to find solutions to problems. Through the National Association of Insurance Commissioners, NAIC, regulators from all states and districts can connect and communicate to share resources and ideas. The NAIC describes itself as “a vehicle for individual state regulators to coordinate their activities and share resources” (“State insurance regulation,” 2013). The NAIC advises individual state insurance departments on model laws in attempts to standardize insurance laws and regulations, but ultimately the state gets to choose whether or not the law is accepted, revised and accepted, or ignored.

## **Federal Regulation**

A federal charter would offer a single set of laws and standards as well as a unified entity that monitors the affairs of insurance companies.

### **Advantages of Federal Regulation**

Two of the major advantages of federal regulation are uniformity and efficiency. As compared to state regulation, a federal charter could potentially be more cost effective. Supporters of federal regulation also claim they can offer more competent regulators.

Under the current system, insurance companies doing business in more than one state are subject to several sets of laws. While under federal regulation one set of laws would apply to every insurance company that does business in the United States. While some see a major problem with this fact, federal supporters see it as a major advantage. With only one set of laws

applying to insurers, and only one unified agency regulating them, both the insurance company and the government benefit by maximizing the use of their resources and the insurance companies reduce cost by having a uniform set of laws to abide by ("Proposed federal insurance," 2014).

Another alleged advantage of a federal charter is more competent regulators. The thinking behind this claim is that the combination of a more prestigious title and a larger salary provided by the federal government would entice more intelligent individuals to become insurance regulators. In theory, more competent regulators monitoring insurance companies by one set of laws would result in a better service and less expensive coverage to consumers ("Proposed federal insurance," 2014; Rejda, 2011).

### **Disadvantages of Federal Regulation**

While federal regulation offers economies of scale and alleged potential for more competent regulators, a completely uniform system of regulation would be weak in innovative advancements and individual needs due to a diverse geographical and sociocultural landscape. These facts leave critics questioning the "one size fits all" solution to insurance regulation (Brown, 2013; Nelson, 2013; Rejda, 2011).

### **State Regulation**

Insurance, unlike most other financial services, is still primarily regulated by the states. Individual insurance companies are regulated by the state in which they are domiciled and are subject to the laws in other states where they do business. The NAIC breaks down regulation

into four categories: company and producer licensing, product regulation, financial regulation, and market regulation.

### **Company and Producer Licensing**

Currently, about 7,200 insurance companies are in the United States alone ("State insurance regulation," 2013). If an insurer wishes to sell insurance in a specific state, in most cases, both the company and the producer must be licensed in the state in which the policy is sold (Rejda, 2011).

More than three million people are licensed to produce insurance in the United States. Classes and exams required to become a producer of insurance are administered by the state department of insurance, and the state requires continuing-education programs to ensure that producers continue to learn and stay up-to-date on issues in the industry ("Proposed federal insurance," 2014).

The activities of producers are primarily monitored by the individual state insurance departments but it is not uncommon for producers to become licensed in several states. In attempts to make monitoring the actions of producers more efficient, the NAIC established the National Insurance Producer Registry, NIPR, to record producer licensing information on a national level ("State insurance regulation," 2013).

### **Product and Rate Regulation**

State regulators ensure that insurance policy provisions are reasonable, fair, and understandable to the consumer. Rate regulation can vary widely from requiring prior approval

of rates to requiring no filing at all, but most states use methods that do require submission and approval at some point ("State insurance regulation," 2013).

### **Financial Regulation**

Financial regulation helps to keep the public informed on the financial security of insurance companies. The states maintain the NAIC financial database, which provides annual and quarterly financial statements from insurance companies. Audits of insurance companies are performed by financial examiners from the state insurance department to investigate accounting methods, investment procedures, and claim reserves. If an audit does not meet the standards of the state, the company is either shut down and liquidated by the state, or is taken over by the insurance department's administrators until it gets back on the right track ("State insurance regulation," 2013).

### **Market Regulation**

Market regulation ensures fair and reasonable insurance prices. When an insurance company violates these laws, they are subject to fines and/or suspension, or license revocation ("State insurance regulation," 2013).

### **Advantages of State Regulation**

To understand the benefits of state charters, an individual must consider the size of the United States. Ours is a very large country in terms of both population and geographical size. The needs of people in rural Midwest may be quite different from the needs of those who live in the industrial Northeast. With that being said, consider the following benefits of state regulation.

A less diverse population would mean a decrease in conflicting interests so changes can be made to address problems specific to an individual state. Because these decisions only effect insurance companies' business in their state, regulators do not have the issue of adverse effects and consequences that affect people in other parts of the country. Thus, more effective regulatory decisions can be made quickly and efficiently. Senator Bill Nelson of Louisiana said, "State regulation continues to change with changing times and is always improving." He went on to contrast the challenges in Louisiana with those in Nebraska; for example, while Nebraska is subject to wind damage they are certainly not subject to hurricanes like Louisiana (Nelson, 2013).

The principle that legislators' decisions only affect individuals in that state also allows the state government to experiment with new and innovative techniques without the drawbacks of negative results affecting the entire country. In an interview with *Insurance Journal*, Kentucky Insurance Commissioner Sharon Clark commented on the mine subsidence fund that is managed by the Kentucky Department of Insurance. Clark called the fund a "special endorsement" that consumers can purchase on commercial or personal property; and if the mining company, for whatever reason, fails to pay a claim, there is a fund from which policyholders can collect (Clark, 2009).

Supporters of the state regulation also argue that central regulation of insurance would give federal government more influence over our nation's economy, resulting in less government having more power ultimately imposing on the rights of states to govern themselves.

## **Government Accountability Office**

The Government Accountability Office (GAO) is an independent agency employed by Congress to investigate the affairs of state and federal government. Describing themselves as “congressional watchdogs” on their own website, their mission is “to support the Congress in meeting its constitutional responsibilities and to help improve the performance and ensure the accountability of the federal government for the benefit of the American people. We provide Congress with timely information that is objective, fact-based, nonpartisan, nonideological, fair, and balanced” (“About GAO,” 2013).

## **Disadvantages of State Regulation**

State regulation is very expensive. When comparing the United States’ budget with the United Kingdom’s, we spend almost 19 times what they do on insurance regulation, with only three times the market. When the same comparison was done with Germany, we spend about 29 times what they spend with only five times the market (Brown, 2013). A federal charter would reduce expenses by improving economies of scale.

GAO has found alleged short-comings with state regulation in areas such as inadequate protection of consumers, ineffectiveness when handling complaints, and lenient market conduct examinations. Critics of the current system claim that state departments are unsystematic and are incapable of effectively determining if consumers are being treated fairly regarding claim payments, rate setting, and unfair discrimination. In Principles of Risk Management and

Insurance, (Rejda, 2013) said that although many states do make complaint ratios (ratio of complaints to premiums), most states do not provide them for public use. Market conduct examinations test insurance companies on their effectiveness when handling claims, underwriting, advertising, and other operations. The GAO claims that these examinations are “seriously lacking” (Rejda, 2013).

## **Conclusion**

Though the federal government can offer efficiency through unification, state-chartered regulation has the advantage of ability to meet consumer needs. Were the federal government offers efficiency, the states offer effectiveness. While there are some problems with state regulation, there is no guarantee that implementing unified regulation would solve any of these problems. With respect to the property and casualty market, the only people who stand to gain through unified regulation are the insurance companies and those who are to become federal regulators themselves. When the primary function of insurance regulation is to protect consumers, unified regulation is not the answer.

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