Future of the Business Disciplines, Regulation and Oversight of the U.S. Insurance Marketplace

The evolving arguments around federalizing insurance regulation

A White Paper by Mark Boozell
Director, Illinois Department of Insurance (1995-1998)

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Preface

The current state of the financial services markets and the failure of federal oversight in the financial industry continues to hold the insurance sector tightly in its grasp. As a result, the move to create a federal regulatory authority for insurance, in some form, continues to be a matter of debate in Congress.

The core principle driving oversight of the business of insurance by the states, together with the enforcement of state insurance laws, is protection for consumers. This means a state oversight and regulatory system that is compatible with state common law; addresses insurance-related matters in courts; and assures a robust, well-ordered insurance marketplace with adequate capacity to meet the needs of consumers. This system also ensures that all insurance participants in U.S. markets conduct their insurance activities in a fair, equitable and nondiscriminatory manner, as well as be legally and financially responsible for errors and/or wrongful actions.

The existing federal bureaucracy as it currently relates to insurance is broad and diverse. A plethora of federal agencies and entities have some measure of authority over various aspects of insurance. The Internal Revenue Service (IRS), the Departments of Health & Human Services (HHS) and Labor (DOL), along with the National Flood Insurance Program (NFIP) under the Federal Emergency Management Agency (FEMA) and the Federal Crop Insurance Program (FCIP) under the U.S. Department of Agriculture (USDA), among others, are all letters in the cauldron of federal "alphabet soup" which have some measure of responsibility that relates to U.S. insurance laws, regulations, insurers and insurance producers. Therefore, these federal entities work regularly with state insurance departments and the National Association of Insurance Commissioners (NAIC) to coordinate their activities, because insurance remains a state-regulated business.

Acknowledging these realities, the Obama Administration has called for a new office of insurance within the Treasury Department, but will not propose federal regulation of the insurance industry as a part of its sweeping financial reform plan. But the devil is in the details.

The federal government and Congress have recent experience with the difficulty in "getting right" a new major government oversight restructuring project, when they formed the Department of Homeland Security (DHS). DHS was forged out of existing and differing federal agencies. The resulting mass remains a largely segregated and redundant organization with lingering interdepartmental and inter-agency struggles. The resulting large federal entity that resulted still fails to serve the very prime entities that DHS was intended to serve: state and local law enforcement agencies.

This white paper is intended to assess the current status of insurance regulation and evaluate the range of potential reforms now being discussed in Congress and throughout our industry.

In the United States, neither the people nor their governments take lightly the standards and processes by which government interferes with and monitors the free market. In the case of insurance regulation and oversight, the debate over whether federal involvement should be expanded is a debate that has only just begun.

Mark Boozell
Chicago, Illinois
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About the Author

Mark Boozell served the State of Illinois for over two decades in a variety of leadership roles in both the Executive and Legislative branches of government. After his government service, he joined a Fortune 500 Company to lead a division of managing general underwriting groups responsible for over $100 million in gross written premium.

Mr. Boozell was Director of the Illinois Department of Insurance from 1995-1998, serving as the state's chief regulator of over 1,900 insurance companies and 92,000 insurance producers. He led a staff of over 600 and implemented a budget of over $32 million.

Mr. Boozell was Chief of Staff to Illinois Governor Jim Edgar (R). He served as the Chief Operating Officer of the State of Illinois developing, implementing and communicating administration policy. In addition, he oversaw the state's $35 billion budget and 65,000 employees; and directed state government's response during crisis situations.

He served as Director of the Governor's Legislative Office with direct oversight and review of all legislation pending before the General Assembly and its committees and commissions. In this capacity, Boozell gave advice to the Governor on final action for all bills pending before him; coordinated and developed implementation of the administration's legislative program and positions on related legislation; and reviewed the legislative programs of all state agencies under the Governor.

Mr. Boozell is currently a government policy advisor with the Chicago-based law firm Dykema Gossett PLLC.

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The Professional Insurance Agents Insurance Foundation (PIA IF, c-3) is dedicated to fostering critical applied research and information (white papers, studies and the like) that furthers the knowledge and understanding of the nature, scope, function, operations, and law of the business of insurance, primarily as practiced in the United States. Through these efforts, the PIA Insurance Foundation strives to communicate and make available these informational materials to our primary audience of interest, the members of the National Association of Professional Insurance Agents (PIA National) and its authorized affiliates. It does so in further support of PIA members' efforts to successfully manage and implement their constantly evolving business operations as independent insurance agencies and brokerage firms.

The PIA Insurance Foundation continues the legacy vested in it by the George Baldwin Trust, established by the National Association of Mutual Insurance Agents (PIA National's predecessor organization) in the late 1950's to further the insurance knowledge and education of those engaged in the independent insurance agency system.

Contact the PIA Insurance Foundation at PIAInsuranceFoundation@pianet.org.

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It is no coincidence that when free markets encounter turbulence, stability in the regulatory environment suffers as a result. In fact, regulation has become the dominant concept in both the domestic and international discourse over the financial services sector in light of recent corporate failures and flawed corporate strategies. *Streamlined regulation. Reformed regulation. More regulation.*

Those involved in the insurance industry who have historically opposed regulation want it further deregulated, and seek the involvement of direct federal oversight. Those who think regulation is necessary support improved modernized and effective reforms to the *current* state system. Caught somewhere in the middle are those who deal with insurance regulators on a regular basis and seek a blend to produce a more efficiently regulated state system.

The insurance industry has been mired in this most significant regulatory debate since well before the current recession. *However, the current financial services markets and failed federal oversight crisis of the financial industry continues to hold the insurance sector tightly in its debate.* Accordingly, the creation of a federal regulatory authority for insurance, in some form, continues to gather steam. Even some state regulators recognize the importance of a more coordinated regulatory structure.

Insurance Is Not Simple

The assessments, questions, suggestions, and even some of the proposed solutions thus far presented in this debate within the insurance industry, as well as by federal public policy authorities, have at times appeared to be greatly over simplified. When the discussion introduces further details, the discourse becomes too mundane for most.

In contrast to this over simplification offered up by some of those with vested interests in this debate, insurance is not simple, it is complex. There are critical material differences that apply to the business of insurance that do not apply in other financial services areas. The plain facts are that the law, products, financial structures and practices of the insurance industry remain, and create, a complex landscape with a wide variety of products available to consumers and made available through a variety of insurance providers. While tempting to believe, a "one size fits all" approach to regulating insurance belies the long history of research, adaptation and evolution that characterizes the existing state system.

To these material insurance character points, state insurance regulators have a strong central argument working in their favor. Should a regulatory system more than 150 years in practice be radically altered via plans crafted by its regulated entities under a variety of incongruous justifications? Put another way, should Congress give more weight and reform consideration to the restructured insurance oversight system plans of firms in the business of insurance, or give more deference and hearing to the authorized state public officials designated by law to actively oversee the business of insurance in the United States?

Competitive Ease vs. Consumer Protection

The core principle behind regulation is not convenience for regulated entities. The core principle behind insurance regulation is protection for consumers. For U.S. insurance consumers, this means an oversight and regulatory system that knows and is compatible with state common law which addresses insurance-related matters daily in their courts; can assure a legal, sound, available, and adequate insurance marketplace; and that all insurance participants in U.S. markets can conduct their insurance activities in a fair, equitable and nondiscriminatory manner, as well as being legally and financially available to consumers and the regulatory system for their errors and/or wrongful actions.

Major change to a complex and sophisticated regulatory structure is not without significant risk, especially in the highly charged political environment in which we find ourselves today.

"Regulatory overreach" is a term that has been used to describe the federal government's interest and discussions of the insurance industry, particularly following what, from an insurance industry and oversight perspective, has been its over-reaction to the AIG situation. The principle danger surrounding the current misguided discussion about AIG as "an insurance problem" is that it is factually and functionally inaccurate, and introduces the risk that all insurers will get swept into the vast federal regulatory overhaul of the U.S. financial services industry.

Without proper and deliberate care, at best this would mean insurers being subjected to duplicative, confusing and costly dual regulation. At worst, it holds the real prospect of failed consumer protections and failed insurance markets. These potential outcomes must be weighed against the current track record that state insurance commissioners have demonstrated in their regulation of the U.S. insurance marketplace.

Modernizing vs. Recreating

It should be remembered that seeking improvements in a current system is not the same as seeking an entirely new oversight system. Make no mistake, the impact of insurance regulatory changes will be felt for decades.

Acknowledging these realities, the Obama Administration has called for a new office of insurance within the Treasury Department, but will not propose federal regulation of the insurance industry in its sweeping financial reform plan. While the plan offered by the Administration creates the Office of National Insurance to monitor all aspects of the industry and flag risks that could contribute to any future financial crisis, it would also give the Federal Reserve some authority to subject large insurers to strict capital and risk rules that apply to large financial holding companies. This recommended approach, while intended to coordinate industry policy while stopping short of being a direct regulator, needs to be monitored very closely as it transforms into actual legislative language. As always, the devil is in the details.

State officials and supporters of the existing state insurance oversight and regulatory system are not resistant to improvement and reform. The suggestion that any regulatory framework is immune from productive change is not realistic, and in the case of the insurance industry, simply not true. However, to suggest that the best way to reform this proven regulatory framework is to start from scratch is equally misguided.

In fact, state insurance regulators are on the record as open to proposals that would create a federal role in insurance regulation. During a Congressional hearing in June 2008, Illinois Insurance Director Michael McRaith, speaking for the National Association of Insurance Commissioners (NAIC), said he was open to supporting a federal role in insurance regulation, provided that role did not pre-empt the consumer protection benefits of the existing state authority.

The NAIC itself has established a Regulatory Modernization Working Group that is charged with the responsibility of developing a general framework proposal for a model or a compact for states to join.

Usurping state authority, however, is ripe with logistical and operational consequences that would lessen the nation's grasp on good, industry-specific insurance practices. Much like the American Constitution itself, the sustaining value in the state-by-state regulatory system is its flexibility and adaptability. It can be improved, but the foundation itself is strong and a worthy baseline from which to advance.

To this point, on May 20, 2009 President Obama issued a memorandum to the heads of all executive departments and agencies of the United States government discussing federal preemption. In the memorandum, he states that it is "…the general policy of my Administration that preemption of State law by executive departments and agencies should be undertaken only with full consideration of the legitimate prerogatives of the States and with a sufficient legal basis for the preemption…"

Other than the legal basis discussion, the memorandum also opines that "…From our Nation's founding, the American constitutional order has been a Federal system, ensuring a strong role for both the national Government and the States. The Federal Government's role in promoting the general welfare and guarding individual liberties is critical, but State law and national law often operate concurrently to provide independent safeguards for the public…"

These safeguards for the public have been in place in state laws regulating the insurance industry for 150 years.

Current Oversight Framework

Since its development, the United States' insurance regulatory framework has been the current state system.

In 1945 Congress, through the McCarran-Ferguson Act, addressed the interstate nature of both the business and oversight of insurance and continued its assignment to the states (which had previously been exclusively an intra-state oversight and industry system).

Since 1945, several trends have emerged. Courts have circumscribed the antitrust exemption substantially, Congressional involvement in and oversight of insurance has increased, and states have adopted and directed the National Association of Insurance Commissioners (NAIC) to develop a national role in establishing standards for state regulation of insurers' financial solvency. The NAIC has become involved in establishing international standards for insurance regulation, as well.

In 1999 Congress adopted the Graham Leach Bliley Act (GLBA). For the first time, the U.S. insurance industry, as a body, was by federal law established and mandated as one of three sectors designated by Congress to form the U.S. financial services industry. However, even here Congress required GLBA to set a functional oversight system, having each sector continue to report to their already established legal, oversight, and permitted business practices systems.

In so doing, Congress continued to defer insurance oversight and law to the states. Therefore, insurance is unique among the other financial services in that it is regulated by the states. And the record shows that in terms of GLBA, having Congress continue its deference to state law and oversight was due to a very effective and tightly coordinated insurance industry and regulatory effort on behalf of the state regulators. It also recognized the reality of the very integrated nature of the conduct and oversight of the business of insurance in the U.S. with the broad spectrum of state administration and common law.

It has been the collective efforts of the state insurance regulators, members of the insurance industry and representatives of consumer interests, that has shaped the current insurance system. The NAIC has been central and valuable in developing and supporting the cause and content of insurance regulation.

The goals of insurance regulation articulated by most states include fair pricing of insurance, protecting insurance company solvency, preventing unfair practices by insurance companies, and ensuring availability of insurance coverage. For example, all states have the power to approve insurance rates, to periodically conduct financial examinations of insurers, to license companies, agents, and brokers, and to monitor and regulate claims handling. Each state has a department within the executive branch to regulate insurance. The head of the department is usually called the commissioner or director of insurance. A handful of states elect their insurance commissioner. In the remaining states, the insurance commissioner is appointed by the governor and serves at the governor's pleasure.

The insurance department typically has broad, legislatively delegated powers to enforce state insurance laws, promulgate rules and regulations, conduct hearings to resolve disputed matters, and to enforce compliance by insurance entities.

In practice, this power is exercised sparingly, and states through the support of the NAIC strive to conduct their efforts in a multi-state, nationally compatible manner. But as with any government office and more often among the states, state insurance departments are often significantly underfunded, and can be subject to political preferences for less regulation.

The fundamental reason for the government regulation of insurance is to protect American consumers. State systems are accessible and accountable to the public and sensitive to local social and economic conditions. State regulation has proven that it effectively protects consumers and ensures that promises made by insurers are kept.

Insurance regulation is structured around several key functions, including company licensing, producer licensing, product regulation, market conduct, and financial regulation and consumer services.

Shortcomings and Drive for Modernization

While the concept of the state regulation of the insurance industry is premised upon the theory of keeping the regulatory environment at the lowest governmental entity possible, it is far from a perfect system. As a matter of fact, the several states obviously need help from time to time, as witnessed by the creation of the NAIC.

The stated mission of the NAIC is to "assist state insurance regulators, individually and collectively, in serving the public interest and achieving the following fundamental insurance regulatory goals in a responsive, efficient and cost effective manner, consistent with the wishes of its members: protect the public interest; promote competitive markets; facilitate the fair and equitable treatment of insurance consumers; promote the reliability, solvency and financial solidity of insurance institutions; and support and improve state regulation of insurance."

Members of the NAIC stressed the importance of a global exchange of ideas and collaboration among the world's financial regulators during the recent Transatlantic Insurance Dialogue Symposium at the

U.S. Chamber of Commerce. The meeting brought together policymakers and industry representatives from Europe and the U.S., and explored key developments critical to modernizing insurance regulation on both sides of the Atlantic.

"The most important lesson to be learned from the current international economic crisis," said New Jersey Banking and Insurance Commissioner Steven M. Goldman, who also chairs the NAIC International Insurance Relations Committee, "is how important it is that we have an open dialogue with regulators from around the world to develop common international regulatory standards through the sharing of ideas and best practices."

Goldman also spoke about the success of U.S. insurance regulatory practices that have been crafted over the past 150 years. In addition, he described how the states work together through the NAIC in support of widespread uniformity in state-based regulatory oversight.

Illinois Insurance Director McRaith — who represents the NAIC on the cross-sectoral Joint Forum of the Basel Committee on Banking Supervision, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) — discussed the need for U.S. regulatory reform to address regulatory weaknesses revealed by the current market stress. "The NAIC agrees that federal regulatory structures need to be updated to better identify and manage systemic risk in the broader financial system," McRaith said. "But we believe that any such proposals should preserve the state-based insurance regulatory system and its proven track record of strong solvency and consumer protections."

NAIC President and New Hampshire Insurance Commissioner Roger Sevigny welcomed the opportunity to meet with European policymakers, regulators and industry representatives. "These exchanges allow us to hear about the progress on solvency reforms in Europe, as we discuss ways to enhance transatlantic relations and provide leadership on regulatory solutions to the challenges of today's marketplace," Sevigny said.

DHS: An Analogous Set of Federal Structural Reforms and Disappointing Performance

While a thorough, candid evaluation of the existing state regulatory environment is crucial in determining a proper strategy for future reform, an equally important examination needs to take place concerning the overall ability of the federal government to exercise the substantial increase in regulatory authority sought by proponents of the optional federal charter.

Students of federal government operations would likely find a surprising number of parallels between the proposed creation of a new federal insurance regulatory authority with Congress creating the Department of Homeland Security (DHS), as an umbrella department from merging numerous already standing federal agencies of existing federal departments. While functionally the jurisdictions are entirely different, the DHS story can shed some useful light on the potential pitfalls of ambitious federal reorganization.

DHS combined existing federal agencies previously housed within other cabinet-level agencies and merged those entities together with vast new authority designed to facilitate better collaboration to secure the American homeland. The resulting mass remains a largely segregated and redundant organization with lingering loyalties to individual agency missions and jurisdictions.

The creation of DHS also left large holes in existing federal departments from which certain of their agency operations were severed and reassigned under DHS. As it was later discovered, not all responsibilities of those transplanted agencies were transferred with them or really fit the mission of DHS. However, all budget dollars and line items did transfer. The reduced federal departments found they had to pick up this overlooked and returned slack, but under a reduced budget.

The inter-departmental and inter-agency struggles have impacted the very prime entities that DHS was to serve. State and local law enforcement agencies, the agreed upon "front line" in ensuring the nation's public safety, have been frustrated and disenfranchised by frequently changing DHS personnel, initiatives and mandates. The country is kept safe, but arguably in spite of the new system rather than because of it.

Like DHS, the existing federal bureaucracy as relates to insurance is broad and diverse. The Office of the Comptroller of the Currency (OCC), Internal Revenue Service (IRS), Commodity Futures Trading Commission (CFTC), Securities and Exchange Commission (SEC), Health & Human Services (HHS), Department of Labor (DOL), National Flood Insurance Program (DHS/FEMA/NFIP), Federal Crop Insurance (USDA/FCIC/RMA) and other federal entities all have responsibilities that relate to U.S. insurance laws, regulations, insurers and insurance producers, and work with state insurance departments and the NAIC.

Many federal agencies and departments already work with and depend upon the safety net of well-organized, well-staffed and institutionally informed regulators at the state level to help coordinate this federal playing field. Insurance companies find their regulatory environment relatively consistent and properly managed.

Therefore, why should anyone expect that thrusting unprecedented new levels of authority into the maze of existing federal agencies will create a better environment for insurers and a safer, more reliable product for consumers? In truth, nobody really knows and that degree of uncertainty is a serious "red flag" for the public policy process.

Furthermore, the unnecessary elevation of responsibilities handled historically well by state jurisdiction goes against basic fundamentals of American federalism. Put more simply: the states are doing the job and the feds already have plenty to do.

During a hearing before the U.S. Senate Banking Committee on April 5, 2009, former Federal Reserve Chairman Alan Greenspan, one of the nation's most respected and accomplished economic statesmen, signaled elements of surprise concerning the behavior of certain financial services companies in not complying with regulations and taking excessive risk. Former Securities and Exchange Commission Chairman Chris Cox and a host of other federal regulatory officials appeared similarly shell-shocked in response to Congressional and other inquiries about root causes of the continuing financial crisis.

The truth is, despite the longstanding roots of existing federal regulatory agencies, the sheer size and scope of modern markets and market players make consumer protection more difficult than it has ever been. Hedge funds, private equity and other investment vehicles have left federal regulators struggling to evolve. Add to the mix a wide array of illegitimate market players throughout the financial services sector and, again, the image left is one of excessive burden and overextension. But somehow the capacity exists to absorb insurance regulation?

Conclusion

It can't be said enough: no public entity or public policy is above or beyond the benefits of thoughtful, strategic reform. The National Association of Insurance Commissioners should, and arguably does, agree with this principle as it relates to insurance regulation. But does that mutual interest in improving the current system automatically justify wholesale abandonment of a good system?

The federal government does, as proponents of the optional federal charter suggest, have some role to play in any reform of insurance regulation in the United States. As Congress and the Obama Administration continue efforts to mitigate past failures of federal regulatory agencies, certainly the insurance industry deserves prominent status as an existing stakeholder under existing authorities. But should their involvement in the public policy debate be mistaken as the implicit stamp of approval on unprecedented changes in the regulatory landscape, particularly when the industry is not universally agreed? Of course not.

A variety of arguments, including the proper role of the federal government in facilitating international agreements regarding insurance, have validity and warrant further consideration. But the very nature of the arguments themselves — relatively young, underdeveloped and ripe with disputable logic — render the overall debate a work in progress and desperately needing additional examination.

The public policy process in this country is intended to be inefficient. This natural inefficiency, while frustrating in some instances, has a broader invaluable purpose. The United States does not take lightly the standards and processes by which government interferes with and monitors the free market. Those issues are debated thoroughly and completely before any real resolution can be achieved. In the case of insurance regulation, the debate over federal regulation has led to only one reasonable conclusion: the process has only just begun.

From the Author

"Over the course of more than three decades of my professional career, my prime focus has been in the public policy arena for the state of Illinois. I was Director of the Illinois Department of Insurance from 1995 to 1998, which was sandwiched between sixteen years of a variety of gubernatorial appointed executive positions responsible for developing new government programs and improving existing governmental law, regulation and program implementation.

"I had the opportunity to see, experience and work with the many different faces of the federal government as I worked in the highest levels of Illinois government. Interaction with Members of Congress and federal agencies was integral to ensure that federal law and regulations did not conflict with the coordination and implementation of state law and regulations.

"The preceding summary discussion is based upon that perspective, developed by my career in public policy implementation, state regulation, and private industry management."

Mark Boozell
August 2009

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