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# Preservation of State-Based Insurance Regulation: An Ongoing Challenge in the U.S. and the European Union

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# Preservation of State-Based Insurance Regulation:

## *An Ongoing Challenge in the U.S. and the European Union*

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## Abstract

Plans for broad financial services regulatory reform in response to the recent global financial crisis have included calls for modernization and improvement of insurance regulatory systems in the U.S. and the European Union (EU). In both cases, proposals have been developed in an effort to preserve state-based insurance regulation—in the U.S., regulation by the 50 states, the District of Columbia and five U.S. territories; and in the EU, supervision by the 27 Member States (nations). In the U.S., the Obama administration has indicated the need for increased national uniformity through either a federal charter or effective action by the states. Responding to the failure of existing state-based insurance—as well as banking and securities—supervisory systems to perform effectively during the recent financial crisis, the EU has formulated a plan to significantly strengthen the systems through the development and enforcement of uniform regulatory standards, as well as the adoption of various measures to increase cooperation, coordination, consistency and trust among national supervisors. This article examines the different approaches taken by the U.S. (establishment of a self-regulatory organization) and the EU (establishment of a European Supervisory Authority at the EU level) in an effort to improve the effectiveness of state-based insurance regulation in the future.

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# Introduction

The debate over the need for federal involvement in insurance regulation to mitigate purported shortcomings of the existing state-based regulatory system is certainly not new. Every decade since 1945, when Congress passed the McCarran-Ferguson Act ceding insurance regulation to the states and exempting insurers from most antitrust laws, Congress has conducted investigations to assess whether the states were carrying out the mandate of the Act by regulating the business of insurance in the public interest. Not much different from the criticisms raised in recent years, the majority reports of a congressional investigation of the effectiveness of insurance regulation that began in 1958 found "state regulation lacking, incapable of dealing with interstate and international issues, and unwilling or unable to 'bring the blessings of competition'" (CRS, 2005, p.14). The findings of periodic congressional investigations have led to a variety of proposals for dual federal-state regulation of insurance. For example, in response to the insolvencies of several property-liability insurers in the 1960s, Congress considered creating a federal guaranty fund to protect policyholders. Expressing continued concern with the adequacy of the existing system for dealing with insurance company insolvencies, in 1976 Sen. Edward W. Brooke (D-Mass.) introduced a bill (S. 3884) to create an optional dual federal-state system for the regulation of insurers that would provide a federal guaranty fund to protect the policyholders and third-party claimants of federally chartered insurance companies (Cooper and Ralston, 1977). With the exception of S. 1373 introduced by Sen. Ernest Hollings (D-S.C.) in 2003 to prescribe guidelines for federal licensing and standards governing interstate insurers, the other recent legislative proposals for federal involvement in insurance regulation have consisted of a series of similar Optional Federal Charter (OFC) bills. Basically, OFC legislation would enable insurers and producers to choose between state and federal regulation, regarding the right to do business (licensing), financial solvency, and market conduct and consumer protection.

For the most part, the debate over the propriety of, and/or need for, establishing an OFC for insurers and producers as the means to improve insurance regulation in the U.S. has largely focused on rehashing the same set of pros and cons by the proponents and opponents of such legislation, with little progress toward resolution. Having heard little, if anything, new in several years of congressional hearings, more recently Congress and the executive branch have moved to more clearly focus the scope of the debate. Since 2008, the two branches have made clear, through both proposed legislation[2] and Treasury Department statements (2008 and 2009) on behalf of the

2. H.R. 5840, the Insurance Information Act of 2008, introduced on April 17, 2008, and reintroduced on May 21, 2009 as H.R. 2609, the Insurance Information Act of 2009, by Rep. Paul Kanjorski (D-PA) would establish an Office of Insurance Information (OII) in the Treasury. In addition to serving as a repository of insurance-related knowledge in the federal government, the OII would have responsibility for establishing federal policy on international insurance matters, and ensuring that state insurance laws are consistent with agreements relating to such federal policy entered into by the United States. Recognizing the federal government's need for relevant information and financial data, the NAIC (2009b) supported H.R. 5840.

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previous and current administrations, that regardless of the outcome of the OFC debate, federal involvement in insurance regulation will be essential to meet two additional areas of concern with the current state-based system—(1) the need for a single source of information and data related to domestic and international insurance and reinsurance matters that would be available to Congress and the executive branch when considering proposed legislation and insurance-related policy issues; and (2) the need to establish a federal presence in international insurance matters.

On June 17, 2009, President Barack Obama presented his plan to reform the U.S. financial regulatory system. The following day, the Treasury issued a detailed description of the plan (2009), a portion of which dealt with enhancing the oversight of the insurance sector through the following two key measures:

- The introduction of legislation proposing the establishment of the Office of National Insurance within the Treasury to gather information, develop expertise, negotiate international agreements, and coordinate policy in the insurance sector.
- Treasury support for proposals to modernize and improve the system of insurance regulation in accordance with six stated principles.

Contending that the long history of state-based insurance regulation "has led to a lack of uniformity and competition across state and international boundaries, resulting in inefficiency, reduced product innovation and higher costs to consumers," the Treasury (2009, p. 39) indicated that in principle, it supports increased national uniformity through either a federal charter or effective action by the states. In discussing this principle, the Treasury indicated that despite the efforts of state insurance regulators to increase uniformity, the results have been insufficient, leaving great differences in regulatory adequacy and consumer protection among the states. Thus, the current administration appears to have made it clear that preservation of state-based regulation will require a proposal offering a new approach that can successfully introduce an acceptable degree of uniformity into the operation of insurance regulation.

An indication that there may now be greater openness at the federal level to objectively consider a proposal for the preservation of a state role in insurance regulation can be found in H.R. 3126, the Consumer Financial Protection Agency Act of 2009 (CFPAA)—Title X of the Obama administration's proposed comprehensive financial overhaul legislation introduced July 8, 2009, by Rep. Barney Frank (D-Mass.), chair of the House Financial Services Committee. The bill would establish the Consumer Financial Protection Agency (CFPA), an independent agency with a range of rulemaking, information gathering, supervisory, and enforcement tools to better protect consumers who purchase financial products from banks and non-bank financial institutions. With the exception of credit, mortgage and title insurance, insurance is not a financial activity subject to regulation by the CFPA. However, Subtitle D of the bill—titled Preservation of State Law—suggests that the administration is supportive of state regulation. For example, by amending the federal laws applicable to banks, other

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federally chartered depository institutions, their subsidiaries and affiliates, and nondepository institutions, the CFPAA limits preemption of state consumer protection laws and regulations to situations where they fail to provide greater protection for consumers than—and thus are considered inconsistent with—CFPA rules, or discriminate against the federally chartered institutions. This would prevent the common strategy used by national banks to hide their state-licensed affiliates (for example, mortgage brokers and mortgage banking operations) from strong state consumer protection laws by making them operating subsidiaries of the bank and thus, freeing them from state regulation with the same preemptive power applicable to the banks themselves. In the future, both the national banks and their subsidiaries and affiliates would be subject to state consumer protection laws that provide greater protection for consumers than the CFPAA and the rules promulgated by the CFPA. In addition, the bill confirms the authority of a state attorney general or state regulator to bring an action or other regulatory proceeding arising solely under state law, as well as civil actions for violations of Title X, in federal or state court.[3] While not applicable to most lines of insurance, Section D of the CFPAA does illustrate the administration's willingness to support the applicability of state-based consumer protection laws and regulatory requirements as part of its plan for financial reform.

The next section examines a modified regulatory system developed to introduce increased uniformity into state-based insurance regulation, as well as provide for the federal government's need for a single source of information for use in evaluating proposed legislation and policies related to insurance, and to play a leadership role on behalf of the U.S. in international insurance matters. Then we examine the current use of two key components of this modified system by U.S. insurance regulators and EU insurance supervisors to explore different paths to the same regulatory objective—preservation of state-based insurance regulation.

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3. On June 29, 2009, the U.S. Supreme Court in *Cuomo, Attorney General of New York v. Clearing House Association, L. L.C., et al.* 557 U.S. ___ (2009) severely limited the extent to which national banks and their operating subsidiaries are exempt from compliance with state civil and criminal laws, including fair lending and other consumer laws. As a result, state attorneys general and state agencies are now able to file suit in state courts against national banks and use the court's subpoena power to obtain documents and other information from them. Adoption of the CFPAA would extend this authority to regulatory proceedings and violations of Title X, and provide for filings in federal as well as state courts.

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# An Approach for Preserving State-Based Regulation

## *Possible Objectives of a Modified Insurance Regulatory System*

**Objective 1**

As mentioned above, the Treasury (2009) has indicated that it will support proposals to modernize and improve the system of insurance regulation in accordance with six principles specified in its report detailing the Obama administration's plan to reform the U.S. financial regulatory system. Principle 4 indicates that the choice between a federal charter and "effective action by the states" to improve the current state-based system would depend upon the ability of the states to submit an acceptable proposal for increasing national uniformity in insurance regulation. Thus, the minimum objective of state action to preserve state-based insurance regulation would appear to be the development of a proposal detailing a new approach for successfully introducing an acceptable degree of uniformity into the operation of insurance regulation. Adoption of uniformity would also provide an improved environment for achieving the goals of Principle 2, the establishment of strong capital standards and the requirement of appropriate insurer risk management—including the management of liquidity and duration risk—and Principle 3, the establishment of meaningful and consistent consumer protection for insurance products and practices.

**Objective 2**

A second objective might be to recognize the importance of, and either suggest a plan or provide support for, the establishment of a leading role for the federal government in dealing with international insurance matters. Support for this objective can be found in: 1) Principle 6 that indicates "improvement to our system of insurance regulation should satisfy existing international frameworks, enhance the international competitiveness of the American insurance industry, and expand opportunities for the insurance industry to export its services" (Treasury, 2009, p. 41); 2) the Treasury's indication that legislation would propose the establishment of the Office of National Insurance (ONI) to negotiate international agreements and coordinate policy on international insurance matters; and 3) the Treasury's call for increased national uniformity in Principle 4 that underlies the first objective of state action discussed above.

**Objective 3**

As indicated earlier, both legislation introduced by Rep. Paul Kanjorski (D-Pa.) in the 110th and 111th Congresses, and statements by the Treasury Department (2008 and 2009) released during the Bush and Obama administrations indicated the need for a single source of information and data related to domestic and international insurance and reinsurance matters that would be available to Congress and the

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executive branch when considering proposed legislation and insurance-related policy issues. With the Treasury (2009) indicating that legislation would propose the establishment of the Office of National Insurance (ONI) to gather information and develop expertise regarding the insurance sector, a third objective might be to recognize the importance of, and either suggest a plan or provide support for, the establishment of a federal entity to gather and analyze industry-related data and information, and report the findings to Congress and the executive branch.

**Objective 4**

With attainment of national uniformity of basic regulatory rules, requirements and standards, a fourth objective might be to reduce the number of states from whom insurers and producers must obtain licenses, and to whom insurers must demonstrate solvency. Based on an examination of possibilities for modernizing U.S. insurance regulation through the adoption of certain key features of the system for insurance supervision employed by the European Union (EU), Cooper and Dorfman (2004) proposed two changes related to licensing and financial regulation under conditions of uniformity in regulatory rules and requirements. First, in order to carry on the business of insurance in the U.S., insurers and producers would be required to be licensed by the state insurance commissioner of their *home* state—for insurers, the state in which their home office is located; for producers who are individuals, their state of residence; and for other producers, the state in which their head office is located. Once licensed by its home state, an insurer or producer would be permitted to carry on the same line(s) of business in all 50 states, the District of Columbia and other U.S. regulatory jurisdictions. In essence, under these circumstances, the U.S. insurance market, like that of the EU, would be a single market without internal frontiers. Second, as with licensing, financial regulation based on uniform rules and regulations would also be the sole responsibility of an insurer's home state. Given the increasing dominance of market share by insurers operating on an interstate basis (Grace and Scott, 2008), adoption of these proposed changes should substantially increase the efficiency of interstate commerce for insurers and their producers. In addition, adoption of the requirements of a single license for an insurer or producer to do business on an interstate basis and home-state regulation of an insurer's financial condition would counter the claimed advantages of an OFC requiring licensing of national insurers and producers, and regulation of a national insurer's solvency by a single federal regulator.

**Objective 5**

Perhaps the most controversial possible objective would involve prohibiting regulation of rates and policy forms as suggested in OFC legislation, as opposed to merely applying uniform rules and requirements in regulating those activities as discussed in Objective 1. Academic researchers have repeatedly found that rate regulation and policy form approval hampers market efficiency—by, among other things, reducing availability of coverage; increasing prices, resulting in a reduction of demand for coverage; significantly increasing the time to bring a new contract to market, causing innovations to spread more slowly; resulting in cross-subsidies

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among groups of consumers; and increasing insurers' cost of capital (Tennyson, 2007; Cummins, 2002; Harrington, 2000). But there appears to still be support, particularly among state regulators, for continued rate and policy form regulation, especially to protect individual and small-business consumers. With the possible exception of health insurance prices, little, if any, attention has been paid to the issue of regulation of insurance rates and policy forms in the Obama administration's discussions of planned financial regulatory reform.

**Other Possible Objectives**

Principles 1 and 5 contained in the Treasury's (2009) statement suggest two additional objectives. In its discussion of Principle 1—effective systemic risk regulation with respect to insurance—the Treasury (2009) mentions that in addition to steps that will be included in the administration's financial regulatory reform legislation to address systemic risks posed by the insurance industry, it would consider proposed changes suggesting ways additional insurance regulation could help to further reduce systemic risk or increase integration into the new regulatory regime. Making reference to the 2008 liquidity crisis of American International Group (AIG), the Treasury indicates that it would also welcome proposals presenting plans that would, according to Principle 5, improve and broaden the regulation of insurance companies and affiliates on a consolidated basis, including those affiliates outside of the traditional insurance business. Having been discussed by regulators at hearings before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises of the House Financial Services Committee (NAIC, 2009c) and the Senate Banking Committee (NAIC, 2009b), the problems related to systemic risk and even the AIG situation[4] appear to be more closely tied to federal system-wide financial reform than to insurance regulatory reform. As such, attempts to address these two problems in a state-based proposal that focused primarily on increasing national uniformity in insurance regulation would appear to be neither directly, nor even closely, related to the main topic. Moreover, in view of the breadth of the debate exhibited in hearings by institutions, associations and regulators from all sectors of the financial services industry, an attempt to deal with these issues in a proposal aimed at preserving state-based insurance regulation by effective action to increase national uniformity would likely divert discussion from the primary topic.

4. Contrary to what frequently has been reported in the press and stated by various federal government employees, AIG—a federally supervised holding company, not a state-regulated insurer—collapsed not due to solvency problems experienced by its insurance subsidiaries, but rather to the mishandling and mismanagement of high-risk, unregulated credit-default swaps by its financial services subsidiary, Financial Products Corp., as well as the federal examiners' lack of technical expertise, failure to recognize the magnitude of the potential liquidity problems related to AIG's credit derivatives portfolio (particularly the swaps), and delayed actions (Gerth, 2008; GAO, 2007). Recently, Harrington (2009) concluded, "If the financial crisis and AIG investigation are to be blamed on ineffective regulation, the blame should reflect the substantial evidence of fundamental failures in U.S. and foreign regulation of commercial banking, thrift lending, and investment banking" (pp. 28-29).

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## *A Modified Regulatory System*

Expanding upon the proposal by Cooper and Dorfman (2004) to draw from key concepts underlying insurance regulation in the European Union (EU) for use in modernizing the U.S. insurance regulatory system, Cooper (2008) proposed *a modified system of insurance regulation that both overcomes the numerous criticisms of the current state-based regulatory system, and achieves the purported advantages of an OFC system, but without the creation of the type of dual federal-state regulation envisioned in recent OFC legislation*. Despite being developed several years prior to the Treasury's recent identification of principles essential to gain its support, Cooper's approach (2008) achieves each of the first five objectives discussed previously. However, while incorporation of the fifth objective into the design of this approach was critical to enabling it to provide the same advantages as those attributed to an OFC system, the controversial requirement of prohibition of rate and policy form regulation is not essential to the key task of increasing national uniformity (Objective 1), nor to achieving Objectives 2, 3 and 4.

The proposed system and process (Cooper, 2008) for achieving these objectives is illustrated in Figure 1. As indicated, the system would require the creation of a federal entity, termed the Federal Insurance Office (FIO)[5] and most likely located in the Treasury Department, that would have certain specified domestic, international and general information-related responsibilities associated with various aspects of insurance regulation (Objectives 1, 2 and 3). In addition, Congress could also permit the creation of self-regulatory organizations (SROs) to carry out certain specified responsibilities related to insurance regulation (Objectives 1 and 2). With implementation of increased uniformity in the regulatory system, duplicate state licensing and financial regulatory requirements would give way to "home state" responsibility[6] for these activities (Objective 4).

Under this proposal, U.S. insurance regulation would involve both the federal and state governments, each with their own roles and responsibilities. Simply put, as Figure 1 shows, the federal government would be responsible for adopting legislation establishing the basic rules, requirements and standards to be applied by the states in licensing and regulating insurers and producers. Essentially, with

5. The Federal Insurance Office (FIO) included in this proposal for modernizing the state-based insurance regulatory system differs in a number of ways from the entity of the same name that would be created by the Federal Insurance Office Act of 2009, released by Rep. Paul Kanjorski (D-Pa.) Oct. 1, 2009. While both FIO entities would have responsibilities associated with international insurance matters and the insurance-related information needs of the federal government (Objectives 2 and 3), the Federal Insurance Office proposed by Cooper (2008) also would have the authority to: 1) establish uniform standards for the licensing and regulation of insurers and producers within parameters set by federal legislation; and 2) supervise their implementation and enforcement by the state insurance commissioners (Objective 1).

6. Unlike licensing and financial regulation, which would be the sole responsibility of an insurer's or producer's home state, market conduct would be regulated by the host state where an insurer or producer is doing business in conjunction with the home state responsible for licensing the entity in accordance with federal standards. For a more complete explanation of how this market conduct regulatory mechanism would work, see Cooper (2008), p. 17.

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respect to insurance regulation, the federal government would be the rule maker and the state insurance commissioners would enforce those rules within their states. The actual breadth of federal rulemaking authority with regard to insurance regulation would be determined by congressional action. Recently proposed legislation and Treasury statements of the administration's plans for financial regulatory reform suggest that federal rule-making authority will likely be applied to both domestic and international insurance regulation.

As shown in Figure 1, the FIO would be responsible for working with congressional committees—with input from an appointed Advisory Committee composed of state regulators, U.S. government agency personnel, and representatives of the industry, consumer groups and possibly other relevant groups and organizations—in drafting proposed legislation on all key aspects of insurance regulation. Once approved by Congress, insurance legislation would be sent to the FIO or appropriate SRO for implementation. The FIO/SRO role in implementation would be to prepare (with advice as needed from its advisory committee) regulations necessary to carry out U.S. insurance law, and then to supervise the implementation and enforcement of U.S. insurance laws and regulations by the state insurance commissioners. Thus, in the proposed system, the state regulator's role in the day-to-day regulation of insurance would be narrowed, focusing primarily on enforcement matters.

The FIO and the federal courts would share the responsibility for ensuring that federal insurance law is being implemented and enforced properly by the states. The FIO would begin an investigation based on complaints lodged by individuals, businesses, other states or an SRO. If it found that a state was not fulfilling its obligations under U.S. law, the FIO would issue recommendations to correct the matter. It should be emphasized that the FIO would not be responsible for investigating or otherwise regulating consumer complaints that specific insurers or producers are not meeting their contractual or other obligations to policyholders and other third parties. These very common complaints would continue to be handled by the state insurance commissioners and, if necessary, the state courts. Instead, the FIO would be responsible for handling complaints that particular states have not properly implemented, and thus are not enforcing, federal insurance laws and regulations. If a state does not comply with the FIO's recommendations, the FIO could take the matter to the federal courts, which would give a final ruling.

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# Current Applications of the Modified Regulatory System

The two approaches for establishing and supervising the implementation of uniform regulatory standards by the states contained in this modified regulatory system (Cooper, 2008)—a federal entity (FIO) and a private entity (SRO)—are being proposed in the effort to improve and preserve the state-based insurance regulatory systems of the U.S. and the EU.

## *U.S. Regulatory Reform – Formation of an SRO*

As first publicly reported by the National Underwriter Online News Service August 27, 2009, the NAIC has prepared a discussion draft of a proposal for the creation of an SRO to develop regulatory standards that would be implemented and enforced by the states (Gusman, 2009a). First discussed by regulators at the NAIC's quarterly meeting in June 2009 and expected to continue to be discussed by regulators, state legislators and other interested parties over the next several months, the proposal currently calls for establishment of the National Insurance Supervisory Commission (NISC) authorized to engage in specified activities by an act of Congress. A private entity with corporate governance and bylaws similar to those of the Interstate Insurance Product Regulation Commission (IIPRC), the NISC's stated purpose is "to facilitate uniformity while maintaining and enhancing consumer protections afforded by the state-based insurance regulatory system" (Gusman, 2009a, p. 6). As reported by the single source of information available at this time, the proposed commission would accomplish this task by developing uniform national standards for such areas of regulation as company licensing, producer licensing, asset-based product review and approval, reinsurance, surplus lines, receivership, and (unspecified) elements of accreditation—that is, by focusing predominantly on the achievement of Objective 1.

States that are not members of the NISC would be expected to implement standards developed by the commission within a given period of time. Failure to do so would subject a non-compliant state's law or regulation to preemption by a federal Office of Insurance Information (OII). The NISC would coordinate with the OII to report on the development and implementation of national uniformity, provide information on insurance-related matters needed by the federal government, and provide a contact point for international insurance regulatory matters. However, the proposal indicates that the OII would not have a role in the formulation of regulatory standards or in the operation of the NISC.

While still in the discussion stage, several aspects of the reported proposal raise questions regarding the likelihood of its acceptance at either the federal or state level. At the state level, State Rep. Brian Kennedy (D-R.I.), immediate past president of the National Conference of Insurance Legislators (NCOIL), has expressed concern that implementation of the proposed commission would cause

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state legislators to "lose their policy role and allow insurance regulators to have total control and authority over state insurance law" (Gusman, 2009b, p. 25). From a federal perspective, while the proposal appears to recognize the OII's role in both information gathering and analysis (Objective 3), and international insurance regulatory matters (Objective 2), the brief unofficial description of its features available at this time does not specifically mention creation and use of uniform national standards in a number of key areas of insurance regulation, such as review and approval of property-liability insurance (non-asset backed) products and rates, and supervision of market conduct.

In its recent review of NAIC and state regulators' progress in achieving greater uniformity and reciprocity in state-based insurance regulation, the Government Accountability Office (GAO, 2009) indicated that uniformity and full reciprocity for approval of property-liability insurance products might not be realistically achievable, due to the significant changes that would be required in state laws, including a wide body of tort law. Perhaps of even greater concern to the GAO were the serious delays that have been encountered in various efforts to improve market conduct regulation. The GAO (2009) indicated that several factors continue to create inefficiencies for insurers and regulators, and uneven levels of consumer protection among states, including: limited uniformity in the use of the NAIC's market conduct tools and in state laws and resources; limited reciprocity among the states; and state regulators' varying use of the NAIC's market conduct data collection instruments, examination tools and guidance. In addition to inviting challenges regarding the possible exclusion of these important areas of insurance regulation from an effort to increase national uniformity, their apparent absence from the NAIC's proposal could also hamper achieving greater efficiency through single (home) state responsibility for licensing and financial regulation (Objective 4). The NAIC's proposal will likely undergo considerable revision and clarification before being adopted by the membership and made available for public distribution.

## *EU Regulatory Reform – Creation of EU Level Supervisory Authorities*

In its efforts to deal with the current financial crisis, the European Union (EU) experienced challenges quite similar to those encountered by the U.S.—a lack of a mechanism and process to identify and mitigate systemic risk (that is, macro-prudential supervision), as well as serious failings of national (Member State) financial supervisors to safeguard the financial soundness of individual financial institutions and markets—and thus protect consumers of financial services (that is, micro-prudential supervision). As in the U.S., these problems indicated the need for broad financial reform of the EU's financial regulatory structure.

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**The Current EU Financial Regulatory Structure**

As indicated in Figure 2, supervision of financial services firms—including insurers, banks and investment companies—that are established in the EU is primarily the responsibility of the firm's "home" Member State (nation), which authorizes it to do business throughout the EU and regulates its financial condition regardless of the Member State in which it is conducting business. Home Member State regulation is conducted primarily according to the provisions of Directives—that is, legislation drafted by the European Commission[7] with input from the appropriate financial sector-based Regulatory Committee and Committee of [Member State] Supervisors, and then approved in co-decision by the EU's Council and Parliament. Once approved, Member State legislatures are required to transpose the Directives into national law to bring the Member State's law into conformance with EU law. In an effort to ensure more consistent implementation of a Directive in the Member States, the appropriate Committee of Supervisors issues non-binding common interpretative guidelines, and works to facilitate cooperation and information exchange among Member State supervisors. Together with the Court of Justice, the Commission is responsible for ensuring that the Member States transpose the Directives into national law and properly apply EU law.

Unlike financial supervision, which is the responsibility of an insurer's home Member State, market conduct is regulated by the host Member State where an insurer is providing services or has established a branch. Market conduct regulation of producers (insurance and reinsurance intermediaries) is also the responsibility of the host State where services are being provided. In areas not covered (not "harmonized") by Directives, including nearly all aspects of market conduct, Member State legislatures are free to establish their own regulatory requirements that apply to all producers and insurers doing business in their country, as long as those requirements serve the "general good." Despite the rigorous nature of the tests for determining whether national rules serve the "general good," regulatory requirements in areas related to insurer and producer market conduct still differ among the Member States. Burdened with the need to comply with differing national rules established under the concept of the general good, insurers have called for the Member States to work with the Commission to identify appropriate common consumer protection standards that would apply throughout the EU.

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7. The European Union, an economic and political union of 27 Member States (nations), has a number of important institutions, two of which will be mentioned frequently throughout this paper—the European Commission and the Council of the European Union. The European Commission (referred to as the Commission) is the executive branch responsible for proposing legislation, implementing decisions, upholding the EU's treaties, and the day-to-day operation of the Union. The Council of the European Union (commonly referred to as the Council) is the more powerful of the two legislative bodies, the other being the European Parliament. It is composed of the Member States' ministers, depending upon the topic being discussed—in this case, the finance ministers. In making legislative decisions, in some cases the Council must only consult with the Parliament, and in others, a codecision process is followed.

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**Need for Reform of the EU's Financial Regulatory Structure**

As mentioned above, the EU encountered an array of serious regulatory challenges in responding to the current financial crisis. In November 2008, the Commission established a High-Level Group (subsequently referred to as the de Larosière Group) to study the regulatory response to the crisis and make recommendations on how the European supervisory structure could be strengthened to better protect EU citizens and rebuild trust in its financial system. In its final report presented to the Commission on February 25, 2009, the de Larosière Group (2009) identified and discussed numerous significant problems involving supervisory failures in responding to the financial crisis—some macro-prudential in nature, others micro-prudential, and still others that arose when the relationship between micro- and macro-supervision was ignored or nonexistent.

Based upon the Group's findings, the de Larosière Report (2009) set out what has been termed by the Commission (2009b, p. 2) as "a balanced and pragmatic vision for a new system of European financial supervision" that contains proposals to: 1) create a European level body charged with overseeing systemic risk in the financial system as a whole; and 2) strengthen cooperation and coordination between Member States' supervisors through the creation of new European Supervisory Authorities for the insurance, banking and securities sectors.

In its Communication for the Spring 2009 meeting of the European Council,[8] the Commission (2009a) indicated its support of the main thrust of the de Larosière Group's 31 recommendations and presented a plan for reforming the supervision of European financial markets. Subsequently, the Commission released a Communication (2009b) that presented the proposal in greater detail. On June 9, 2009, the Ecofin Council[9] (Council, 2009a), composed of the EU finance ministers, agreed on the outline of the proposed changes to the financial supervisory system. With governments still divided over several key details of the proposal described below, the discussion continued among the EU heads of state at the June 19 meeting of the European Council. The European Council (2009b) indicated its support for the creation of a European Systemic Risk Board, recommended that a European System of Financial Supervisors be established, and agreed on responses to the issues raised at the Ecofin Council meeting on June 9. On September 23, 2009, the Commission adopted a package of draft legislation to create the new European financial supervisory system that incorporated the recommendations of the European Council. The objective is to have both the macro-prudential and micro-prudential components fully in place during 2010.

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8. The European Council, composed of the heads of state of the 27 Member States and the President of the European Commission, differs from the Council of the European Union in that it has no formal powers. However, being composed of national leaders, the European Council provides the impetus for the major political issues relating to European integration as well as seeks to resolve disagreements between Member States.

9. The Economic and Financial Affairs Council—the Ecofin Council, or simply, ECOFIN—refers to the Council of the European Union when the Council is composed of the Member States' finance ministers.

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**Proposed New Supervisory Framework for the EU**

As indicated in Figure 3, the new supervisory system supported by the Council and reflected in the Commission's draft legislation (2009d and 2009e) would consist of the following two main components:

- A European Systemic Risk Board (ESRB) to monitor and assess potential threats to financial stability that arise from system-wide risks—that is, macro-prudential supervision.
- A European System of Financial Supervisors (ESFS) "consisting of a robust network of national financial supervisors working in tandem with new European Supervisory Authorities to safeguard financial soundness at the level of individual financial firms and protect consumers of financial services" (Commission, 2009b, p. 3)—that is, micro-prudential supervision.

As shown in Figure 2, supervision of insurance presently involves the relationship of the national (Member State) insurance supervisors and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) at the EU level. As such, what follows focuses on the proposed establishment of the European System of Financial Supervisors (ESFS).

*European System of Financial Supervisors (ESFS).* In addition to demonstrating the inability of the EU's existing micro-prudential supervisory structure to identify and effectively respond to the threat of systemic risk to the financial system as a whole, the financial crisis highlighted a number of other problems with the system. For example, exhibiting serious failings in cooperation, coordination, consistency and trust among national supervisors, the micro-level structure failed to meet its own objective of supervising and limiting the distress of individual financial institutions, thereby protecting the customers of a particular institution (de Larosière, 2009). Moreover, the existing system provided convincing evidence of its inability to perform any better in the future (Commission, 2009b).

As shown in Figure 3, the draft legislation (Commission, 2009e) proposes that the ESFS be established as an operational European network with shared and mutually reinforcing responsibilities. At the EU level, the ESFS would replace the three existing Committees of Supervisors, shown in Figure 2, with three new European Supervisory Authorities—the European Insurance and Occupational Pensions Authority (EIOPA), the European Banking Authority (EBA), and the European Securities Authority (ESA). In addition to assuming the missions of the current Committees of Supervisors, including giving technical advice to the Commission, the European Supervisory Authorities would have increased responsibilities, defined legal powers and greater authority as described below. The European Supervisory Authorities would be independent in relation to national authorities other than supervisors, have their own autonomous budget,

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and be governed by rules that ensure their efficiency, independence, and accountability to the Council, the Parliament and the Commission.

The day-to-day supervision of insurance, securities and banking would remain at the Member State level, with national supervisors continuing to be responsible for the regulation of individual financial entities. The Commission (2009c) believed that this approach would preserve experience, expertise and continuity by building on the existing decentralized supervisory structure.

With regard to financial conglomerates and cross-border institutions, colleges of supervisors composed of those Member States' supervisors involved in the supervision of the insurance, banking and/or securities activities of a particular institution (referred to as the "group") would serve as the group's supervisory system. In addition to improving cooperation and coordination among the various Member State authorities responsible for the supervision of the group, the college provides a mechanism for gathering and disseminating information related to ongoing and emergency situations; reviewing and evaluating risks to which the group and its entities are exposed; providing early warning of major risks; and coordinating supervisory review at the group level. Regarding the major financial conglomerates in the EU, colleges already exist or are being set up in 2009. In approving the outline of the proposed changes to the financial supervisory system on June 9, 2009, the Council (2009a) indicated its support for strengthening the oversight of cross-border groups by setting up colleges of supervisors for all such groups in the EU by the end of the year. Likewise, the importance of the role played by the colleges of supervisors was recognized by the European Council (Council, 2009b) and reflected in the draft legislation.

*European Supervisory Authorities*. The Council had a number of goals in recommending the establishment of the three new European Supervisory Authorities. These included upgrading the quality of supervision; strengthening national supervisors by providing them with far stronger and more consistent supervisory and sanctioning powers; strengthening the oversight of cross-border groups; and moving toward a single, core set of EU-wide rules and standards applicable to all financial institutions. To accomplish this, the draft legislation entrusts the Authorities with, among others, the following tasks and powers:

- Developing a single set of binding technical standards[10] and enforcing their application by national supervisors with support of the Commission if necessary.
- Drawing up non-binding standards, recommendations and interpretative guidelines, which the national authorities would apply in making individual decisions.

10. More specifically, the Authorities would adopt draft technical standards for their respective sectors, submit the drafts to the Commission for endorsement in the form of regulations or decisions, and then enforce their application by national supervisors (Commission, 2009e).

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- Ensuring consistent supervisory practices through the adoption of a variety of measures.
- Settling disputes between national supervisors or within a college of supervisors through a binding decision when the parties are unable to reach an agreement.
- Playing a role with regard to international issues.
- Collecting information from national supervisors for use by colleges of supervisors and the European Systemic Risk Board.

The European Insurance and Occupational Pensions Authority (EIOPA) would exercise these responsibilities and powers with regard to insurance supervision in the EU.

*Key Concerns Expressed by Several Member States*. As mentioned above, with governments still divided over several key details of the proposal at the end of the meeting of the Member States' finance ministers held on June 9, 2009, discussion of these matters continued at the June 19 meeting of the European Council. In addition to the issue of whether the European Central Bank (ECB) should lead the newly created systemic risk board, key concerns raised by the United Kingdom and shared by several others involved: 1) whether EU Supervisory Authorities should have the power to order nations to bail out or recapitalize a bank, insurer or financial group in trouble, since that would involve someone outside a Member State telling a particular nation's government how to spend its taxpayers' money; and 2) whether EU Supervisory Authorities should have the power to step in when national supervisors are unable to resolve a dispute and make a decision for them.

Responding to the concerns of several Member States that binding decisions made by the European Supervisory Authorities might give rise to potential or contingent liabilities for Member States, the European Council (Council, 2009b) stressed that decisions made by the Authorities should not intrude in any way on the fiscal responsibilities of Member States. However, given this exception, the European Council (Council, 2009b, p. 8) agreed that

> the European System of Financial Supervisors should have binding and proportionate[11] decision-making powers in respect of whether supervisors are meeting their requirements under a single rule book and relevant Community law, and in the case of disagreement between the home and host state supervisors, including within colleges of supervisors.

11. The principle of proportionality requires that EU action not go beyond what is necessary to achieve particular objectives satisfactorily.

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These decisions by the European Council were reflected in the draft legislation related to the establishment and functioning of the new European financial supervisory system adopted by the Commission on September 23, 2009.

# Concluding Comments

In their efforts to achieve a common goal—the preservation of state-based insurance regulation through, among other things, the introduction of increased uniformity in regulatory standards and practices—the U.S. and EU have initially undertaken different approaches. With an entity related to insurance regulation already existing at the EU level, the EU's approach is essentially to significantly strengthen the role and authority of that entity to foster increased uniformity in day-to-day state-based insurance regulation by national supervisors. Planned replacement of the current advisory committee—CEIOPS—with EIOPA would: 1) introduce powers at the EU level to develop a single set of binding technical standards and enforce their application by national supervisors; 2) ensure consistent supervisory practices through adoption of a variety of measures; and 3) settle disputes between national supervisors or within a college of supervisors through a binding decision when the parties are unable to resolve the matter themselves. In addition, the insurance supervisory authority would play a role with regard to international issues, and collect information from national supervisors for use by colleges of supervisors and the European Systemic Risk Board—roles similar to those called for by recent legislation and the Obama administration in the U.S. Interestingly, although the five objectives discussed earlier were formulated on the basis of the key issues in the ongoing U.S. OFC-vs.-state-based-regulation controversy—and the Treasury's recent statements regarding the need, and criteria, for improving the insurance regulatory system—the EU's draft legislation for creating its new supervisory framework also reflects Objectives 1, 2 and 3. Moreover, Objectives 4 and 5—"home state" licensing and financial regulation, and prohibition of Member States requiring prior approval of premium rates and policies—are already met by the EU's existing law.

Unlike the EU, without an entity already existing at the federal level, the NAIC is reported to be proposing creation of an SRO—the NISC—authorized by congressional action to develop national standards as a means of introducing increased, although perhaps somewhat limited, uniformity into the U.S. insurance regulatory system. In recommending the use of preemption of conflicting state standards by a federal Office of Insurance Information (OII), the reported proposal also recognizes the likely establishment of a new federal entity for dealing with the information needs of Congress and the executive branch, and possibly, various international regulatory matters, as called for by recent legislation and the Obama administration. If either the somewhat limited list of areas of regulation reportedly proposed for uniform standards or the SRO mechanism itself fail to attract sufficient congressional support, the option exists for a proposal that the OII's mission (and

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name) be modified to include the authority to prepare regulations necessary to carry out U.S. insurance law approved by Congress, and supervise the implementation and enforcement of U.S. insurance law and regulations by the state insurance commissioners, as indicated for the FIO in Figure 1 and currently proposed for the European Insurance and Occupational Pensions Authority in the EU.

Perhaps the area offering the greatest opportunity for improvement in terms of increased uniformity in both the U.S. and EU is market conduct regulation. The considerable interstate differences in market conduct standards, requirements, sanctions and their application that exist in both jurisdictions are known to create inefficiencies in the processes of supplying and regulating insurance, as well as variation in the quality of protection offered consumers. However, despite the opportunities for improvement and the calls for more effective consumer protection by the government in both the U.S. and EU, a significant increase in uniformity of market conduct regulation is likely to remain difficult to achieve in the near future. As has traditionally been the case in the EU, the new system of insurance supervision focuses more heavily on the development of binding technical standards essential to enforce more uniform ("harmonized") application of directives and other Community legislation, as opposed to attempting to create greater uniformity in areas not covered ("not harmonized") by directives—including nearly all aspects of market conduct. Given the numerous factors discussed earlier that have hampered the efforts of regulators to significantly increase the degree of uniformity in U.S. market conduct regulation, a mechanism must be established, such as an SRO or a federal entity, with the power to develop and enforce the implementation of national standards and regulations related to acceptable conduct by insurers and producers, particularly with regard to insureds, third-party claimants and consumers in general. While likely to be fraught with controversy, such action by state regulators is critical to the preservation of state-based insurance regulation, particularly now with heightened government focus on regulatory reform aimed at strengthening consumer protection in general.

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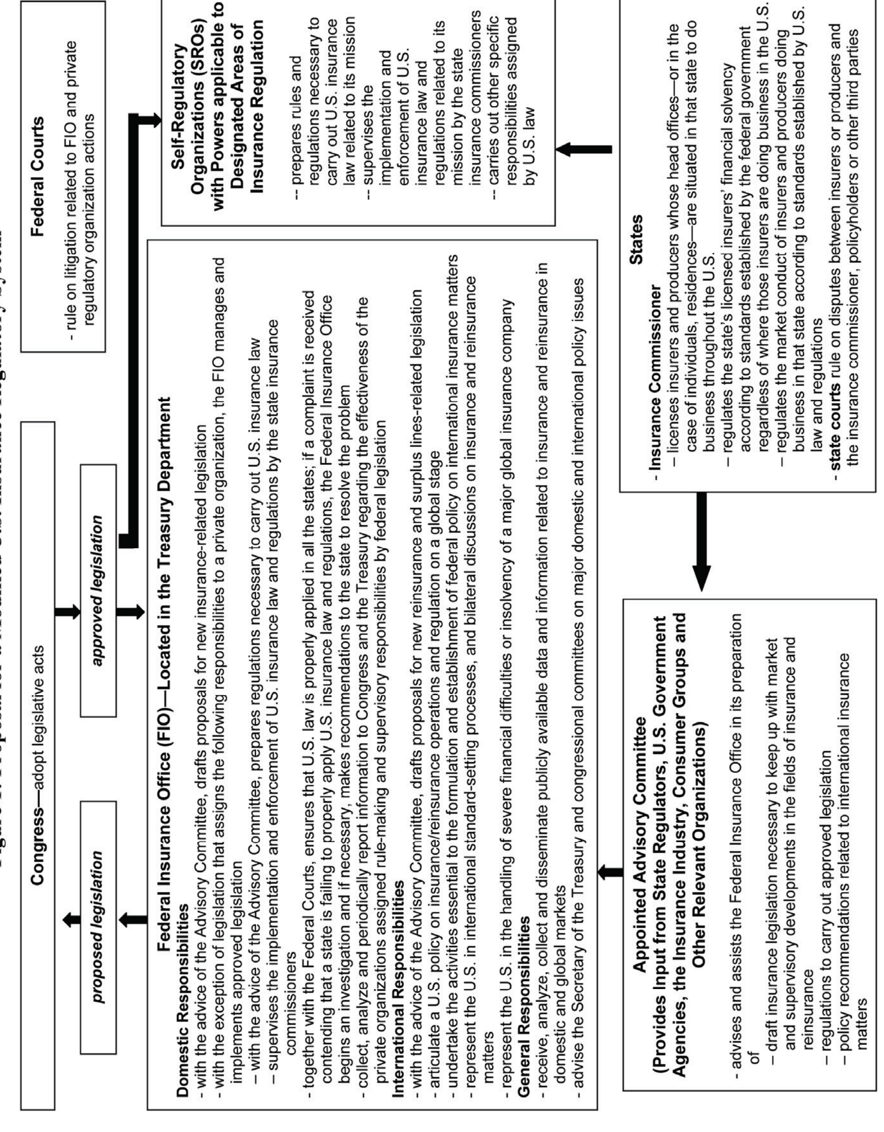


**Figure 1: Proposal for a Modified U.S. Insurance Regulatory System**

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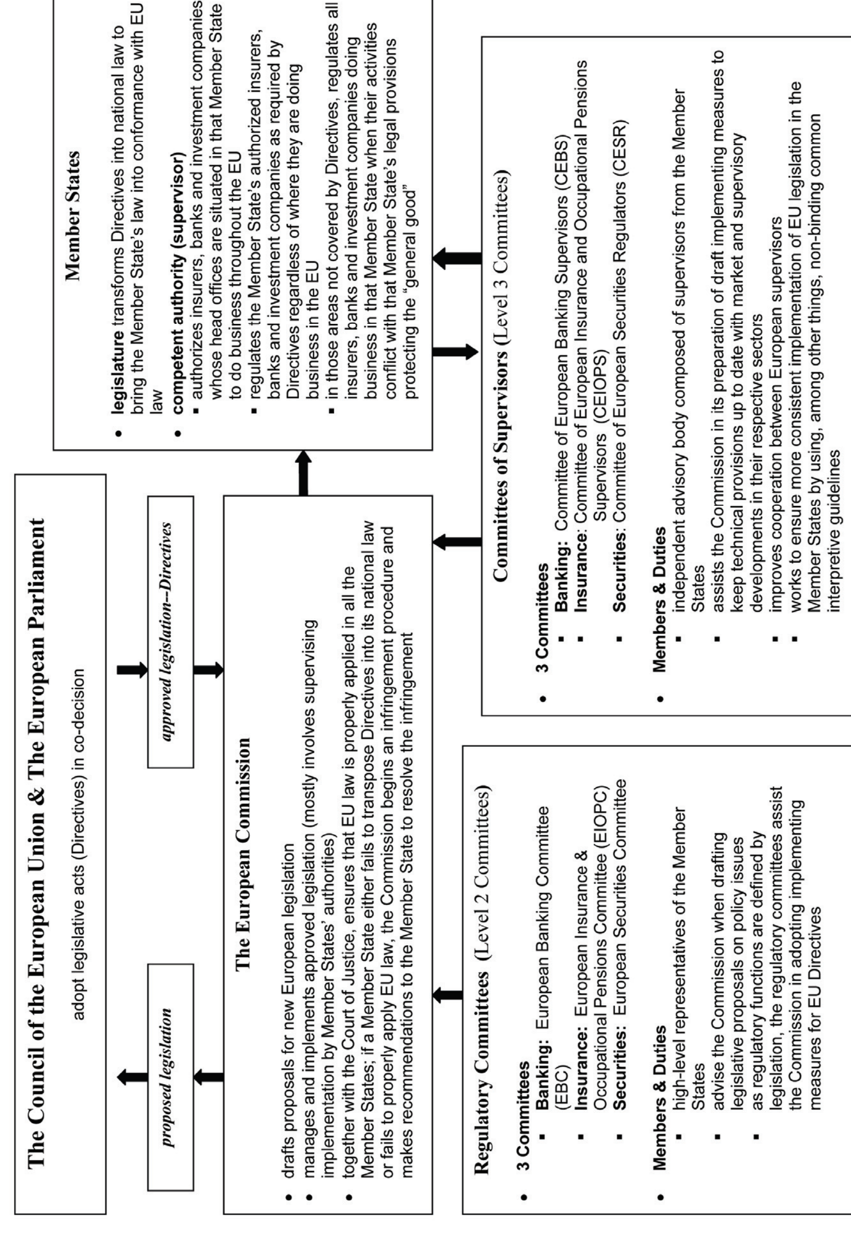


**Figure 2: Current EU Financial Services Regulatory Framework**

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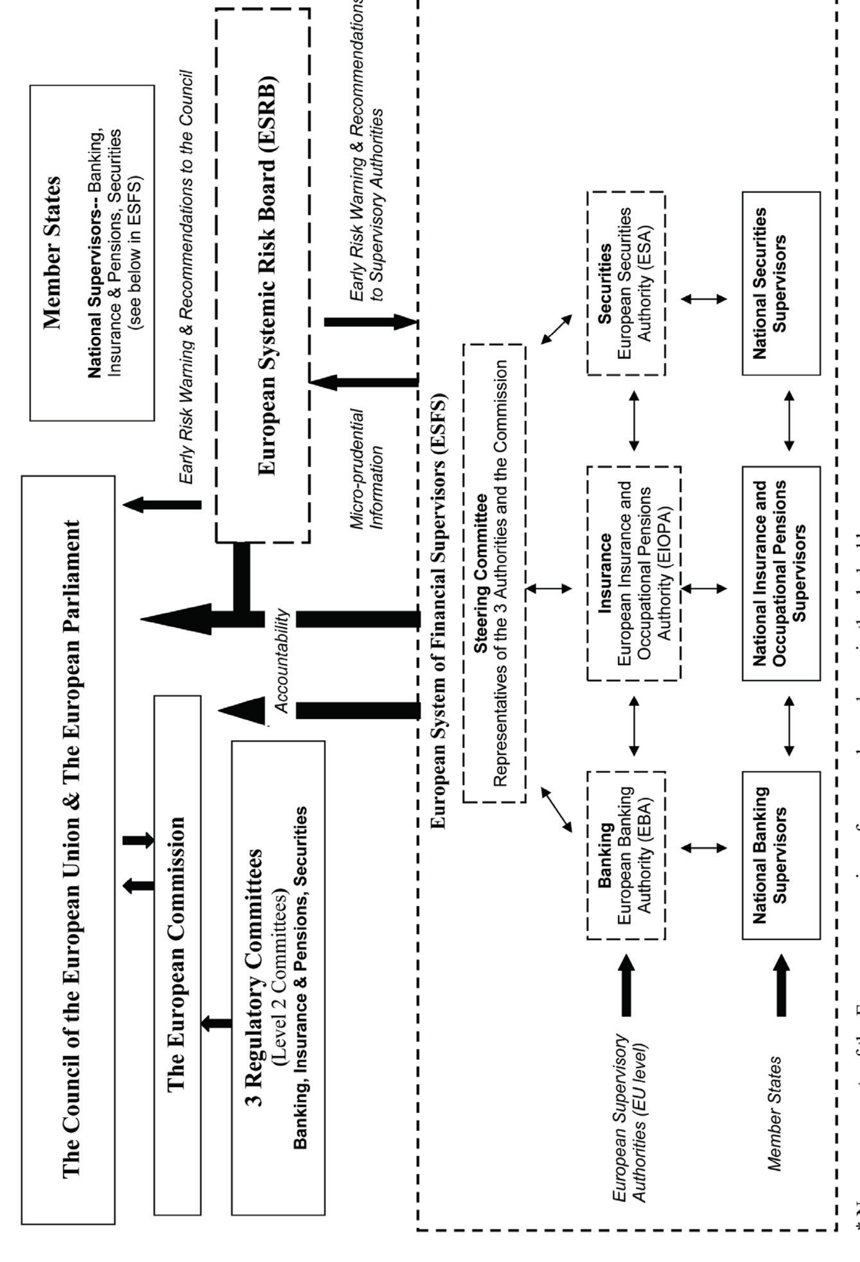


Figure 3: New* EU Financial Services Regulatory Framework

* New components of the European supervisory framework are shown in the dashed boxes.

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