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INSURING AGAINST REGULATORY CATASTROPHE: COMPOUND, OR COMPACT?

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Markets are increasingly global. From raw produce to digital downloads, from political consulting to athletic competition, national origin is increasingly irrelevant to the modern marketplace. Global trade negotiations, designed to generate rules of engagement for a dizzying array of products and services crossing hundreds of national boundaries, have become so unwieldy they risk collapsing of their own political weight.

Nowhere are the good, bad, and ugly sides of globalization more apparent than in financial services; particularly in the U.S. market for insurance.

America's historical template for regulating insurance, with 51 different jurisdictions reviewing forms, rates charged, service packages, and product lines, is grossly inefficient in serving the interests of consumers and achieving economic efficiency. Trading partners, indeed, accuse the U.S. of hiding behind the matrix of state regulations to deflect foreign-based insurers from entering the U.S. market.

With the heightened importance of innovative financial instruments to manage old and new risk potentials (terror, global climate change), the U.S. needs a more forward-looking posture for regulating insurance. Various remedies are suggested: greater federal preemption of state power over insurance, federal back-up protection to hedge against catastrophic industry losses, and most recently a federal charter option for insurers, modeled to some extent on the division of regulatory authority over banks that characterizes our federal system.[1]

OPTIONS, AND OPTIONS

The federal charter option is a well-conceived approach to address several interrelated problems:

- Reducing the regulatory redundancy and friction insurers face in serving customers in different states, each with a substantially different risk matrix and employing different (sometimes starkly different) standards, deadlines, and pre-approval processes for rates and forms;
- Making U.S. industries more competitive in global financial markets for insurance; and
- Invoking federal power with a new regulatory layer on top of existing state regulations while reducing (or at least rationalizing), the cost of regulation and enhancing not impeding the flow of commerce in risk-management services.

This is a tall order! The federal charter idea has merit because it would be optional and revocable, and would not, at least initially, demand direct federal oversight of what states do in chartering insurers. The federal charter for insurers has the potential to walk the fine line (or rather gauntlet) of state vs. federal regulatory preeminence—allowing insurance companies to vote for the regulatory regime they operate under without having to vote with their feet by leaving their state just to escape a regulatory regime they find onerous. Fostering competition among regulators could drive the system to an optimal form of regulation that best meets the needs of both consumers and companies.

The optional federal charter will be the focus of much debate (www.Insurancenewsnet.com has documented seven major industry endorsers of the idea and four major opponents). At this early date it may be most useful to consider: (1) If a federal option (as opposed to blanket federal preemption) is a good idea, what other conditions might be required to make it work as intended? (2) Do some of those conditions suggest other approaches to reform of insurance regulation that have merit in themselves?

COMPACTING

Another reform option is the interstate compact: agreements among states to coordinate, consult, and/or share power in a contractual arrangement when it comes to regulating insurance. Such accords have a long and complex history, entailing a distinction between 'constitutional compacts' (agreements among states formally submitted to Congress for approval in accord with the Compact Clause of the U.S. Constitution[2]) and 'voluntary compacts' (interstate accords supported by enacted legislation in the subscribing states but not submitted to Congress for approval, normally because constitutional jurisprudence doesn't require it although this is a point of legal controversy).

Compacts have advantages and disadvantages. They can avoid the conundrum of 'state vs. federal' in regulatory matters and can minimize the parallel risks of concentrating too much power in Washington, and permitting the kind of regulatory maze we find in the insurance industry. On the downside, compacts are fluid: states can join and leave, depending on the terms of the contract, and the kind of regulatory clarity we need in risk-management services may be lacking. Further, compacts don't have to involve every state, and even a perfectly-drafted compact on insurance regulation may not solve the problem of inconsistent, duplicative, or just plain silly regulations in some states.

Trying it out

Fortunately, we have a real-world example to learn from on the question of insurance regulation. An Interstate Insurance Compact already exists, a voluntary (not constitutional) accord designed to coordinate and rationalize such things as product standards and serve as a clearinghouse for product information. Already 30 states have approved legislation joining the Compact,[3] which should start operations this year.

This insurance compact, while ambitious, is limited in scope: it doesn't cover property and casualty insurance or basic health insurance, for example. Still, any real-world experience beats abstract analysis so the compact will be closely watched, not just for its impact on industry efficiency, but for consumer responses (the agreement is being promoted by state regulators as a pro-consumer regulatory reform).

The Interstate Insurance Compact also could play a useful role if and when an optional federal charter, or other federal-law insurance reform, comes on line. As an information clearinghouse, the compact could help insurers evaluate their choices more quickly and could be adapted to accommodate a federal chartering authority as well as state regulators.

What else?

Whatever route the federal government takes in insurance regulation, interstate compacts could play an important role. If, for example, six of the most efficient state regulators (maximizing consumer welfare, minimal regulatory friction) drafted their own regulatory compact (ideally a congressionally-approved constitutional compact), they could offer an attractive regulatory alternative to insurers and consumers. They could also minimize the danger that a federal insurance-chartering authority might become a regulatory captive, no better than the worst state regulator today.

Insurance compacts pose numerous questions, such as how to establish a chartering authority that is neither state nor federal, yet is consistent with the Constitution's disposition of powers between Washington and the sovereign states. Similarly, if multiplying sources of regulation is an issue for the optional federal charter, it would also be an issue for interstate compacts. Even so, when legislators are taking a serious and detailed look at redefining the federal role in insurance regulation, the potential of such compacts for modernizing regulation while respecting the genius of federalism should not be ignored.

Notes

[1] Senate Bill 40, introduced on May 24, 2007 by Senators John Sununu (R-NH) and Tim Johnson (D-SD), would authorize an Optional Federal Charter that insurers could elect in lieu of chartering in their home state. Similar legislation was introduced in the 109th Congress and was discussed in hearings in the Senate Banking Committee in July, 2006.

[2] Article I, section 10 of the Constitution states in pertinent part: "No State shall, without the Consent of Congress… enter into any Agreement or Compact with another State…"

[3] Twenty-six states were needed to activate the accord.

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