Issue Brief
Institute For Policy Innovation

A Two-Pronged Approach to Insurance Regulation Reform

by Lawrence A. Hunter

Synopsis: Rather than stifling regulatory competition by centralizing regulation, insurance companies should be allowed to choose between an optional federal charter and mutual recognition among state regulators. Such expansion would create a 21st century regulatory system in which they can be globally competitive and better serve the American consumer.

Introduction

Under the current system of bank regulation in the United States, banks may choose whether to be regulated by the states in which they operate or by the federal government. Until the recent banking and mortgage crisis, there was widespread consensus that the regulatory competition created by this system of optional bank chartering had well served both consumers and financial-services firms.

Indeed, there was growing sentiment among policy makers that the system of optional chartering should be extended to the insurance industry, which currently is stuck in an exclusively state-based regulatory system—a throwback to the pre-global economy. It was becoming apparent to Members of Congress that insurance companies, like banks, should be afforded an opportunity to choose an optional federal charter (OFC), which would improve U.S. domestic insurance companies' ability to compete with their global rivals.

No National Insurance Market

Unimaginable as it may seem in today's global economy, there exists no true national market for insurance products in the United States. Rather, there are 50 separate state-insurance markets. Each is bounded by a state regulatory wall impenetrable to out-of-state companies that would like to compete by selling products in the state and impervious to consumers in the state who might desire to reach outside the state to purchase insurance from competing companies chartered beyond their state's boundary. It's a system of the bureaucrats, by the bureaucrats and for the bureaucrats.

During the past several years, as this antiquated system of insurance regulation increasingly put U.S.

firms at a considerable competitive disadvantage in the global marketplace, lawmakers began to recognize that something along the lines of an optional federal charter must be adopted to eliminate this competitive disadvantage. Bills were introduced in the Congress, and the Bush Administration endorsed the OFC concept.

With the emergence of the banking and housing crises, however, a misguided counter thesis began to emerge, namely, that too much regulatory competition was a major contributor to the crises. This knee-jerk reaction threatens not only to eliminate optional chartering for banks but also to prevent optional federal chartering from being extended to insurance companies. That would be a huge mistake.

Writing in the *New York Times* September 3, 2008, former Clinton Administration Deputy Treasury Secretary Roger Altman roundly criticized the "balkanized" system of financial services regulation in the United States and called on the next president to "create a single framework...administered by the Federal Reserve alone."

> Our entire regulatory system, conceived long ago for a different financial world, must be rebuilt. . . Today, regulatory authority is divided among the Federal Reserve, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Office of Federal Housing Enterprise Oversight, the Securities and Exchange Commission, the Commodity Futures Trading Commission, state banking regulators and state insurance regulators. That's too many players.

Contrary to this panic-induced urge to expand and centralize regulatory authority, *regulatory competition is not the problem*. Properly designed, regulatory competition can be a significant part of the solution.

The real source of the current financial/housing crisis was eight years of the worst monetary policy since the Great Depression. More centralized regulation would not have prevented today's financial meltdown; it would simply have led it to manifest itself in a different manner and channeled it along different economic avenues.

Regulatory Competition

Vertical Competition. With vertical regulatory competition, bureaucratic agencies at different levels of government compete. In the financial services world, vertical competition is illustrated by optional bank chartering. Vertical competition could be increased by expanding optional chartering to the insurance industry under an OFC.

Congress currently is considering bills to provide vertical competition among regulators in the insurance industry through an optional federal charter (H.R. 3200) that, if enacted into law, would allow companies seeking to compete globally to choose the federal option without forcing all insurance companies to do so.

Another bill currently making its way through the Congress (H.R. 5840) would establish a federal Office of Insurance Information. It would take another important step toward improving insurance companies' international competitiveness. H.R. 5840 would preempt any state insurance law or regulation that is inconsistent with federal policy on international insurance matters set forth in any treaty or international agreement entered into by the United States.

Horizontal Competition. With horizontal competition, regulatory competition occurs among bureaucratic agencies at the same level of government in different geographic locations. There is no current horizontal regulatory competition over financial services in the United States today. There is in Europe, however, where so-called "mutual recognition" of different countries' regulatory regimes works quite well and gives European insurance companies a significant competitive advantage over U.S. firms in global markets.

As the European Union illustrates, centralization of regulatory authority is not required to remedy the balkanization of the insurance industry identified by Mr. Altman. If both vertical and horizontal competition were allowed to flourish by permitting both optional federal charter and mutual recognition among state regulators, dysfunctional balkanization would not be inevitable under a fifty-state regulatory arrangement. If structured properly, a system of horizontal regulatory competition among states would improve regulation.

After all, the European Union, which comprises 27 member countries, does not regulate insurance centrally. The EU has a tradition of mutual recognition of member states' regulatory regimes. This allows an integrated, union-wide market to flourish where consumers are free to purchase insurance products across national boundaries without regard to which jurisdiction regulates the products or the companies from which they are purchased.

What distinguishes the EU system of insurance regulation from the U.S. system is extensive horizontal competition—competing centers of political and bureaucratic power across political jurisdictions at the same level that create checks and balances against over-reaching local regulators.[1]

By contrast, although 50 different state bureaucracies regulate insurance in the United States, each has managed to insulate itself (and, to some extent, the companies doing business in their states) from competition with the other 49. Each state insurance regulatory apparatus operates like a small cartel, carving up the market with 49 sister regulatory cartels.[2]

Because of mutual recognition among member country regulators in the EU, national regulators' prerogatives to regulate stop short of erecting protectionist chartering barriers at the border. There exists a form of geographic or horizontal regulatory competition among regulators that creates checks and balances against excessive, ill-conceived regulatory policies.[3]

In the EU, unlike the United States, consumers are free to choose from a union-wide array of insurance products. This not only maximizes competition among competing insurance firms but also heightens competition among EU country regulators. EU member countries are compelled by the force of regulatory competition to refrain from over regulating insurance companies chartered there.

European consumers are able to vote with their premium payments against heavy-handed and inefficient regulation by purchasing products from companies that do business outside the regulatory reach of overzealous, self-interested bureaucrats. In particular, if any particular regulator restricts the availability of the insurance coverage provided by companies under their regulatory purview by instituting price controls, consumers may circumvent the stifling bureaucratic price fixing by purchasing insurance from companies outside the regulator's jurisdiction.

A bill currently under consideration by the Congress suggests how horizontal regulatory competition might be introduced in the United States to complement the vertical competition created by an optional federal charter. The stated purpose of H.R. 5611 is to establish a nation-wide system of licensing for registered insurance brokers and dealers by providing:

> "a mechanism through which licensing, continuing education, and other insurance producer qualification requirements and conditions can be adopted and applied on a multi-state basis, while preserving the right of States to license, supervise, and discipline insurance producers, and to prescribe and enforce laws and regulations with regard to insurance-related consumer protection and unfair trade practices."

The bill would authorize an insurance producer to sell, solicit, negotiate, effect, procure, deliver, renew, continue, or bind insurance in any state for any line or lines of insurance specified in such producer's home state license. And it would prohibit any state other than brokers' and dealers' home states from denying them a license. Were this limited application of horizontal regulatory competition extended beyond registered brokers and dealers to apply to the state chartering of all insurance companies and then combined with increased vertical regulatory competition under an optional federal charter, it would create a 21st-century regulatory system allowing insurance companies to serve American consumers and be globally competitive.[4]

Conclusion

If both optional federal charter were introduced to increase vertical competition between state and federal insurance regulators and some form of mutual recognition were enacted to create widespread horizontal competition among state insurance regulators, it would maximize a company's ability to choose while maintaining the best of state-based regulation.

Regulatory competition isn't the problem; it's an important part of the solution. Rather than stifling regulatory competition by centralizing regulation and eliminating choice among regulators in the name of reform, Congress should enhance and expand regulatory competition by allowing insurance companies to choose between state and federal regulation under an optional federal charter and to have their domicile-state regulation recognized by all other 49 states if they elect to remain state-regulated.[5]

ENDNOTES

1 As described by Gatsios and Homes: "In the late 1970s and early 1980s, the European Court of Justice and the European Commission developed the notion of "mutual recognition" of technical standards as an alternative to the centralised process of harmonisation of national standards and regulations whose lack of progress was becoming an embarrassment.

"The 'new approach' was most firmly entrenched in financial services through the 1989 Second Banking Directive. This established the principle of 'home country regulation' according to which banks could in principle operate in any member-state provided they complied with the home country's regulations and prudential rules and satisfied the minimum essential requirements in the form of prudential safeguards, such as capital adequacy requirements. This was of course a highly sensitive issue, as many financial centres, including Luxembourg and London, have flourished essentially as a result of comparatively lax regulatory requirements on banks operating from them. The EU later introduced similar directives for insurance and investment services."

"Mutual recognition, minimum standards and subsidiarity provide a framework for regulatory competition which reduces the scope for strategic regulation and the resulting prisoners' dilemmas." See Gatsios, Konstantine and Peter Holmes, "*Regulatory Competition and International Harmonisation*," New Palgrave Dictionary of Law and Economics, Forthcoming, http://www.sussex.ac.uk/economics/documents/geireg3week_8lecnotemore.doc.

2 Actually there are 52 regulatory authorities when one includes the District of Columbia and Puerto Rico.

3 This lack of regulatory competition with regard to insurance is ironic, given the fact that it has such a strong pedigree back to America's origins. As James Madison wrote in *Federalist Paper #51*, "Ambition must be made to counteract ambition." It has been a long-held political presupposition in the United States that regulatory competition is desirable to prevent a single bureaucratic regulator from accumulating exclusive regulatory authority and pursuing its own agenda and the political interests rather than pursuing the public interest.

4 Creating horizontal regulatory competition would require Congress to enact legislation allowing insurance companies to choose a "primary state" for the purpose of regulating certain activities, e.g., premiums, forms, and other types of functional areas that would allow firms to operate in all other states where they are licensed ("secondary states") without having to be subject to the regulatory requirements of those states.

The Health Care Choice Act, proposed by Representative John Shadegg and Senator Jim DeMint, adopts a version of this "primary-state-regulator" approach for individual health insurance. Under the bill, insurers would be regulated chiefly by the primary state but also would be allowed to operate in secondary states subject to primary-state rules. The bill contains numerous safeguards and minimum standards for primary-state regulation regarding, for example, solvency regulation, guaranteed renewability of contracts and independent review of disputed claims. The bill also requires clear disclosure and warning to consumers where primary-state regulation applies and where various secondary state regulations do not apply.

5 A refinement on the regulatory-competition theme that would elevate market forces to check and balance regulators toward optimal regulation would be a variation on the EU's mutual recognition approach. Congress could enact legislation allowing insurance companies to choose a "primary state" for the purpose of regulating certain activities, e.g., premiums, forms, and other types of functional areas that would allow firms to operate in all other states where they are licensed ("secondary states") without having to be subject to the regulatory requirements of those states.

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About the Author

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