

# Insurance Executive Review

*Market Commentary on the Property & Casualty Insurance Industry*

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## Here Come the Feds

*A discussion on the history of federal insurance industry regulation and the potential benefits and downside to future regulation*

In 1869 the US Supreme Court in Paul vs. Virginia, ruled that the issuance of an insurance policy was not a transaction of commerce and therefore states and not the federal government had jurisdiction over the insurance industry. State insurance regulation at that time varied considerably with some states like New Hampshire creating a board of insurance commissioners in 1851, to others having no established insurance regulatory body. The concept of state insurance regulation quickly expanded and in 1871 the National Association of Insurance Commissioners (“NAIC”) was formed to coordinate regulation of insurers operating in multiple states. In 1944 another US Supreme Court case (United States v. South-Eastern Underwriters Association ) the court reversed the prior court ruling and found that insurance was “interstate commerce” and subject to federal regulation. In order to preserve state regulation, Congress passed the McCarran-Ferguson Act that returned the regulation of insurance to the states. Over the years there have been instances when the action of Congress has threatened to become more involved or has actually intervened so as to bring certain insurance activities under federal involvement or control. In other cases state regulators hearing the footsteps of federal intervention, have quickly joined forces, in response to an industry problem, to create solutions that held off further federal action. In 2008 we find several major initiatives by the Bush Administration as well as Congress that would have major impact on the insurance industry and state regulatory bodies. The state regulators have held off the feds before but can they do it again?

### State Insurance Regulation

The NAIC coordinates a number of activities and regulatory work where the pooling of resources is of assistance to all states. Its’ major activity continues

to be to provide a forum for the exchange of information and to deal with developing uniform policy through model laws and regulation. In spite of

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significant strides to develop some regulatory uniformity and consistency individual states will often change the so-called “model laws” if they are adopted at all. Regulators have limited powers and must rely upon gaining state legislative support for model laws to be enacted. There have been times when the limited resources of individual states or the ability to obtain collective agreement among states has caused the need for federal intervention. Examples would include:

1966- in response to inner-city riots the federal government creates a “riot and civil commotion” reinsurance pool to preserve commercial policy holders ability to buy coverage from commercial insurers;

1968- in response to commercial insurers unwillingness to provide “flood” insurance to homeowners and small commercial policyholders, the Federal Flood Program was created via the National Flood Insurance Act providing coverage in communities that practiced or met flood control requirements;

1983- Congress passes the Product Liability Risk Retention Act in response to commercial insurers withdrawal of products coverage (1975-78)\* for manufacturers, wholesalers and retailers in response to increase in litigation activity and awards. Legislation sets aside most state prohibitions involving unrelated entities jointly sharing their products liability risks or collectively negotiating coverage for the group;

1986- Congress passes an extension to the above called the Risk Retention Act of 1986 to apply to all liability risks (excluding workers compensation) in response to the casualty market crisis of 1984-85 with hundreds of insurance company failures that followed the

cash-flow underwriting cycle of the commercial market;

1990- Extensive prior hearings in Washington and government reports were issued citing serious questions about the adequacy of state insurance solvency regulation. In the famous publication by Representative John Dingell, Chairman of a Commerce sub-committee called Failed Promises: Insurance Company Insolvencies, the document found serious deficiencies and lack of uniformity in state regulatory surveillance of insurance company financial condition. With nearly 42% of the 140 insolvencies between 1969 and 1986 had occurred after 1983 and an increase in potentially impaired insurers jumping from 132 to 590 between 1978 and 1986, it seemed to provide substantial evidence that state deficiencies did exist;

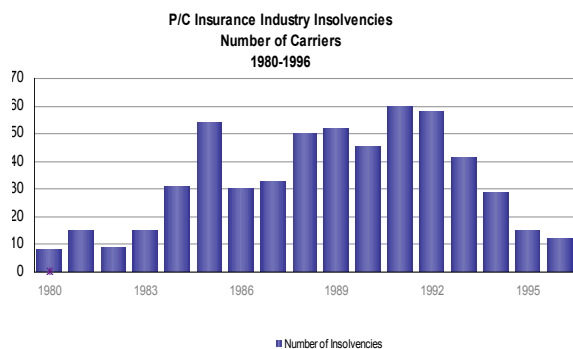
2001- The terrorist attacks of September 11th with the exceptionally high cost in loss of life and property damage, made it clear to insurers that the private sector could not financially withstand such events and retain their financial viability to respond to the wide number of other risks to which they are exposed in their existing portfolio of business. The Federal Terrorism Risk Insurance Act (TRIA) was passed in November 2002 for an initial 3 year period, was extended in 2005 for 2 additional years and renewed in 2007.

All of these events and others show the federal government’s periodic involvement with the insurance industry and some of the regulatory difficulties that have eluded the state-by-state approach to commercial insurance. Now the federal government has several initiatives that would materially alter the state regulatory landscape.

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## Regulatory Fundamentals

The basic function of State regulation is centered on issues of (1) Solvency or financial regulation concerned with preventing insurer insolvencies; and (2) Consumer protection or regulation of market conduct including unfair policy terms or treatment and deceptive or discriminatory practices. The state regulators have made great strides toward improving solvency after the major property casualty and life insurer insolvencies of the 1980's and early 1990's. The chart below shows the insolvency activity prior to the state regulators adopting a Risk Based Capital system that would provide a better tool to measure the total adjusted capital position of the insurer relative to the underlying risks being insured. This was in re-



response to Rep. Dingell's "Failed Promises" report but according to the March 2008 Department of the Treasury report "the degree of success for many of NAIC's financial modernization initiatives remain uncertain."

On the matter of market conduct, the system of state regulation starts to show some signs of difficulty in being consistent and effective. In respect of the insurance policy form (i.e. terms and conditions) there are at least seven different categories in existence in various states:

- State-adopted forms- required to be used by

admitted insurers;

- Strict prior approval- forms can not be used without affirmative regulatory approval;
- Prior approval- form is deemed "approved" in a specified period of time absent specific disapproval;
- File and use- must be filed prior to it's proposed use date;
- Use and file- may be used prior to filing but must be filed in required number of days thereafter;
- Form filing only- must be filed but no time period specified; and
- No form filing required.

The inability of state regulators to achieve some uniformity in respect of form filing is only compounded by the varied conditions that apply to rate and price control filing conditions. Here are the existing patchwork conditions applicable to most commercial insurance lines;

- No File (5 states)- no filings by insurers are required;
- Information Only (2 states)- rate filing is an "FYI" only basis;
- Flex Rating (2 states)- rates get automatic approval if change within a specified band;
- File and Use (13 states & DC)- require that rates be filed before they are used;
- Use and File (9 states)- rates can be used without pre-filing but need to be subsequently filed;
- Prior Approval with Express Deemer (19 states)- require rates to be filed before use but are "deemed" to be approved if state takes no action within 30 days.

The only exceptions to this rate and price control process are (1) applies in 19 of 43 states with some price controls that allow exemptions on "large" (varies between \$10,000 and

\$500,000 threshold) commercial property and casualty lines of insurance, and (2) non-admitted surplus lines carriers not directly licensed except in its state of domicile.

### Potential Benefits of Regulation

Insurance is not only a part of national commerce but has had international implications for decades. Although there are thousands of domestic insurance companies they are heavily reliant upon risk participation from global reinsurance markets, most of whom operate outside the US. The current regulatory system introduces a significant amount of cost and inefficiency into the insurance system without a demonstrated and quantifiable benefit. A national chartering system would allow the following benefits:

- A single agency to oversee the registration, supervision and review of insurance company operations;
- Intermediaries would also benefit from a single regulatory license and review process;
- New forms of coverage could be introduced quickly on a national scale;
- Rates would be competitively based on market conditions rather than subject to regulatory delay;
- Foreign capital and insurance markets would be attracted to a simpler regulatory process giving access to a national insurance market;
- States could benefit by re-deploying insurance regulatory resources to internal state issues and programs;
- A more efficient commercial market system would be created that would ultimately benefit the local, regional and national business and institutional community.

It seems clear that as long as states' resis-

tance to unified action on regulatory initiatives, it plays perfectly into the hands of those pushing federal legislation to return part of the business of insurance back to federal control.

### Downside to Federal Regulation?

While federal regulation can offer a number of potential benefits there may be some negative factors that would be introduced with a federal chartering system.

- Insurers and intermediaries opting for national charter status would become subject to additional federal laws and penalties (i.e. marketing, trading and market conduct) as they may have been exempt under state regulatory supervision;
- Attractiveness of federal regulatory review may be an issue for some foreign markets entry as they might be concerned with the potential oversight reach with foreign regulatory agencies;
- A National Charter would increase the direct involvement of Congressional oversight via several committees that would be an added burden to insurers and intermediaries.

The old adage "Be careful what you wish for!" seems to be most appropriate here.

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