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on

Emerging Issues in Insurance Regulation

Mr. Chairman, Ranking Member,

My name is Baird Webel. I am a Specialist in Financial Economics at the Congressional Research Service. Thank you for the opportunity to testify before the Committee. This statement responds to your request for hearing testimony addressing issues in insurance regulation that may be the focus of the Committee's attention. It begins with a brief introduction on the insurance sector and the regulation of insurance. Following this is a discussion of the role insurance played in the recent financial crisis, the recent Dodd-Frank Act, and the issues arising from the crisis and Dodd-Frank. Finally, my testimony will briefly summarize current proposals addressing insurance regulation at the federal level and the ongoing issues that this legislation addresses.

CRS's role is to provide objective, non-partisan research and analysis to Congress. CRS takes no position on the desirability of any specific policy. The arguments presented in my written and oral testimony are for the purposes of informing Congress, not to advocate for a particular policy outcome.

The Insurance Industry and the Regulation of Insurance

Insurance companies constitute a major segment of the U.S. financial services industry. The industry is often separated into life and health insurance companies, which also often offer annuity products, and property and casualty insurance companies, which include most other lines of insurance, such as homeowners insurance, automobile insurance, and various commercial lines of insurance purchased by businesses. Premiums for life/health companies in 2010 totaled $543.4 billion and life/health companies held $5.3 trillion in assets. Premiums for property/casualty insurance companies totaled $424.7 billion and these companies held $1.6 trillion in assets.[1] In general, the insurance industry has weathered the recent financial crisis and its aftermath fairly well. A.M. Best, an insurance rating firm, reports a total of 29 insurer impairments from 2008 to 2010.[2] In contrast, the Federal Deposit Insurance Corporation's (FDIC's) Failed Bank List includes more than 320 banks in the same time period.[3] The current year could prove challenging with insurer exposure to sovereign debt and a relatively large number of catastrophic weather events.

Different lines of insurance present very different characteristics and risks. Life insurance is typically a longer-term proposition with contracts stretching into decades and insurance risks that are relatively well defined in actuarial tables. Property/casualty insurance is typically a shorter-term proposition with six month or one year contracts and greater exposure to catastrophic risks. Health insurance has evolved in a very different direction, with many insurance companies heavily involved with healthcare delivery including negotiating contracts with physicians and

[1] Statistics from A.M. Best, *2011 Statistical Study: U.S. Property/Casualty – 2010 Financial Results*, March 28, 2011, and A.M. Best, *2011 Statistical Study: U.S. Life/Health – 2010 Financial Results*, March 28, 2011. Premium amounts used are net premiums written; assets amounts are admitted assets.

[2] A.M. Best, *Best's Impairment Rate and Rating Transition Study – 1977 to 2010*, May 16, 2011.

[3] http://www.fdic.gov/bank/individual/failed/banklist.html.

hospitals and a regulatory system much more influenced by the federal government through Medicare, Medicaid, the Employee Retirement Income Security Act of 1974 (ERISA), [4] and the Patient Protection and Affordable Care Act (PPACA).[5] When this testimony refers to "insurance," it addresses life insurance and property/casualty insurance unless health insurance is specifically included.[6]

Insurance companies, unlike banks and securities firms, have been chartered and regulated solely by the states for the past 150 years. One important reason for this is an 1868 U.S. Supreme Court decision.[7] In *Paul v. Virginia*, the Court held that the issuance of an insurance policy was not a transaction occurring in interstate commerce and thus not subject to regulation by the federal government under the Commerce Clause of the U.S. Constitution. Courts followed that precedent for the next 75 years. In a 1944 decision, captioned *U.S. v. South-Eastern Underwriters Association*, the Court found that the federal antitrust laws were applicable to an insurance association's *interstate* activities in restraint of trade.[8] Although the 1944 Court did not specifically overrule its prior holding in *Paul, South-Eastern Underwriters* created significant apprehension about the continued viability of state insurance regulation and taxation of insurance premiums. By 1944, the state insurance regulatory structure was well established, and a joint effort by state regulators and insurance industry leaders to overturn the decision legislatively led to the passage of the McCarran-Ferguson Act of 1945.[9] The act's primary purpose was to preserve the states' authority to regulate and tax insurance.[10] The act also granted a federal antitrust exemption to the insurance industry for "the business of insurance."[11]

Since the passage of McCarran-Ferguson, both Congress and the federal courts have taken actions that have somewhat expanded the reach of the federal government into the insurance sphere. The two large overhauls of financial regulation in the last two decades, the Gramm-Leach-Bliley Act of 1999 (GLBA)[12] and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), [13] expanded the federal role in insurance to some degree but the states continued as the primary regulators of insurance following these acts.

GLBA removed legal barriers between securities firms, banks, and insurers, allowing these firms to coexist under a financial holding company structure. Such a holding company was overseen

[4] P.L. 93-406, 88 Stat. 829.

[5] P.L. 111-148, 124 Stat. 119.

[6] For more information on health insurance, see CRS Report RL32237, *Health Insurance: A Primer*, by Bernadette Fernandez.

[7] *Paul v. Virginia*, 75 U.S. (8 Wall.) 168 (1868).

[8] *U.S. v. South-Eastern Underwriters Association*, 322 U.S. 533 (1944).

[9] 15 U.S.C. Sec. 1011 *et seq*.

[10] Richard Cordero, *Exemption or Immunity from Federal Antitrust Liability Under McCarran-Ferguson (15 U.S.C. 1011-1013) and State Action and Noer-Pennington Doctrines for Business of Insurance and Persons Engaged in It*, 116 ALR Fed 163, 194 (1993).

[11] 15 U.S.C. § 1012(b). The Supreme Court has made clear that the business of insurance does not include all business of insurers. Group Health and Life Insurance, Co. v. Royal Drug, Co., 440 U.S. 205, 279 (1979). For further explanation of this distinction, see CRS Report RL33683, *Courts Narrow McCarran-Ferguson Antitrust Exemption for "Business of Insurance": Viability of "State Action" Doctrine as an Alternative*, by Janice E. Rubin.

[12] P.L. 106-102, 113 Stat. 1338.

[13] P.L. 111-203, 124 Stat. 1376.

by an umbrella regulator—the Federal Reserve for holding companies, which included bank subsidiaries, or the Office of Thrift Supervision (OTS), for holding companies with thrift or savings association subsidiaries. Within the holding company, GLBA established a system of functional regulation for bank, thrift, securities, and insurance subsidiaries of holding companies. This meant that insurance company subsidiaries within a bank or thrift holding company were functionally regulated by state insurance authorities, with limited oversight by the federal regulator of the holding company. Should there be no functional regulator for a subsidiary, the financial holding company regulator assumed primary regulatory responsibility for that subsidiary.

The Dodd-Frank Act altered the GLBA structure, although to a large degree it left the basic functional regulatory structure intact. It appears that the act will affect insurance regulation in three primary ways: (1) the creation of a Federal Insurance Office (FIO) with information gathering and very limited preemptive powers; (2) the provisions addressing systemic risk, such as the creation of a Financial Stability Oversight Council (FSOC) with the authority to oversee systemically important non-bank financial firms, including insurers; and (3) the provisions harmonizing[14] the tax and regulatory treatment of surplus lines insurance and reinsurance (the Nonadmitted and Reinsurance Reform Act).[15] Under Dodd-Frank, primary regulatory power over insurance firms continues to rest with the individual states and there is no federal chartering authority.

Issues Arising from the Recent Financial Crisis

In the past, insurance has generally been seen as presenting little systemic risk. The recent financial crisis brought this assumption into question with the individual failure of American International Group (AIG) and the multiple failures of monoline bond insurers. These failures brought issues to the fore that are likely to remain issues before Congress and financial regulators in the future.

AIG and the Oversight of Large and Complex Insurers

The failure of AIG was one of the most prominent business failure during the financial crisis and might be used as a case study of what can go wrong in overseeing a large, complex financial institution. AIG was a large company, with more than 175 subsidiaries identified by the National Association of Insurance Commissioners (NAIC). It listed a total of more than $1 trillion in assets in its 2007 annual filing with the Securities and Exchange Commission (SEC). Although most of the subsidiaries of AIG were, and are, insurance companies, AIG also had a thrift subsidiary, which put the entire holding company under the umbrella supervision of the OTS. AIG's derivatives operation, its Financial Products division (AIGFP), dealt in financial products not within the jurisdiction of any of the federal functional regulators. OTS as umbrella regulator

[14] These provisions had been introduced as separate legislation before being included in Dodd-Frank.

[15] For more information on the specific insurance provisions in the Dodd-Frank Act, see CRS Report R41372, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Insurance Provisions*, by Baird Webel.

of the AIG holding company was responsible for overseeing AIGFP. Thus, the federal regulator of the thrift industry, OTS, had broad oversight over a holding company with approximately $1 trillion in assets that listed its business as "insurance and insurance-related activities"[16] and specific oversight on a derivatives subsidiary with $2 trillion in notional value of derivatives outstanding.

AIG's failure is generally perceived to have resulted from risk-taking that flourished in holes created by overlapping, but incomplete oversight. AIGFP took on billions of dollars in liabilities from credit default swaps (CDS) tied to the U.S. housing market while securities from the insurance subsidiaries were being transferred to another AIG subsidiary for a securities lending program. The collateral for this securities lending was also invested in securities tied to the U.S. housing market. Paradoxically, the securities lending program was increasing its exposure to the housing market at the same time (2006) that AIGFP had concluded that it was overexposed to this market and was attempting to reduce its risks. As the housing market slumped and the financial markets reached a panic state in September 2008, billions of dollars flowed out of AIG as a result of losses in both CDS and the securities lending program. Ultimately, the Federal Reserve and U.S. Treasury extended approximately $200 billion in financial commitments to prevent an AIG default.

Regulatory lapses associated with AIG have been indentified at multiple levels. In hindsight, it appears that whatever company-wide risk assessments were performed by AIG or by OTS underestimated the scope of its exposure to the housing market. It also appears that OTS either did not understand the risk inherent in the CDS being sold by AIG or did not seriously consider scenarios as destabilizing as the housing bust that sparked the crisis. The functional regulators of the insurance subsidiaries were focused on the condition of the individual subsidiaries and did not effectively exercise what authority they did have over the holding company, such as overseeing what was done with the securities that originated with the insurance subsidiaries.

The perceived regulatory lapses associated with AIG have largely been addressed in some way in the aftermath of the crisis. Dodd-Frank abolished the OTS and dispersed its functions among the federal banking regulators, making the Federal Reserve the sole regulator of bank, thrift, and financial holding companies. The act's systemic risk provisions provide for increased oversight of insurers deemed systemically important. In addition, derivatives in general were brought under federal oversight and regulation split between the SEC and the Commodity Futures Trading Commission (CFTC). At the state level, the insurance regulators responded with new model laws and regulations increasing oversight on insurance holding companies generally and on securities lending in particular. The effectiveness of these steps, of course, may not be clear until the next financial crisis. It may be worth remembering that, for example, large banking institutions overseen by the Federal Reserve, such as Citigroup and Bank of America, also required exceptional, multi-billion dollar rescues from the federal government during the crisis.

The statutory framework that Dodd-Frank has established addressing the perceived regulatory failures may have been put into place, but such statutory changes are only a beginning step. At

[16] American International Group, *Annual Report (Form 10-K) for the fiscal year ended December 31, 2007*, February 28, 2008, p. 3.

the federal level, regulators first promulgate regulations implementing the new law and then undertake ongoing regulatory action to see that these regulations are indeed followed. This latter step, regulators fully enforcing both letter and spirit of the law over the years or decades following adoption, is perhaps the most important, and underestimated, step.

Of particular interest going forward will be the decision by the FSOC as to which, if any, insurers might be designated as systemically important and what actions the Federal Reserve takes in its role of overseeing systemically significant insurers. Insurers are generally arguing that the pre-crisis view that the sector presents little systemic risk was correct and that AIG was an outlier. The overall expectation seems to be that few insurers will be deemed systemically important. At the state level, the process may take longer because the NAIC model laws must first be adopted by the individual state legislatures in order to take effect. This process can take substantial amounts of time and, in addition, state legislatures are not required to pass the NAIC models as suggested by the organization. This may alter the effectiveness of the models or introduce variation in regulation among different states.

The Bond Insurer Failures and Oversight of Smaller Insurers

With arguments being made, and possibly accepted, that even large insurers present little systemic risk, one might expect the oversight of smaller insurers to receive at best passing mention in testimony such as this. The experience with the failure of several "monoline" insurers who focused on insuring municipal bonds and moved into insuring mortgage-backed securities (MBS), however, raises issues that may bear future consideration.

Before the crisis, there were only about a dozen bond insurers in total, with four large insurers dominating the business. This type of insurance originated in the 1970s to cover municipal bonds but the insurers have expanded their businesses since the 1990s to include significant amounts of MBS. In late 2007 and early 2008, strains began to appear due to exposure to MBS. Ultimately some smaller bond insurers failed and the larger insurers saw their triple-A ratings cut significantly. Some insurers are still operating, but the volume of insurance is greatly reduced. The insurer downgrades rippled throughout the municipal bond markets, causing unexpected difficulties in sectors previously perceived as unrelated to rising mortgage defaults. Individual investors in auction rate securities, which had been marketed as liquid and safe investments, found their assets frozen because the markets had depended on the bond insurers' high ratings as backing for the securities. Municipalities, particularly smaller ones, faced great difficulty and higher costs in accessing credit markets to fund projects like roads, sewer systems, and schools. While the bond insurer failures had unexpected spillover effects, whether or not such insurers would, or should, be considered systemically important under the systemic risk regulatory structure created by Dodd-Frank is an open question.

The failure of the bond insurers, unlike that of AIG, was not a story of multiple regulators and holes in regulatory oversight. The bond insurers were, and are, state-regulated entities, operating as permitted by the regulators. What occurred was a failure by both regulators and insurers to appreciate the additional risks being undertaken when the insurers moved from their initial business of insuring state and municipal debt into insuring MBS. In addition, the danger of a ratings agency downgrade, as opposed to the actual inability of the insurers to pay claims, was not well understood. The regulatory failures coupled with the spillover effects that occurred prompted some to call for federal regulation of the financial guaranty insurance with an amendment to do so being offered, and then withdrawn in the House Financial Services Committee markup of the insurance titles of the Dodd-Frank Act.

Issues Arising Directly from Dodd-Frank

Implementation of the Federal Insurance Office

Title V, Subtitle A of the Dodd-Frank Act creates a Federal Insurance Office (FIO) inside the Department of the Treasury. FIO is to monitor all aspects of the insurance industry and coordinate and develop policy relating to international agreements. It has the authority to preempt state laws and regulations when these conflict with international agreements. This preemption authority is somewhat limited. It can only apply when the state measure (1) results in less favorable treatment of a non-U.S. insurer compared with a U.S. insurer and (2) is inconsistent with a written international agreement regarding prudential measures. Such an agreement must achieve a level of consumer protection that is "substantially equivalent"[17] to the level afforded under state law. FIO preemption authority does not extend to state measures governing rates, premiums, underwriting, or sales practices, nor does it apply to state coverage requirements or state antitrust laws. FIO preemption decisions are also subject to *de novo* judicial review under the Administrative Procedure Act.[18] The monitoring function of FIO includes information gathering from both public and private sources. This is backed by subpoena power if the director issues a written finding that the information being sought is necessary and that the office has coordinated with other state or federal regulators that may have the information.

Since the passage of the Dodd-Frank Act, the FIO has begun hiring staff, and a director, former Illinois Insurance Commissioner Michael McRaith, has been appointed. The process, however, has taken longer than some hoped as Mr. McRaith did not take up the position of director until June 2011. This raised particular concern within Congress and the insurance industry in relation to the FIO director's role in FSOC discussed below. Also as part of the creation of FIO, Treasury has announced the creation of a Federal Advisory Committee on Insurance to be composed of various stakeholders and experts from the state regulatory system, the insurance industry, academia, and public advocates. The Dodd-Frank Act requires a report to Congress by January 21, 2012, on how to modernize and improve the insurance regulatory system in the United States.[19] The Treasury Department has in the past advocated for additional federal oversight of insurance[20] and the Dodd-Frank study may provide insight into how FIO will approach this issue.

[17] 31 U.S.C. §313(r)(2) as added by P.L. 111-203 §502; the law renumbers the current 31 U.S.C. sec. 313 as 31 U.S.C. Sec. 312.

[18] 5 U.S.C. §551 *et seq*.

[19] Eighteen months after the July 21, 2010 date of enactment of the act..

[20] See, for example, the 2008 "Treasury Blueprint for a Modernized Financial Regulatory Structure," which proposed an optional federal charter for insurers as part of an overall reform of the U.S. regulatory structure. Available at http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf.

NRRA/Surplus Lines Insurance

Title V, Subtitle B of the Dodd-Frank Act addresses a relatively narrow set of insurance regulatory issues pre-dating the financial crisis. In the area of nonadmitted (or "surplus lines") insurance, the act harmonizes, and in some cases reduces, regulation and taxation of this insurance by vesting the "home state" of the insured with the sole authority to regulate and collect the taxes on a surplus lines transaction. Those taxes that would be collected may be distributed according to a future interstate compact or agreement, but absent such an agreement their distribution would be within the authority of the home state. It also preempts any state laws on surplus lines eligibility that conflict with the NAIC model law unless the states include alternative uniform requirements as part of an agreement on taxes and implements "streamlined" federal standards allowing a commercial purchaser to access surplus lines insurance. For reinsurance transactions, it vests the home state of the insurer purchasing the reinsurance with the authority over the transaction while vesting the home state of the reinsurer with the sole authority to regulate the solvency of the reinsurer.

The general effective date for the surplus lines provisions of Dodd-Frank was 12 months after the date of enactment or July 21, 2011. If the states wished to enter into a compact or adopt other measures to supersede the provisions specifying that the home states would have the sole right to collect premium taxes before these provisions took effect, the states were required to do so within 330 days from the date of enactment, a deadline that has now passed. NAIC and the National Conference of Insurance Legislators (NCOIL) both developed interstate agreements that would have superseded the federal provisions. The two models that were developed, however, differed significantly as to the extent of authority that would be ceded by the states to the new body overseeing the agreement. NCOIL's Surplus Lines Insurance Multistate Compliance Compact (SLIMPACT) is a broader agreement that would address surplus lines regulatory issues and taxes whereas the NAIC's Nonadmitted Insurance Multi-State Agreement (NIMA) is more narrowly focused on tax allocation. Each approach has been ratified by some states, but neither has been ratified by a majority. This lack of uniformity was criticized at a July 2011 hearing before the House Financial Services Committee and representatives of the NAIC and NCOIL pledged to address this, possibly through some sort of blending of the two approaches.[21]

Issues Predating the Financial Crisis

Financial Services Industry Convergence

The financial regulatory structure implemented by the Gramm-Leach-Bliley Act (GLBA) was nominally a functional regulatory structure wherein insurers and insurance products would be

[21] See U.S. Congress, House Committee on Financial Services, Subcommittee on Insurance, Housing and Community Opportunity, *Insurance Oversight: Policy Implications for U.S. Consumers, Businesses and Jobs*, 112th Cong., 1st sess., July 28, 2011, particularly the statements by Mr. Clay Jackson and Ms. Letha E. Heaton, available at http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=252895.

regulated by insurance regulators, banks and banking products by banking regulators, and securities firms and securities products by securities regulators. Issues arise in such a structure, however, as financial innovation results in, for example, products sold by banks or securities firms taking on insurance characteristics or vice versa. Who decides what product belongs in what category, and thus, who regulates it? While GLBA was in part a response to financial industry convergence, it did not fully resolve this question. The *de facto* outcome has been that whatever charter the producing firm holds has determined which regulator regulates the product. The Dodd-Frank Act may affect this as the FSOC could act as such a referee, particularly for products deemed systemically important, but it is unclear how much of a role FSOC will play in this regard.

Financial product innovation that resulted in mismatched regulation played a central role in the financial crisis. One example of this is the experience with credit default swaps (CDS). Economically, a CDS shares a much greater similarity with an insurance policy than with a more traditional swap, such as an interest rate swap. Because a CDS is structured as a swap, which is a securities product, it generally did not fall under the purview of insurance regulators. This had a huge impact on the usage of CDS and the role that CDS played in the crisis. Were CDS regulated as an insurance product, the regulators would have required that capital be held to back each CDS as it was written, putting an additional cost in the creation of CDS. Because this was not the case, firms could essentially create as many CDS as the market would bear. This stoked the boom in structured financial products, as, for example, CDS were used as raw material to create synthetic collateralized debt obligations, increasing the overall exposure to the housing market and deepening the crash once the bubble burst. Other examples include lending by non-bank institutions backed by securities markets and bank-like accounts, such as money market mutual funds, offered by securities firms and outside of the deposit insurance system.

Multistate Licensing of Agents and Brokers (NARAB II)

Licensing of insurance agents and brokers is currently a responsibility of the individual states with different states sometimes having differing requirements. An agent or broker serving a client seeking a policy that would cover risks in multiple states is thus required to be licensed in multiple states. This multiplicity of licensure has resulted in complaints from the insurance industry. In 1999, Congress included provisions in the GLBA calling for the creation of a federally backed licensing association, the National Association of Registered Agents and Brokers (NARAB), to supersede multiple state licenses. NARAB was to have come into existence three years after the date of enactment if at least 29 states failed to enact the necessary legislation for state uniformity or reciprocity. Following GLBA, the requisite number of states enacted this legislation, and thus the NARAB provisions never came into effect. The issue of insurance producer licensing reciprocity or uniformity continued to be of concern, however, as some continue to see problems in the actions taken by the individual states.[22] In addition, although 47 states were identified by the NAIC as meeting GLBA's requirements, those that have

[22] See, for example, the April 16, 2008 testimony by Tom Minkler on behalf of the Independent Insurance Agents and Brokers made before the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises at http://www.house.gov/apps/list/hearing/financialsvcs_dem/minkler041608.pdf.

not, California, Florida, and Washington, are not small states, representing together approximately 20% of the nation's population.

Recent Congresses have again seen legislation (H.R. 1112 in the 112th Congress) to create a NARAB, with such legislation generally referred to as "NARAB II." H.R. 1112 would establish private, nonprofit corporation, whose members, once licensed as an insurance producer in a single state, would be able to operate in any other state subject only to payment of the licensing fee in that state. The NARAB member would still be subject to each state's consumer protection and market conduct regulation, but individual state laws that treated out of state insurance producers differently than in-state producers would be preempted. NARAB would be overseen by a board composed of five appointees from the insurance industry and four from the state insurance commissioners. The appointments would be made by the President and the President could dissolve the board as a whole or suspend the effectiveness of any action taken by NARAB. NARAB II legislation has been passed by the House of Representatives in previous Congresses, but has not been acted upon by the Senate. H.R. 1112 has not been acted upon by either chamber in the 112th Congress.

Expansion of the Liability Risk Retention Act

Risk retention groups (RRGs) and risk purchasing groups (RPGs) are alternative insurance entities authorized by Congress in the Liability Risk Retention Act (LRRA).[23] These groups are chartered in single states, but are then authorized by the LRRA to operate throughout the country with minimal oversight by the other 49 states. The goal was to expand insurance supply through a simplification of insurance regulation. Membership in risk retention and purchasing groups is limited to commercial enterprises and governmental bodies, and the risks insured by these groups are limited to liability risks. Although the RRGs and RPGs are a relatively minor part of the insurance marketplace, some believe they have served a meaningful role at various times over the past decades, particularly in serving lines of insurance under stress, such as medical malpractice.[24]

Legislation has been introduced in the House during the last few Congresses (H.R. 2126 in the 112th Congress) to expand the LRRA's preemption of state laws to allow the sale and purchase of property insurance by RRGs and RPGs in addition to liability insurance. Such expansion has been resisted by those, such as the state insurance regulators, who worry that the lessened oversight on these groups, and the lack of coverage by state insurance guaranty funds, may lead to insured parties not receiving the purchased coverage in the case of a loss. In addition to expanding the scope of the law, H.R. 2126 would also place new corporate governance standards on the groups and authorize the director of the Federal Insurance Office to issue a determination as to whether a particular state law or regulation should be preempted by the act. LRRA expansion legislation has not been acted on by the House, nor introduced in the Senate.

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[23] 15 U.S.C. Sec. 3901 *et seq*. See CRS Report RL32176, *The Liability Risk Retention Act: Background, Issues, and Current Legislation*, by Baird Webel.

[24] For example, "RRGs have had a small but important effect in increasing the availability and affordability of commercial liability insurance for certain groups." U.S. Government Accountability Office, *Risk Retention Groups: Common Regulatory Standards and Greater Member Protections Are Needed*, GAO-05-536, August 2005, p. 5.

The McCarran-Ferguson Act's Antitrust Exemption

The 1945 McCarran-Ferguson Act prohibits application of the federal antitrust laws and similar provisions in the Federal Trade Commission Act, as well as most other federal statutes, to the "business of insurance" to the extent that such business is regulated by state law—except that the antitrust laws are applicable if it is determined that an insurance practice amounts to a boycott. While this exemption has been limited by courts over the years,[25] this exemption has been seen by some as allowing the insurance industry to undertake collusive practices having negative effects on consumers. Over the years, numerous bills have been introduced to eliminate the exemption either entirely[26] or for particular lines of insurance.[27]

The insurance industry argues that the antitrust exemption allows for information sharing and other cooperation among insurers that result in greater efficiency and overall lower rates for insurance. Small insurers, in particular, depend on the sharing of information in order to accurately assess risks. If McCarran-Ferguson antitrust protection for "the business of insurance" were to be curtailed or abolished, many lawsuits challenging some of these insurer practices as violations of the federal antitrust laws seem likely. Depending on the outcome of such litigation, major changes in the operation of insurers could result, particularly by small insurers that do not have large pools of information from their own experience. Should additional data be unavailable to small insurers in some way, it would, ironically, likely spur further consolidation in the insurance industry as small insurers may merge in order to gain the competitive advantage of additional information. This outcome, however, is only one of a range of possibilities. It is also possible that many of the cooperative activities that insurers engage in would be found to be permissible under the "state action" doctrine.[28]

Federal Chartering for Insurers

Although proposals for some form of federal chartering for insurers have existed for decades, interest in the concept was particularly sparked by the Gramm-Leach-Bliley Act in 1999. While GLBA statutorily reaffirmed the primacy of state regulation of insurance, it also unleashed market forces that were already creating more direct competition among banks, securities firms, and insurers. The insurance industry increasingly complained about overlapping and sometimes

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[25] See CRS Report RL33683, *Courts Narrow McCarran-Ferguson Antitrust Exemption for "Business of Insurance": Viability of "State Action" Doctrine as an Alternative*, by Janice E. Rubin.

[26] The latest was H.R. 1583 in the 111th Congress.

[27] H.R. 1150 and H.R. 1943 in the 112th Congress would address the exemption solely for the health insurance industry.

[28] The state action doctrine was first enunciated by the Supreme Court in1943 (*Parker v. Brown*, 317 U.S. 341). It is based on the concept of federalism, and is the reason why federal antitrust laws are not applicable to the states. The doctrine has, over the years, been interpreted, clarified and expanded to the point that it now confers antitrust immunity not only on the states *qua* states (including state agencies and officials who act in furtherance of state-directed activity, but also on those who act pursuant to state-sanctioned, but not necessarily mandated, courses of action). Its essence is captured in the two-part test set out in *California Retail Liquor Dealers Ass'n v. Midcal Aluminum, Inc.* (445 U.S. 97 (1980)): first, the challenged restraint must be "clearly articulated and affirmatively expressed as state policy" (e.g., in a legislatively enacted statute); second, the policy must be "actively supervised" and subject to enforcement by the state itself. See CRS Report RL33683, *Courts Narrow McCarran-Ferguson Antitrust Exemption for "Business of Insurance": Viability of "State Action" Doctrine as an Alternative*, by Janice E. Rubin, for a brief analysis of that doctrine as it pertains to the insurance industry.

contradictory state regulatory edicts driving up the cost of compliance and increasing the time necessary to bring new products to market. These complaints existed prior to GLBA, but the insurance industry generally resisted federalization of insurance regulation at the time. Facing a new world of competition, however, the industry split, with larger insurers tending to favor some form of federal regulation, and smaller insurers tending to favor a continuation of the state regulatory system. Because life insurers tend to compete more directly with banks and securities firms, they have tended to favor some form of federal charter to a greater extent than have property/casualty insurers.

Some Members of Congress have responded to the changing environment in the financial services industry with a variety of legislative measures. In the 108th Congress, Senator Ernest Hollings introduced S. 1373 to create a mandatory federal charter for insurance. In the 108th and 109th Congresses, Representative Richard Baker drafted, but never introduced, the SMART Act[29] that would have left the states as the primary regulators, but harmonized the system through various federal preemptions. Such a state-centric approach was generally favored by the smaller stakeholders, while larger stakeholders tended to favor an Optional Federal Charter (OFC) for insurance, with OFC legislation being introduced in the 107th, 109th, and 110th Congresses.

OFC legislation can vary widely in the specifics, but the common thread is the creation of a dual regulatory system, inspired by the current banking regulatory system. OFC bills generally would create a federal insurance regulator that would operate concurrently with the present state system. Insurers would be able to choose whether to take out a federal charter, which would exempt them from most state insurance regulations, or to continue under a state charter and the 50-state system of insurance regulation. Given the greater uniformity of life insurance products and the greater competition faced by life insurers, some have suggested the possibility of OFC legislation that would apply only to life insurers, but no such bills have been introduced. There were proposals to implement narrow federal regulation for reinsurance and for financial guaranty insurance in the 111th Congress, but neither were adopted.[30]

The recent financial crisis amplified concerns about the negative aspects of allowing financial institutions to choose their regulators. Perhaps in response to these concerns, the broad federal charter bill in the 111th Congress, H.R. 1880, added some mandatory aspects to a framework similar to the previous OFC bills. There have been no federal chartering bills introduced into the 112th Congress.

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[29] This act was the subject of a June 16, 2005, hearing in the House Financial Services Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises entitled "SMART Insurance Reform."

[30] During the December 2, 2009, House Financial Services Committee markup of H.R. 2609, a bill to create a Federal Office of Insurance, Representative Dennis Moore offered an amendment (no. 3) that would have created an optional federal license for reinsurers, while Representatives Ed Royce and Melissa Bean offered an amendment (no. 7) that would have created an optional federal license for financial guarantee insurers. Both were withdrawn before votes were taken on the amendments. Representative Moore introduced his amendment creating a federal license for reinsurers as a standalone bill, H.R. 6529, on December 16, 2010.

International Issues

Although banking, insurance, and other financial services sectors do not produce a tangible goods shipped across borders, the trade in such services makes up a large amount of international trade. The United States has generally experienced a surplus in trade in financial services, other than insurance, but in insurance services in the United States has consistently run a deficit with the rest of the world.[31] Consolidations in the insurance industry are creating larger international entities with growing market shares, particularly in the reinsurance market. Some have speculated that the growing "internationalization" of the financial services industry means governments may find it difficult to reform their regulation in isolation. The need for a single voice at the federal level to represent U.S. insurance interests on the international stage is a frequently heard argument for increased federal involvement in insurance regulation and the Federal Insurance Office is specifically tasked with developing federal policy in international insurance matters.

The European Union and Solvency II

The European Union (EU), the United States' biggest trading partner in insurance services, is implementing a comprehensive program to transform the EU into a single market for financial services. Part of this is an updated solvency regime for insurers—known as Solvency II—attempting to more closely match the capital required by regulators to the risks undertaken by insurers. It is

> an ambitious proposal that will completely overhaul the way we ensure the financial soundness of our insurers. We are setting a world-leading standard that requires insurers to focus on managing all the risks they face and enables them to operate much more efficiently.[32]

The European Parliament passed Solvency II legislation in 2009 with implementation recently delayed until January 1, 2014. As part of the project, the EU has created a new European Insurance and Occupational Pensions Authority (EIOPA) with the ability develop regulations and rules that are binding at a European level, rather than merely advisory as was the case with its predecessor. If the EU truly creates a more efficient regulatory system, this could improve the competitive standing of EU insurers compared with U.S. insurers. Concerns have also been expressed that the new EU system might result in discrimination against U.S. insurers, particularly if state supervision of U.S. insurers is judged insufficient to allow the same "single passport" access to all EU countries that EU insurers will enjoy. EIOPA has published draft reports on equivalence for Switzerland, Bermuda, and Japan, but has not done so for the United States. There have been suggestions in the past that an EU regulatory change might serve as "a

[31] U.S. exports of non-insurance financial services were $66.4 billion in 2010 vs. imports of $13.8 billion. Insurance exports in 2010 totaled $14.6 billion vs. imports of $61.8 billion. See the Bureau of Economic Analysis website at http://www.bea.gov/international/bp_web/simple.cfm?anon=71&table_id=22&area_id=3.

[32] Charlie McCreevy, European Union Internal Market and Services Commissioner, quoted in "'Solvency II': EU to take global lead in insurance regulation" available at http://europa.eu/rapid/pressReleasesAction.do?reference=IP/07/1060&format=HTML&aged=0&language=EN&guiLanguage=en. The general EU website on Solvency 2 is http://ec.europa.eu/internal_market/insurance/solvency/index_en.htm.

useful tool in international trade negotiations as it could help improve access for European reinsurers to foreign markets," such as the United States.[33] The EU has also cited the overall complexity of the regulatory system in the United States as a barrier to overseas companies operating in the United States.[34]

Reinsurance Collateral

Although U.S. insurers see access to the EU as a significant issue under Solvency II, access to the U.S. market for insurance is also an issue for EU insurers. Of particular concern have been the state regulatory requirements that reinsurance issued by non-U.S. or "alien"[35] reinsurers must be backed by 100% collateral deposited in the United States. Alien reinsurers have asked state regulators to reduce this requirement to as low as 50% for insurers who meet particular criteria, pointing out, among other arguments, that U.S. reinsurers do not have any collateral requirements in many foreign countries and that the current regulations do not recognize when an alien reinsurer cedes some of the risk back to a U.S. reinsurer. In the past, the NAIC has declined to recommend a collateral reduction, citing fears of unpaid claims from alien reinsurers and an inability to collect judgments in courts overseas. In 2009, the NAIC proposed draft federal legislation to create a board with the power to enforce national standards for reinsurance collateral, including the reduction of collateral for highly rated reinsurers.[36] In 2010, an NAIC Task Force approved recommendations to reduce required collateral based on the financial strength of the reinsurer involved. This proposal is working its way through the NAIC process and may be approved by the full NAIC by the end of 2011. Some states, such as New York, Florida, and New Jersey, have already begun lowering reinsurance collateral requirements.[37]

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[33] European Commission, "Commission Proposes a Directive To Create a Real EU-Wide Market for Reinsurance," *Internal Market: Financial Services: Insurance: Press Release,* http://europa.eu/rapid/pressReleasesAction.do?reference=IP/04/513&format=PDF&aged=1&language=EN&guiLanguage=en.

[34] See, for example, p. 54 of the European Commission's *US Barriers to Trade and Investment Report for 2007*, at http://trade.ec.europa.eu/doclib/docs/2008/april/tradoc_138559.pdf.pdf.

[35] In the United States, the term "foreign" insurer generally denotes an insurer that is chartered in a different state; those insurers from a different country are termed "alien" insurers.

[36] The NAIC proposal can be found on their website at http://www.naic.org/committees_e_reinsurance.htm.

[37] See, for example, "NY DOI Approves Lloyd's Request to Post Lower Collateral," *BestWire*, July 29, 2011.