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Abstract: In this article, the author explains the current state-based insurance regulatory system. Proposed legislation that would expand the federal role in regulating the business of insurance is evaluated in terms of whether it could potentially improve the current state-based insurance regulatory system.

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Insurance Regulatory Reform: An Evaluation of Options for Expanding the Role of the Federal Government*

William J. Warfel

Since 1868, the business of insurance has been subject to substantial regulation at the state level. Several justifications have been cited for this substantial regulation. First, policymakers have cited a concern relating to the potential insolvency of an insurance carrier. For example, underestimation of asbestos and environmental liability claim reserves could pose a threat to the solvency of a commercial insurer; unfavorable investment earnings could pose a threat to the solvency of a life insurer. An insolvency potentially can jeopardize not only the interest of policyholders, but also the interest of third parties (e.g., a claimant who has a legal claim against a liability insurance policyholder, or a creditor who is insured under a homeowners insurance policy). Thus, the financial condition of insurers has been subject to substantial regulatory scrutiny. Second, policymakers have cited a need for consumer protection, particularly in the case of an unsophisticated policyholder. Insurance products are complex, and policyholders oftentimes lack sufficient knowledge to evaluate the coverage provided under a policy and the terms of the coverage. Thus, coverage forms typically must be approved by the regulator, and claim settlement practices of an insurer are subject to regulation. Insurers and insurance agents must meet various requirements to become licensed; the market conduct of insurers (e.g., advertising and promotion of insurance products) has been subject to substantial regulatory scrutiny.

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Third, policymakers have cited a need to achieve important social goals. For example, facilitating home ownership and urban renewal are important social goals that can be more easily achieved if property insurance is available at an affordable price. Thus, the risk classification system utilized by insurers in determining homeowners insurance rates has been subject to substantial regulatory scrutiny.

In this article, key legal decisions that had a significant impact on the development of the insurance regulatory apparatus that currently is in place are discussed. This discussion provides a historical perspective concerning the evolution of insurance regulation, and sets forth the context in which the current insurance regulatory apparatus emerged.

The McCarran-Ferguson Act (1945) affirmed the power of states to regulate the business of insurance. Whether the McCarran-Ferguson Act has been effective in creating a regulatory environment that is oriented toward protecting the interest of consumers is examined here along a number of dimensions. Advantages of the current regulatory structure are discussed. Illustrations are provided that suggest that the current state-based insurance regulatory apparatus may not be optimal. Finally, the proposed State Modernization and Regulatory Transparency (SMART) Act and National Insurance Act are evaluated in terms of whether the legislation could potentially improve the current state-based insurance regulatory apparatus.

Key Legal Decisions Shaping the Current Regulatory Structure

Two legal cases heard by the U.S. Supreme Court had an enormous impact on the development of the insurance regulatory apparatus that currently is in place. In Paul V. Virginia, 75 U.S. 168 (1868), an insurance agent who was a resident of Virginia violated a local statute in Virginia pertaining to the regulation of insurance agents who represented an insurance carrier domiciled in another state. In an appeal filed with the U.S. Supreme Court, Paul contended that this local statute conflicted with the clause in the U.S. Constitution giving the U.S. Congress the power “to regulate commerce ...among the several states.” In upholding the validity of this local statute, the U.S. Supreme Court reasoned that insurance contracts are not interstate transactions even if the parties to the contract are domiciled in different states. On this basis, the Court concluded that insurance transactions were not governed by federal law, but rather were governed by local law. Based on this ruling, a number of state statutes were subsequently enacted for the purpose of correcting widespread abuses of consumers by insurance carriers; the U.S. Congress at no time attempted to control the insurance business. In turn, because invalidation of these state statutes would have practically been equivalent to granting insurance carriers engaged in interstate activities a blanket license to operate without legal restraint, the U.S. Supreme Court on a number of occasions repeatedly ruled that insurance transactions were governed by local law. For three quarters of a century after Paul, state legislatures responded on an *ad hoc* basis to perceived problems in local insurance

markets by enacting various state statutes designed to protect the interest of policyholders.

The issue presented to the U.S. Supreme Court in U.S. V. South-Eastern Underwriters Association (S.E.U.A.), 322 U.S. 533 (1944), however, did not concern the validity of another state insurance law; it concerned the applicability of a federal antitrust law that was intended to promote competition in the marketplace and regulate transactions stretching across state lines. In this particular case, the S.E.U.A. and its membership, which included nearly 200 property insurance carriers, were indicted by the lower court for alleged violations of the Sherman Anti-Trust Act. Alleged violations included, for example, (1) fixing and maintaining arbitrary rates in several states (i.e., member insurers engaged in “self-regulation” by enforcing adherence to rates developed by a cooperative rating bureau – the S.E.U.A. – to which all member insurers contributed their premium and loss data), (2) utilization of boycotts together with other types of coercion and intimidation to force non-member insurance carriers into the conspiracies, and (3) utilization of boycotts together with other types of coercion and intimidation to force independent insurance agencies to represent only S.E.U.A. insurance carriers. In responding to the indictment, the S.E.U.A. contended that it was not required to conform to the standards of business conduct established by the Sherman Act because “the business of fire insurance is not commerce;” this reasoning was embraced by the lower court. In reversing this decision, the U.S. Supreme Court reasoned in part that the business of insurance is interstate commerce and, thus, is governed by federal law.

The effect of the S.E.U.A. decision was to nullify the Paul decision; the legal validity of numerous statutes that had been enacted over the years for the purpose of protecting the interest of consumers was threatened. The immediate response of the U.S. Congress was to enact the McCarran-Ferguson Act, the purpose of which largely was to restore state regulation of insurance. The legislative history of this legislation seems to suggest on balance that the intent essentially was to nullify the S.E.U.A. decision, with the notable exception of egregious anticompetitive acts of the sort that were alleged in the S.E.U.A. case (i.e., federal antitrust law is inapplicable with the exception of conspiracy, boycott, and intimidation). More precisely, the McCarran-Ferguson Act provides for a “reverse preemption;” it authorizes the states to preempt any federal legislation except for federal legislation specifically related to the business of insurance. Assuming that state insurance law is applicable, federal law not specifically related to the business of insurance including, for example, the Federal Trade Commission Act, as well as federal antitrust laws, is inapplicable. State statutes aimed at protecting or regulating the relationship between the insurance carrier and the policyholder, directly or indirectly, preempt federal law unless the federal law specifically relates to the business of insurance.

Advantages of the Current Regulatory Structure

In providing for a “reverse preemption,” the McCarran-Ferguson Act served as an impetus for the development of the current state-based regulatory system. It prompted in Wisconsin, for example, the enactment of a number of statutes that collectively can be appropriately viewed as an “insurance code.” The statutes in

Wisconsin are sufficiently unified in both form and in substantive content to warrant being characterized as a regulatory code, or as a body of insurance law. Clearly, if a state legislature is truly committed to effective regulation of the business of insurance, the current regulatory structure is conducive to the development of a comprehensive, state-based regulatory system.

Perhaps, more importantly, the current regulatory structure allows for flexibility from state to state so that a given state can devise a regulatory system that addresses the unique needs of insurers domiciled in its state. At least 20 Risk Retention Groups (RRGs), which are association captives that provide liability insurance only for the owners, or members, of a RRG, have elected to charter in Vermont, and the state currently ranks as the top RRG domicile. In part, this ranking is attributed to (1) enactment of legislation providing for a favorable regulatory environment, and (2) a superior regulatory agency in terms of administering and supervising captive regulatory matters. Most importantly, the regulatory apparatus in this state is illustrative of the fact that their reduced capitalization requirements, and flexibility concerning rates and forms does not necessarily translate into lax regulatory oversight concerning the financial integrity of an RRG. Indeed, in Vermont, the licensing process, the monitoring and surveillance process, and the examination process are extraordinarily stringent for RRGs. This stringency is reflected in the fact that the percentage of RRGs domiciled in Vermont that have been liquidated is relatively low in comparison to other states. Several of the RRGs domiciled in other states that were eventually liquidated originally had sought admission in Vermont, but were denied for one reason or another. There seems to be

a learning curve with respect to effective regulation of RRGs. The current regulatory structure allowed Vermont to take advantage of this learning curve and devise a regulatory system that reflects the unique needs of RRGs.

Finally, through the National Association of Insurance Commissioners (N.A.I.C.), state legislatures have been encouraged to adopt “best practices” standards. A “best practices” standard is determined by a task force, or a working group that is formed by the N.A.I.C. for the purpose of addressing a regulatory issue. Typically, the membership of the task force, or working group, includes consumer, industry, and state regulatory department representation. These task forces, or working groups, have developed model laws which reflect “best practices” standards, relating to various facets of insurance regulation including, for example, agent licensing and reciprocity, many of which have been substantively adopted by most states. Through the creation of a state accreditation program in 1989, solvency regulation has been strengthened, and state legislatures have been encouraged to more adequately fund state regulatory agencies.

Perceived Shortcomings of the Current Regulatory Structure

The current regulatory structure has a number of perceived shortcomings.

Failure to Modernize Insurance Regulatory System. The McCarran-Ferguson Act preserved the legal validity of state statutes enacted on an *ad hoc* basis during the three quarters of a century after the Paul decision. Many of these state statutes have become antiquated and are ineffective in terms of protecting the interest of

consumers. For example, many insurance agent licensing laws that were enacted during this period did not include reciprocity measures. Perhaps the intent was to protect the interest of local insurance agents. Many state legislatures failed to address this issue until prompted to do so as a result of passage of the federal Gramm-Leach-Bliley financial services reform law in 1999. Under this Act, if within three years (by 2002), a majority of states had not enacted uniform insurance agent licensing laws or reciprocity measures, a private national licensing organization would have been created. In response to this threat, as of August 2004, most states had finally passed insurance agent licensing reform legislation that included a reciprocity measure.

Undue Emphasis on Protecting “Turf.” Under the McCarran-Ferguson Act, the primary regulator is the state. Federal legislation including federal antitrust laws and the Federal Trade Commission Act, for example, which do not specifically address the business of insurance, act as a regulatory backstop in the event a state does not adequately regulate the business of insurance. State legislatures historically have displayed a propensity to be reactive in responding to perceived infringement of their “turf” by the federal government; they have not been proactive in enacting legislation that protects the interest of consumers. In the immediate aftermath of enactment of the McCarran-Ferguson Act (1945), the sole focus of state legislatures was responding to the S.E.U.A. decision by enacting state statutes pertaining to rate regulation so as to preempt federal antitrust law, with the notable exception of egregious anticompetitive acts of the sort that were alleged in the S.E.U.A. case (i.e., federal antitrust law is inapplicable with the exception of conspiracy, boycott, and

intimidation). Fair trade practices statutes (i.e., a statute addressing issues such as false advertising) were not enacted until the late 1950s when the Federal Trade Commission initiated some inquiries and preliminary investigations into some of the promotional and advertising practices employed by insurers in the fields of accident and health insurance. Clearly, the primary goal of enacting state statutes regulating the business of insurance should be protecting the interest of consumers; the propensity displayed by state legislatures historically not to enact appropriate state statutes regulating the business of insurance until threatened with federal intervention seems to suggest that protecting the interest of consumers was not the paramount consideration.

Failure to Uniformly Implement “Best Practices” Standards. Under the McCarran-Ferguson Act, each state legislature must independently enact state statutes regulating the business of insurance. The result has been enactment of state statutes that do not reflect the “best practices” standard. For example, for whatever reason, Louisiana is the only state with a one-year statute of limitations that applies to the filing of a lawsuit against an insurance carrier based on breach of a homeowners insurance policy; all other states have prescriptive periods that are two years or longer. This period of time has proven to be insufficient and not in the interest of policyholders with respect to unresolved property insurance claims from hurricanes Katrina and Rita. Lack of uniformity means that some states have statutes that do not reflect the “best practices” standard.

Unnecessary Duplication. Under the McCarran-Ferguson Act, each state regulatory authority is required to perform the same tasks. This unnecessary duplication has overwhelmed state regulatory authorities, which oftentimes have limited resources. For example, PHL Variable Insurance Company, a Connecticut-domiciled affiliate of Phoenix Life Insurance Company, recently sought approval for a new ownership clause contained in an individual life insurance policy – the clause disallows transfer of ownership unless the insurer is first given the right to purchase the policy. This ownership clause gives the insurer a favored status in bidding for the policy, which may or may not be consistent with the best interest of the policyholder. The policy containing the new ownership clause was submitted to 51 jurisdictions in the spring of 2006, of which 46 quickly approved it. Approval is pending in the other five jurisdictions as of spring 2006. Significantly, an examination of the Connecticut and Indiana files on the approval of this policy form does not contain documentation that would suggest that a serious discussion occurred concerning whether the new ownership clause was consistent with the best interest of the policyholder. A reasonable inference is that unnecessary duplication (i.e., all jurisdictions must independently evaluate insurance coverage forms) means that each jurisdiction must evaluate an unreasonably large number of insurance coverage forms. Because a given jurisdiction must evaluate an unreasonably large number of insurance coverage forms, the evaluation process is severely compromised. The process has become superficial.

Lack of Timely Responsiveness to Emerging Issues. Under the McCarran-Ferguson Act, state legislatures are permitted to move at a very slow pace in response to emerging issues, which may or may not be to the detriment of policyholders. In at least some cases, this very slow pace can be attributed to the fact that the N.A.I.C. cannot compel a state legislature to enact a model act (i.e., the N.A.I.C. is strictly an advisory organization). For example, in the wake of the 2004 broker compensation scandal that was brought to light by Attorney General Elliot Spitzer, the N.A.I.C. drafted model producer compensation language amending its Producer Licensing Model Act as a means to protect insurance buyers. The model language stipulates that producers who receive compensation from buyers or those that represent buyers in placing new or renewal insurance disclose their compensation from insurers or other third parties. Thus, the producer must disclose the dollar amount of a contingent commission received from an insurer, or a third party, for reaching a quota or profit goal of the insurer, or third party. Clearly, a contingent commission represents a potential conflict of interest that should be disclosed to the policyholder. Despite the general trend toward disclosure and transparency, since late 2004, only six states – Arkansas, Connecticut, Georgia, Oregon, Rhode Island, and Texas – have adopted statutes based on the N.A.I.C. model. Nevada issued regulations requiring disclosure of compensation that did not use the model language. New York, Utah, and Wisconsin enacted producer disclosure rules before 2004. This lack of a national standard adopted in all U.S. jurisdictions means that many brokers are operating under a patchwork quilt of state disclosure laws; other brokers are not required to disclose their compensation at all.

Furthermore, this slow pace on the part of some state legislatures to respond on a timely basis to an emerging issue undoubtedly has encouraged some state attorneys general to seek settlements that set forth rigorous transparency requirements. In so doing, these state attorneys general are “usurping” the state legislators’ powers. In particular, the role of a state attorney general should be to enforce the law, not make it. It is the state legislator who best understands regulatory issues and how to resolve these regulatory issues in a way that can be consistently applied throughout the insurance and risk management community.

Lack of Coordination. Under the McCarran-Ferguson Act, undue burdens are placed on insurers in complying with the regulatory process because of the lack of coordination among regulatory authorities in different states. Coordination has been achieved to some degree by placing responsibility for financial and market conduct examinations with a zone that comprises several states. Membership of a zone team includes representation from each of the state regulatory departments; membership assignments are coordinated through the central office of the N.A.I.C. Because market conduct examinations tend to be focused on local insurance markets, however, there may still be a lack of coordination. An insurer may be asked to supply the same data on multiple occasions. For example, because of an insurance availability and affordability issue with respect to homeowners insurance in high minority, low income geographic areas, numerous market conduct examinations have focused on underwriting practices having a disparate impact on inner-city residents. Undoubtedly, in attempting to make an assessment concerning whether

these underwriting practices are racially discriminatory and, therefore, unlawful, homeowners' insurers have been asked to submit the same data (i.e., underwriting manuals, data relating to location of insurance agents and claim offices, copies of insurance policies) to multiple state regulatory authorities, who can, potentially at least, reach differing judgments about the same underwriting practices.

Tendency to Focus on Symptoms of a Problem Rather than Root Causes.

Under the McCarran-Ferguson Act, state regulatory authorities and state legislatures have displayed a propensity to focus on addressing the symptom of an insurance price/availability problem as opposed to the underlying causes of the problem, particularly in the case of homeowners and automobile insurance. In states in which affordability of insurance is an issue, the result has been creation of an insurance rate regulatory apparatus that allows for politically expedient decisions in the short run as opposed to creation of an insurance rate regulatory apparatus that produces stable, competitive insurance markets over the long term.

Implementation of rate regulatory measures that result in an insurance carrier not being allowed to charge a rate commensurate with risk of loss remains a key impediment to an efficient insurance market; such measures have resulted in severe market dislocation. For example, in "prior approval" rate regulation states such as New Jersey, for example, state regulatory authorities have suppressed insurance rates by refusing to approve a rate increase for automobile insurance even though the loss data supports a rate increase. In response to this rate suppression, some insurance carriers have exited the state, with the result being the creation of an insurance

availability issue. Insurance carriers in New Jersey understandably were not willing to voluntarily provide coverage in those cases where the insurance rate was inadequate, with the result being a substantial increase in the population insured by a “residual” market (i.e., the involuntary market). The “residual,” or involuntary, market is a market of last resort that makes coverage available to those consumers unable to secure coverage in the voluntary market. Because the insurance rate is inadequate in the “residual” market, the resulting deficit produced by this market (i.e., loss cost exceeded premiums) is funded by assessments levied on insurance carriers in the voluntary market. These assessments are presumably then shifted to policyholders in the voluntary market in the form of surcharges. In an effort to make coverage affordable, rates in “residual” markets tend to be inadequate. Thus, policyholders in the voluntary market subsidize the cost of insurance for policyholders in the “residual” market.

Reliance on an open competition pricing system is the only way to minimize the cost of insurance over the long term, and to avoid the unintended and adverse consequences associated with a regulatory system that results in inadequate insurance rates. A regulatory system that allows for competitive pricing of insurance forces regulatory authorities and state legislatures to address underlying cost factors in response to an affordability issue; addressing underlying cost factors is the only way to minimize insurance rates over the long term.

While the McCarran-Ferguson Act has resulted in a state-based regulatory system that has been at least somewhat effective, the question arises whether an

expanded role for the federal government could potentially improve the current state-based insurance regulatory system.

Options for Expanding the Role of the Federal Government

Two federal insurance regulatory reform proposals are currently pending, and the 110th U.S. Congress is likely to engage in extended debate concerning the merits of these two proposals after the November 7, 2006 general election. First, the House Financial Services Committee's Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises is considering the State Modernization and Regulatory Transparency (SMART) Act, which proposes a "standards based" approach to insurance regulatory reform. Second, the Senate Committee on Banking, Housing, and Urban Affairs is considering the National Insurance Act, which proposes to allow an insurance carrier to seek an optional federal charter in place of the current state-charter-only system. In turn, these two alternative approaches to insurance regulatory reform are evaluated in terms of the extent to which the approach could potentially improve the current state-based insurance regulatory system.

SMART Act. This legislation proposes to improve the current state-based insurance regulatory system by compelling uniform adoption of "best practices" standards in all jurisdictions and/or mandating deference to the home state regulator (i.e., the

regulator in the state in which an insurance agent, or carrier, is domiciled, or chartered – the state in which the insurance agent, or carrier, is based).

With respect to market conduct regulation, the SMART Act contains several provisions that improve the current regulatory apparatus. First, it mandates that all states adopt various N.A.I.C. model acts pertaining to market conduct regulation including the N.A.I.C. Market Surveillance Model Act, the N.A.I.C. Market Analysis Handbook, and the N.A.I.C. Uniform Examination Procedures Act. To the extent that current market conduct regulation in a given state is inconsistent with the model act, the current regulation is preempted. In this way, antiquated market conduct regulation is nullified and uniform, “best practices” standards are adopted across all the states. Second, market conduct model acts subsequently drafted by the N.A.I.C. must be adopted by all states within a specified period of time. This requirement assures that market conduct regulation across all the states is uniformly responsive to market conduct issues in insurance markets on a timely basis. Third, non-chartering states are required to defer to the chartering state and not perform a market conduct examination, unless it uncovers abuses through a market analysis that (1) pose a significant risk to consumers, and (2) have not been addressed as a result of a previous market conduct examination. In the event that a “for cause” market conduct examination focusing only on the abuses in question is scheduled, other states must be informed so that they can participate. Thus, costly, unnecessary, duplicative market conduct regulation is avoided. Fourth, it provides for the coordination of information requests presented to an insurer so that the same data is not requested

from an insurer on multiple occasions. Again, costly, unnecessary, duplicative market conduct regulation is avoided.

The SMART Act contemplates that the N.A.I.C. will draft a model Accelerated Licensure Evaluation Review Techniques Act for the purpose of providing uniform standards for undertaking an assessment concerning whether an insurer's application for a license should be approved. All states must adopt this model act. To the extent that insurer licensing regulation in a given state is inconsistent with this model act, the regulation is preempted. In this way, antiquated insurer licensing regulation is nullified, and a uniform, "best practices" standard is adopted across all the states. Also, an insurer is required to present the application for a license only to a single point-of-entry state (i.e., the single point-of-entry state typically would be the state in which the insurer is domiciled). In this way, costly, unnecessary, duplicative regulation is avoided. Most importantly, by facilitating entry of an insurer into another state in which it is currently not licensed, insurance markets are likely to become more competitive.

The SMART Act contemplates that the N.A.I.C. will draft a model producer (i.e., insurance agent) application form and adopt uniform standards for the purpose of assessing whether a producer should be granted a license. Also, it provides for reciprocity. Thus, antiquated producer licensing regulation that does not provide for reciprocity is nullified, and a uniform, "best practices" standard is adopted across all states. Most importantly, by facilitating entry of a producer into another state in

which a license is not currently held, insurance markets are likely to become more competitive.

The SMART Act provides for (1) the establishment of a single point for electronic filing of a life insurance policy form, and (2) the adoption of a uniform standard across all states for the purpose of assessing whether a life insurance policy form should be approved. In this way, costly, unnecessary, duplicative regulation is avoided, and a “best practices” standard is adopted across all states. Also, it provides for a streamlined regulatory process that is applicable to sophisticated consumers.

The SMART Act contemplates that the N.A.I.C. will draft a model Property and Casualty Commercial Rate and Policy Form Act that will provide uniform standards for the purpose of assessing whether rates and coverage forms should be approved. Non-conforming state insurance regulation is preempted to the extent that it is inconsistent with the model act. In this way, antiquated insurance regulation is nullified, and a uniform “best practices” standard is adopted across all states. Also, it provides for (1) the establishment of a single point for electronic filing of a commercial property and casualty coverage form for purposes of meeting informational filing requirements applicable in states in which the policyholder is not domiciled, (2) the adoption of a review checklist for the purpose of determining what needs to be filed, and (3) deference to the state in which the policyholder is domiciled for purposes of coverage form regulation. In this way, costly, unnecessary, duplicative regulation is avoided. It provides for competitive rating for commercial

insurance with expedited rate filing, with the result being the creation of a competitive insurance market. Finally, it provides that commercial coverage forms and rates are not regulated with respect to sophisticated consumers, with the result being the creation of a competitive insurance market.

The SMART Act contemplates that the N.A.I.C. will draft a model Personal Lines Property and Casualty Insurance Form Act that will provide a uniform standard for the purpose of assessing whether a coverage form should be approved. Failure by a state to adopt this model act has potentially unfavorable implications in terms of filing fees that can be imposed on insurers. In this way, a uniform “best practices” standard is likely to be adopted in most states. Also, it provides for (1) the establishment of a single point for electronic filing of a personal property and casualty coverage form, and (2) the adoption of a review checklist for the purpose of determining what needs to be filed. In this way, costly, unnecessary, duplicative regulation is avoided.

With respect to personal lines including, for example, automobile and homeowners insurance, while (1) regulation is permitted requiring that an insurer file rates for purposes of meeting an informational filing requirement, and (2) rates are subject to regulatory review in terms of whether an insurer is in compliance with a rate regulation (i.e., rates must not be inadequate, excessive, or unfairly discriminatory), rates are governed by competitive market forces (i.e., prior approval regulation is not permitted). Most importantly, state regulatory authorities are not

permitted to suppress rates below expected loss cost and transaction cost in not only the voluntary market, but also the “residual” or involuntary market. The result is likely to be more stable, competitive insurance markets over the long term, with regulatory attention being focused on addressing underlying cost factors.

Furthermore, to prevent extreme volatility in rates that can be caused, for example, by a major hurricane, personal lines rates filed by an insurer must be within a flex-band; the extent to which a rate can be increased or decreased on an annual basis is subject to a ceiling and floor based on a specified percentage.

The SMART Act contemplates that the N.A.I.C. will draft a model Non-Admitted Insurance Act that will provide a uniform standard for the purpose of undertaking an assessment concerning whether a non-admitted insurer qualifies as an “eligible” non-admitted insurer. A non-admitted insurer is an insurer not licensed, or admitted, to do business in the policyholder’s state of domicile. The non-admitted market provides an insurance market for unique or hard-to-place risks through non-admitted insurers. These non-admitted insurers can adapt coverage forms to a unique risk. Also, because non-admitted insurers are not required to file insurance rates and coverage forms for regulatory approval, coverage can be made available to hard-to-place risks by charging a higher rate or offering more restrictive coverage than is permitted in the admitted market. The non-admitted insurance market is not unregulated, however. Coverage can be placed only with an “eligible” non-admitted insurer. Eligibility hinges on whether the non-admitted insurer meets a “seasoning” requirement that stipulates, for example, that the non-admitted insurer must be

licensed as an admitted insurer in at least one state, or the non-admitted insurer must have been in operation for a minimum period of time. Contradictory state rules govern whether a non-admitted insurer qualifies as an “eligible” non-admitted insurer. The SMART Act preempts these contradictory state rules by (1) stipulating that nonadmitted insurance is subject to regulation only in the policyholder’s home state, and (2) setting forth a uniform “eligibility” standard. In this way, a uniform “best practices” standard is adopted across all states.

Also, provision is made for a uniform and centralized national electronic system for licensing surplus lines brokers (i.e., brokers who are licensed to place coverage only in the non-admitted insurance market), or entities (i.e., policyholders) who directly procure insurance from non-admitted carriers. Failure by a state to participate would preclude it from collecting licensing fees from licensed surplus lines brokers. The regulatory process pertaining to payment of surplus lines premium taxes is streamlined. The tax is remitted to the state in which the policyholder is domiciled, and it is then allocated among the states in which the policyholder operates based on a uniform standard to be specified in a N.A.I.C. model act. Non-conforming state regulation that provides for an allocation that is at odds with the uniform standard is preempted by the model act.

Finally, under the act, no state could allow coverage to be placed in the non-admitted market unless a failed search was first undertaken to secure coverage in the admitted market. This provision protects policyholders. Admitted insurance carriers have always been covered under the state guaranty fund; non-admitted insurance carriers have never been covered under the state guaranty fund. The failed search

would have to have been diligent, typically meaning that at least three admitted insurance carriers declined to provide coverage. Under the SMART Act, this rule is preempted with respect to a “sophisticated” policyholder. Criteria are set forth under the SMART Act to determine whether a policyholder qualifies as a “sophisticated” policyholder (e.g., the policyholder employs a “qualified” risk manager).

“Sophisticated” policyholders do not need guaranty fund protection because information is available to evaluate the financial condition of a non-admitted insurer; deletion of the diligent search requirement will expedite the coverage placement process.

With respect to monitoring primary insurers and reinsurers for solvency purposes, the SMART Act provides for (1) implementation of uniform, “best practices” standards, and (2) deference to the state in which the primary insurer or reinsurer is domiciled. In this way, costly, unnecessary, duplicative regulation is avoided. In view of the fact that the intent underlying solvency regulation is to protect policyholders, one could argue that deference should be to the state where the policyholder is domiciled. Insurers underwrite coverage for policyholders in multiple states, however. Thus, the only way to avoid costly, unnecessary, duplicative regulation is to defer to the state where the insurer is domiciled.

In summary, under the SMART Act, the McCarran-Ferguson Act is preserved; states collectively through the N.A.I.C. continue to regulate the business of insurance. Non-conforming state regulation is preempted when it conflicts with

N.A.I.C. model acts so that uniform, “best practices” standards are applicable across all states. In some cases, deference to the state in which an insurer, producer, or policyholder is domiciled is required in order to avoid costly, unnecessary, duplicative regulation.

National Insurance Act. This legislation proposes to improve the current state-based insurance regulatory system by creating a dual regulatory system under which an entity can elect state regulation or federal regulation. It provides for the creation of an Office of National Insurance within the Department of Treasury, to be funded primarily with assessments levied on regulated entities, which is vested with authority to issue a federal charter and license to those insurers and producers who opt to be regulated at the federal level rather than the state level. In this way, the regulated entity can avoid costly, unnecessary, duplicative regulation; only the Office of National Insurance has the authority to license and examine the affairs of the insurer or producer.

The legislation contemplates the promulgation of national standards. During an initial period of transition commencing with enactment of the federal legislation, regulation presumably would be based on N.A.I.C. model acts. After this initial period of transition, a federal regulatory system would evolve as the U.S. Congress enacted federal statutes based on consultation with the Office of National Insurance. In this way, national standards would be put in place over time. The intent is that the national standard would reflect the “best practices” standard.

Insurance rates are governed by competitive market forces; coverage forms are not regulated. While insurers are subject to state laws with respect to participation in “residual,” or involuntary markets, such is not the case if a deficit is produced (i.e., premiums in the “residual,” or involuntary, market must be sufficient to cover losses and expenses). The result is likely to be stable, competitive insurance markets over the long term, with regulatory attention being focused on addressing underlying cost factors that contribute to increasing claim costs. Insurers and producers who opt for a federal charter are generally subject to federal antitrust law and the Federal Trade Commission Act.

Both the SMART Act and the National Insurance Act clearly have the potential to improve the current regulatory apparatus. The SMART Act appears to be less risky because it does not require the creation of a new bureaucracy, although the role of the N.A.I.C. is increased substantially; the National Insurance Act does require the creation of a new bureaucracy. The National Insurance Act creates regulatory competition, thus providing an incentive for state legislatures to improve the state-based insurance regulatory system.

Conclusion

The current regulatory apparatus has proven to be suboptimal in terms of being conducive to the creation of a stable, competitive insurance market over the long term. To a large extent, the state-based insurance regulatory system is suboptimal because (1) the N.A.I.C. does not have the authority to compel state legislatures to adopt its model laws on a timely basis; and (2) state regulatory authorities have displayed a propensity not to defer to the state in which the insurer or producer is domiciled. The SMART Act appears to address these deficiencies through the adoption of national, uniform standards and deference to the home state regulator. Legislation providing for an optional federal charter also provides for the adoption of national standards, but it would require the creation of a new federal bureaucracy. Its primary advantage is that regulatory competition would be created, thus spurring state legislatures to be proactive rather than reactive in responding to emerging issues.