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## Competitive Equity: An Optional Federal Charter for Insurance Companies

By Peter J. Wallison

*Now that insurance companies are competing with banks and securities firms in offering products and services to financial services consumers in a nationwide market, the regulatory structure of the insurance industry has become an important element of the competitive playing field. Banks can obtain swift approval of new products, and securities firms have few approval requirements, but insurance companies are regulated solely at the state level and must obtain approval from fifty-one state regulators in order to offer a product or service nationally. The delays in obtaining these approvals can place insurance companies at a competitive disadvantage in the fast-moving financial services market. For this reason, many in the insurance industry have been arguing for the creation of a federal chartering authority, like the comptroller of the currency for national banks, that would provide a federal alternative to state regulations and permit insurance companies to gain approval for new products at a single place. Although the National Association of Insurance Commissioners has been working for years to create a modernized and uniform state regulatory system, such a system has not yet been achieved and seems unlikely to be realized in the near future. Under these circumstances, an optional federal chartering system for insurance companies seems to be an idea whose time has come.*

The business of insurance has never been regulated at the federal level. The Constitution gives Congress the power to regulate interstate commerce, but the Supreme Court ruled in 1868 that insurance was not commerce.<sup>1</sup> Thus, since its earliest days, the insurance industry has been regulated by the states. Although the Supreme Court reversed course in 1944,<sup>2</sup> the states have continued to function as the sole regulators of both life insurance and property and casualty insurance.

This structure worked well until late in the twentieth century, when banks, securities firms, and insurance companies began to offer products that competed across industry boundaries. To cite only a few examples, fixed annuities offered by insurance companies compete with bank savings accounts and time deposits; variable annuities

compete with equity mutual funds; standby letters of credit compete with surety bonds; and reinsurance competes with catastrophe bonds. By 2004, 70 percent of the premium receipts of life insurance companies came from annuities, which in their various forms compete directly with securities firms and banks for the retirement savings of Americans.

This new cross-industry competition made the differential competitive impact of regulation a matter of concern to the insurance industry and significantly changed the industry's attitude toward state regulation. When insurance companies competed only with one another, all were equally disadvantaged by the deficiencies of a multistate regulatory regime. But when insurance companies faced competition from banks and securities firms, the difficulties of competing nationally while complying with the regulatory requirements of fifty-one separate jurisdictions (fifty states and the District of Columbia)<sup>3</sup> began to make a competitive

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difference. The ability of banks and securities firms, for example, to create and market products nationally without the requirement in most cases for specific regulatory approval—or, if necessary, approval by only a single regulator—contrasted sharply with the insurance industry’s need to obtain regulatory approval for a new product from every state in which the product would be offered.

This new competitive environment forced insurance companies and their associations to consider the advantages of a new regulatory framework, and at an AEI conference in June 1999, the American Bankers Insurance Association—an affiliate of the American Bankers Association—proposed the idea of an optional federal charter for insurance companies.<sup>4</sup> Such a charter would essentially create for the insurance industry a regulatory structure that roughly replicates the dual-chartering system that exists for banking. It would continue the state regulatory system unchanged, but would add a federal chartering and regulatory regime as an option—just as banks have the option to be chartered either as state or national banks. The concept of an optional federal charter quickly attracted support within the insurance industry and has been endorsed by the American Council of Life Insurance, the American Insurance Association (an organization of property and casualty insurers), the Financial Services Roundtable, and many other insurance and financial services associations. By May 2003, all the major insurance associations had agreed on the language of a legislative proposal that embodied the elements of an optional federal charter.

The legislation has not yet been introduced. Among other things, strong public opposition to an optional federal charter from congressmen Michael Oxley (R-Ohio) and Richard Baker (R-La.)—the chairmen, respectively, of the House Financial Services Committee and the subcommittee that would have jurisdiction over insurance matters—made legislative action for the time being seem fruitless.<sup>5</sup>

However, the possibility that Congress might authorize a federal chartering system for insurance stimulated a concerted effort by the National Association of Insurance Commissioners (NAIC), an organization representing all state insurance regulators, to address the concerns that had given rise to the industry’s demand for action at the federal level. In March 2000, the NAIC adopted an “action plan” entitled “Statement of Intent—The Future of Insurance Regulation.” As described by Gregory Serio—then the New York superintendent of insurance—in testimony to Congress in 2004:

This important document sets forth a common vision of . . . how a state-based system of national regulation should develop in each area where modernization is needed. In September 2003, state regulators took the next step in the modernization process by setting specific program topics and a common schedule for implementing them through adoption of the *Reinforced Commitment: Insurance Regulatory Action Plan*. This landmark document—the result of lengthy discussions and negotiations—puts the states on a track to reach all key modernization goals at scheduled dates within the next few years.<sup>6</sup>

The description of the NAIC’s efforts as a “statement of intent,” a “common vision,” and a “reinforced commitment” adopted after “lengthy discussions and negotiations” provides some indication of the difficulties that the NAIC has faced in bringing all state regulators to a consensus on what should be done. In fact, in all major respects, six years after its adoption of an “action plan,” the NAIC appears to have fallen short of its objectives. This should not be surprising. After almost 150 years of independent operation, the insurance regulatory structures within each state consist of substantial bureaucracies, are backed by state legislative committees with important jurisdictional concerns, account for significant amounts of state revenues, and have adopted widely disparate supervisory procedures, regulatory policies, and interpretations of state laws and regulations. The NAIC has no enforcement authority to overcome these differences or to override the political constituencies that have developed around insurance regulation in each state. Attempting to create uniformity out of this diverse environment may be possible over time, but it does not seem at this point that it can be done within a time frame that is relevant to the competitive needs of the insurance industry today.

Accordingly, it seems that the time has come for Congress to give serious consideration to an optional federal insurance charter.

## **The Case for an Optional Federal Charter**

At its base, the case for an optional federal charter rests on the character of the national and international markets in which many of the larger insurance companies operate. Because of advances in transportation and communications, the United States is now indisputably one market in

which providers of goods and services operate and compete most efficiently—and hence with greatest benefit to the public—when they are able to offer the same products and services nationally. To compete successfully with banks and securities firms across a broad spectrum of products and services, insurance companies must be able to respond quickly to products offered by the other industries. This may not be possible if, before doing so, they must satisfy the requirements of fifty-one separate regulators. Proponents of optional federal chartering point to the following factors as the major sources of competitive difficulty for insurance companies, and hence the principal elements of the case for federal intervention:

**1. Uniformity of company licensing.** When a bank is chartered as a state or national bank, it is immediately authorized to take deposits, make loans, and offer other routine banking services through branches anywhere in the United States. The financial soundness of a bank is deemed to be the responsibility of its chartering authority. In contrast, insurance companies are subject to separate licensing—including consideration of their financial condition—in every state in which they seek to do business. The licensing process can be expensive and time consuming, and must address differential requirements between states, necessitating constant monitoring of state legislation, regulations, and administrative determinations. The cost of obtaining a license to offer products in more than one state is an impediment to competition among insurance companies and competition by insurance companies with banks and securities firms. An optional federal charter would permit insurance companies that want to operate nationally to obtain a nationwide license at a single place.

A study of life insurance regulation by a group at the University of Massachusetts headed by Professor Sheila Bair showed that during the period from 1997 to 2002, approval times for company licensing required over six months in 58 percent of the states and two years in 17 percent of the states. Applications for new business lines were approved more quickly, although 15 percent of the states took over six months.<sup>7</sup>

**2. Speed to market.** The market for banking products and services is substantially affected by the existence of the comptroller of the currency as a national bank chartering authority. In order to assure that state-chartered banks are able to compete with national banks, many

states have what are called “wild card” statutes, which automatically authorize state-chartered banks to offer products and services that have been authorized for national banks. Although a state-chartered bank must apply to its home state chartering authority for approval to offer new products or services, competitive conditions in the banking industry—including the possibility that state-chartered banks can switch their charters to become national banks—generally result in the rapid approval of new products by state bank regulators. Securities products may generally be offered nationally without any federal or state approval.

New insurance products or forms, however, are subject to an approval process in all states in which they are offered. Some states may act quickly, while others may not. For an insurance company hoping to offer a product nationally, accumulating enough state approvals to make a national rollout possible is the crucial event, so even if some states act quickly, the cumulative time for approval is what is important. Even if approved, state regulators frequently require new products or forms to have special conditions or add-ons that make it difficult to market them on a national basis.

In a survey of life insurance firms, Bair and her colleagues found that 40 percent of the respondents reported that it required over three months to get approvals that would permit them to reach 75 percent of their customer base with a new product. Another 33 percent said they could get the necessary approvals in sixty to ninety days, and 28 percent said it usually took less than sixty days.<sup>8</sup>

The “shelf life” of a product in the fast-moving financial services market today has been estimated at two years,<sup>9</sup> and thus serious delays in obtaining approvals for a new product can be a significant competitive disadvantage. An optional federal charter would permit insurance companies to obtain approval for new products at a single place, enhancing their ability to offer products that compete with other financial services companies.

**3. Producer licensing approvals.** Producer licensing refers to the licensing of agents to sell insurance. Again, while banks and securities firms have minimal state requirements for their sales representatives, insurance company sales agents must be approved separately in each state in which they operate. These approvals take less time than company approvals, presumably because they are less complex. The Bair study found that for

more than 60 percent of life insurance companies, these approvals could be obtained in less than thirty days, although for most of the rest of the states it required thirty to sixty days.<sup>10</sup> Strictly speaking, an optional federal charter for insurance companies will not affect producer licensing, but legislation addressing an optional federal charter is also likely to contain provisions for federal producer licensing.

**4. International competition.** U.S. insurance companies are increasingly going overseas to offer products and services. In doing so, they are entering markets such as the European Union, where regulators will grant approval for operations only where they are assured that foreign companies are operating under the supervision of a strong and capable home country regulator. Although some state regulators qualify under this standard, U.S. companies may find that smaller state regulators do not, and that foreign standards may tighten in light of later events. Moreover, the cumbersome state regulatory system is increasingly seen by foreign countries as a barrier to entry, jeopardizing access by U.S. companies to their markets if they decide to retaliate. The existence of a federal regulatory regime may enable more U.S. insurance companies to compete in an increasingly globalized financial services market.

Proponents of optional federal chartering also see other advantages of a federal regulatory regime beyond enabling the insurance industry to compete more effectively with banks and securities firms.

**1. Federal level understanding of insurance.** The absence of a federal agency with expertise in insurance can disadvantage the insurance industry. Many insurance industry observers have noted that the industry did not have a seat at the table when Congress was framing the Gramm-Leach-Bliley Act of 1999, which attempted to level the playing field among the banking insurance and securities industries. This deficiency also became apparent after the September 11 attacks, when Congress and the administration had no source of insurance expertise at the federal level to assist in the framing and implementation of the Terrorism Risk Insurance Act. While

neither the Securities and Exchange Commission nor the Office of the Comptroller of the Currency is necessarily an advocate for the industry it regulates, when it is necessary for Congress or the executive branch to understand the needs of either industry, each agency becomes a source of unbiased expertise for policy-makers in the executive and legislative branches.

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**2. Regulatory competition.** The dual-banking system, in which state and federal regulators compete to charter banks, has generally been considered salutary for the banking industry. Banks can readily switch their charters from state to federal and back again, and many have done so over time. The proponents of the dual-banking system argue that the regulatory competition this encourages keeps both sets of regulators alert to changes in the economy and financial system that alter the competitive environment for banks. Indeed, the existence of the national banking system may over time induce state bank regulators to agree to the uniform rules structure that has thus far eluded insurance regulators. An optional federal charter will set up a similar competitive environment in the insurance industry, improving conditions for all insurers, even those that remain state-chartered and regulated.

The Bair study concluded, for example, that producer licensing at the state level had become more streamlined because the Gramm-Leach-Bliley Act authorized a contingent licensing system for agents if the states did not develop a more efficient system of their own. This suggests that an optional federal chartering regime will also induce more efficiency at the state level.

## Objections to an Optional Federal Charter

Opposition to an optional federal charter arises from two sources: the NAIC's view that it can create sufficient uniformity at the state level to meet the major concerns of the insurance industry, and the objection of some in Congress to the creation of another federal regulatory agency. Consumer advocates are also concerned that consumer interests may receive less attention at the federal level than the state level.

**1. The NAIC's Efforts to Achieve Uniformity.** In testimony to congressional committees, the NAIC has committed itself to addressing the insurance industry's concerns in most important areas, including the three that the industry believes are the principal obstacles to the its ability to compete effectively with banks and securities firms: company licensing, agent licensing, and speed to market for insurance products. In 2004, in the last such report to Congress, Gregory Serio, the New York securities commissioner, presented an NAIC report that recounted the progress that the organization had made in each of these three areas since its promise in 2000:<sup>11</sup>

**Company licensing.** On this topic, the NAIC reported that state regulators have made progress in agreeing on a uniform application form and a data processing format for insurance company applications, and that a Company Licensing Model Act is in the process of development. Although some additional progress may have been made since 2004, industry sources say it has been slight. In other words, the NAIC is still struggling to achieve the uniform company licensing system it said in 2000 was its goal. It is also important to note that a uniform company licensing system is not a system in which insurance companies are able to obtain a nationwide license by receiving a license in a single state; that is the system that generally prevails in the banking industry, but the NAIC seems only to be aiming at the more modest objective of requiring each state to use the same application for licensing.

**Agent or producer licensing.** In this area, the NAIC can point to some significant progress. It has approved a uniform application which has been adopted by forty-six states for nonresident licensing, achieved some reciprocity in continuing education, and created a national insurance producer registry through which thirty-one states and the District of Columbia are accepting applications. The Bair report noted that only a little over 30 percent of the states are taking longer than thirty days to approve a producer application.

**Speed to market.** Here the NAIC reported that forty-five states have posted their review standards on their websites. There is now an NAIC database that allows insurers to search for the product requirements of each state before filing an

application for a new product. States, according to the NAIC, are being "actively encouraged" to use a model law that "places greater reliance on competition for commercial lines insurance products."<sup>12</sup> The NAIC has developed—and all fifty-one U.S. jurisdictions have adopted—the System for Electronic Rate and Form Filing (SERFF). This is a "one-stop, single point of electronic filing system for insurance products," and the NAIC notes that "[i]nsurers that have chosen to use SERFF are experiencing an average 23-day turn-around time for the entire filing submission and review cycle."<sup>13</sup> The figures given by the NAIC for SERFF are disputed by life insurance industry sources surveyed by Bair and colleagues, who note that the averages lump together the faster processing times for minor changes in products with the longer processing times for more complex filings, and report only on average state processing times, not the time it takes to clear multiple states.<sup>14</sup> The Bair report's survey of life insurance companies produced quite different results, as discussed above.

Again, it should be noted that uniform filing requirements, and even streamlined filing through SERFF, does not mean that states are giving up their prerogative to approve products under widely varying state policies, laws, and regulations. In this sense, the insurance industry still faces difficulties in obtaining approval of individual products—difficulties that are not faced by the banking or securities industries.

Nevertheless, the NAIC also reported that in December 2002 it adopted a form of interstate compact on insurance product regulation—an agreement among the states that would "[e]stablish a mechanism for developing uniform national product standards for life insurance, annuities, disability income insurance and long term care insurance products. It will also create a single point to file products for regulatory review and approval. In the event of approval, an insurer would then be able to sell its products in multiple states without separate filings in each state."<sup>15</sup> The compact would go into effect among the signatory states once it is ratified by twenty-six states, and if adopted by most of the states could be a major event; it would meet the need of many insurers to have a single place to obtain approval of products. However, ratification has been slow and seems to have stalled; twenty

states, mostly small, had ratified the compact by 2006, but many of the largest states, with the exception of Texas and Pennsylvania, have not yet acted. Many observers doubt that the compact will ever go into effect in a sufficient number of states to permit a national rollout of a new product. It is also important to note that the compact does not apply to the products of property and casualty insurers or the approval of their rates.

**2. Congressional Objections to Optional Federal Chartering.** As noted above, the principal objections in Congress to optional federal chartering have come from two highly influential sources—Michael Oxley and Richard Baker. They ruled out any support for an optional federal insurance charter or any direct federal regulation of insurance. Instead, Oxley and Baker proposed a novel structure in which the federal government would preempt certain state regulation that interfered with a single point of entry for licensing or approval of specific products.<sup>16</sup> Although how such a system would function is not entirely clear, it seems to be an effort to force the development at the state level of a system roughly comparable to what prevails in banking, without a national bank option.

The Oxley-Baker proposal appears to have stopped further action on an optional federal charter, at least in the House. In August 2004, the two chairmen put flesh on the bones of this approach by circulating a draft of a State Modernization and Regulatory Transparency (SMART) Act. The proposal, which was never formally introduced as a bill in Congress, contemplates that insurers will have a single state point of entry to the licensing process, based on the development of a state model law; the adoption by the states of an interstate compact that creates a single point of filing, review, and approval for life insurance policy forms; recognition of single-state governance of policy form requirements and expedited review of commercial property and casualty products; and single-point filing of personal lines property and casualty policy forms. In order to achieve more streamlined regulation, the proposal included the preemption of some state authority.

The SMART Act drew the sharp opposition of state regulators and some state legislatures. In a letter to Chairman Oxley, the NAIC denounced the SMART Act in strong language, referring to it as “totally flawed,”<sup>17</sup> and the National Council of Insurance Legislators (NCOIL), a body representing state legislators, said that it could not support the proposal because “it could undermine the role of state legislatures in the development of insurance

public policy.”<sup>18</sup> The NAIC’s uncompromising opposition was unusual because the organization was responding to what was clearly an effort on the part of Chairman Oxley to preserve state regulation of insurance while achieving what all sides in the debate referred to as “modernization” of insurance regulation. The NAIC was apparently unwilling to accept the idea of federal interference with continuing state authority. The NAIC letter continued: “Our concerns are deeply rooted in the basic structure of the SMART Act that mandates federal preemption of state laws and regulations, federal supervision of state regulations, and complete de-regulation for all states. We do not believe that tweaking the language of the SMART Act discussion draft can resolve these basic conflicts.”<sup>19</sup>

## Conclusion

In testifying before a House subcommittee on June 16, 2005, Gregory Serio, then the former New York superintendent of insurance and a frequent spokesman for the NAIC before Congress, noted that:

Uniformity was and continues to be the gold standard for measuring effective modernization of state insurance regulation, but it also is proving to be far more elusive a goal than many thought. Perhaps it is because some did not realize that the quest for uniformity within a state-based system would still require some states to shed some individual autonomy, perhaps it is because some erroneously thought that uniformity would mean deregulation when it clearly does not, or perhaps it is because at the end of the day there may not be the same level of commitment to modernization of insurance policy and practice as many had originally thought.<sup>20</sup>

The NAIC letter and the NCOIL statement are significant because they indicate how difficult it will be, without federal intervention in some form, to achieve the kind of change in insurance regulation that the insurance industry requires. The NAIC has been working hard to achieve some degree of uniformity in how the states regulate insurance, but outsiders and members of the insurance industry could very well question whether in the end that uniformity will actually reduce the tendency of the states to impose their own policies and preferences on each company licensed and on each product reviewed. If this is what the NAIC and the states

ultimately want, “modernization” of insurance regulation will never occur.

Until this issue is clarified, an optional federal charter seems to be the only workable solution to the insurance industry’s inability to compete effectively with banks and securities firms.

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*AEI staff assistant Daniel Geary and editorial assistant Nicole Passan worked with Mr. Wallison to edit and produce this Financial Services Outlook.*

## Notes

1. *Paul v. Virginia*, 75 U.S. 168 (1868).
2. *U.S. v. South-Eastern Underwriters Assn.*, 322 U.S. 533 (1944).
3. Technically, an insurance company that wants to sell a product in every U.S. jurisdiction must clear it with fifty-six regulators—the fifty states, the District of Columbia, and five U.S. territories.
4. Larry LaRocco, “Federal Regulation of Insurance, ABAIA’s Proposal for Optional Dual Chartering of Insurance” (speech, American Enterprise Institute, Washington, D.C., June 3, 1999).
5. Independent Insurance Agents and Brokers of America, “Chairman Baker, Senator Allen Discuss Future of Insurance Legislation,” news release, April 22, 2004, available at [www.iaa.org/eprise/main/CB\\_Website/Affiliated/NationalAssociation/IIAA/02\\_News/02\\_PressRelease/NA20040422143241?ContentPreference=NA&ActiveState=0&ContentLevel1=NEWS&ContentLevel2=NEWSPRESS&ContentLevel3=&ActiveTab=NA&StartRow=0](http://www.iaa.org/eprise/main/CB_Website/Affiliated/NationalAssociation/IIAA/02_News/02_PressRelease/NA20040422143241?ContentPreference=NA&ActiveState=0&ContentLevel1=NEWS&ContentLevel2=NEWSPRESS&ContentLevel3=&ActiveTab=NA&StartRow=0). “I want to assure you, and this is directly from Chairman Oxley: There will not be a proposal considered by the Congress for creation of a federal regulator on K Street in Washington to regulate insurance nationally. That is just not on the table,” Baker said to a rousing ovation from the independent insurance agents and brokers.”
6. Gregory Serio, Senate Committee on Banking, Housing, and Urban Affairs, *Examination and Oversight of the Condition and Regulation of the Insurance Industry*, 108th Cong., 2nd sess., September 22, 2004, 4, available at [http://banking.senate.gov/\\_files/serio.pdf](http://banking.senate.gov/_files/serio.pdf).
7. Sheila Bair et al., *Consumer Ramifications of an Optional Federal Charter for Life Insurers*, (Amherst, Mass.: University of Massachusetts—Amherst, Isenberg School of Management, March 2004), 37, available at [www.isenberg.umass.edu/finopmgt/uploads/basicContentWidget/8631/bair-cons-ramifications.pdf](http://www.isenberg.umass.edu/finopmgt/uploads/basicContentWidget/8631/bair-cons-ramifications.pdf).
8. *Ibid.*, 39.
9. Arthur Ryan, Senate Committee on Banking, Housing, and Urban Affairs, attachment prepared by the American Council of Life Insurance, “The Changing Marketplace and the Importance of Efficient Insurance Regulation,” *Examination and Oversight of the Condition and Regulation of the Insurance Industry*, 108th Cong., 2nd sess., September 22, 2004, 8–9, available at [http://banking.senate.gov/\\_files/ryan.pdf](http://banking.senate.gov/_files/ryan.pdf).
10. Sheila Bair et al., *Consumer Ramifications of an Optional Federal Charter for Life Insurers*, 37.
11. Gregory Serio, Senate Committee on Banking, Housing, and Urban Affairs, attachment A, “A Reinforced Commitment: Insurance Regulatory Modernization Action Plan, Updated Status—September 2004,” *Examination and Oversight of the Condition and Regulation of the Insurance Industry*, 108th Cong., 2nd sess., September 22, 2004, 13–31.
12. *Ibid.*
13. *Ibid.*, 18–22.
14. Sheila Bair et al., *Consumer Ramifications of an Optional Federal Charter for Life Insurers*, 39.
15. *Ibid.*, 22.
16. Michael Oxley, “Road Map to State-Based Insurance Regulatory Reform” (speech, National Association of Insurance Commissioners, New York, NY, March 14, 2004), available at <http://financialservices.house.gov/News.asp?FormMode=release&ID=457>.
17. “NAIC Calls Smart Act Totally Flawed,” *National Underwriter News*, March 24, 2005.
18. National Association Professional Insurance Agents, “NCOIL Says It ‘Cannot Support’ SMART Act,” news release, September 17, 2004, available at [www.pianet.com/NewsCenter/IndustryOrgNews/9-17-04-8.htm](http://www.pianet.com/NewsCenter/IndustryOrgNews/9-17-04-8.htm).
19. “NAIC Calls Smart Act Totally Flawed.”
20. Gregory Serio, House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, *Smart Insurance Reform*, 109th Cong., 1st sess., June 16, 2005, 2, available at <http://financialservices.house.gov/committees.asp?formmode=detail&comm=1>.