

# An Evaluation of US Insurance Regulation in a Competitive World Insurance Market

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Charges that US insurance regulation acts as a barrier to entry and discriminates unfairly against foreign insurers have been voiced for many years by US trading partners. The effects of these barriers and discrimination are said to result in a less competitive and robust national insurance market. Simultaneously, many US insurers believe that they are hampered in international competition by the US regulatory system and that other countries justify their own trade barriers against them because of the difficulties that US regulation impose on foreign insurers. This paper addresses these and related issues in the context of the Optional Federal Charter (OFC) proposal.

The proposal for an OFC needs to be examined in the context of insurance regulation at the national and international level. This paper accordingly starts by reviewing global regulatory trends affecting financial services, with an overview of international insurance markets. The international aspects of the US market are then examined, with particular attention to features of the US regulatory pattern that affect foreign-owned insurance providers in the US market.

Drawing on this analysis, the paper concludes by suggesting how an OFC might bring competitive advantages for US insurers and welfare benefits for US insurance consumers in a competitive world insurance market. It highlights how a federal insurance presence could serve the cause of US insurers and reinsurers seeking international expansion, provide global representation and advocacy for US insurance interests, minimize international retaliation against them, and enhance the efficiency and competitiveness of the US market, both in the global marketplace and for the benefit of US insurance consumers.

### **Internationalization and Convergence in Global Financial Markets**

In recent decades convergence among financial services providers (earlier operating in largely separate markets) has been a global phenomenon. Convergence has taken place both at the product (e.g., asset insurance through guarantees and credit derivatives) and supplier levels (e.g., banks engaging in reinsurance or insurers in the capital markets). At the center of this process is the growth of alternative risk transfer techniques. Against this background, governments worldwide have accepted the need to foster integrated financial services markets that allow greater competition. They have also acknowledged the need for greater regulatory integration that takes account of financial convergence while guarding against global systemic risk.

Different approaches to supervision have emerged. Partly reflecting economic development, most are prudential while others remain more protective with further divisions between principles-based and rules-based approaches. Given the convergence between different financial services subsectors, growing numbers of countries (starting with Singapore, 1984) have adopted forms of integrated systems with a single regulatory agency. These include the two biggest insurance markets outside the US (UK [1997] and Japan [1998]). Others, including India and China, retain functional regulatory regimes with forms of structured consultation to foster regulatory coherence. Still others, notably Australia, follow a so-called twin-peaks model of having one regulatory agency responsible for prudential matters and another responsible for consumer protection and market conduct functions.

From the US point of view, the European Union (EU) approach seems particularly relevant. It combines a high degree of harmonization of prudential supervisory standards with a national regulator in each of the 27 member states. The harmonized approach enshrined in EU law means that all member states must follow similar standards for insurance supervision, developed under the EU's Financial Services Action Plan (FSAP), based on mutual recognition. A striking effect of these common standards is that an insurer (whether EU-owned or foreign-owned) established and supervised in one member state has the legal right to establish/provide its services in any other member state without further prudential requirements. This approach is being developed under the FSAP to cover all of the main areas of financial services and provide a high degree of coherence in prudential regulation (while

market-conduct regulation remains at the member-state level). Looking forward, the FSAP's ultimate goal is to ensure that supervisory best practice is followed uniformly throughout the EU's regulatory system, working as a single whole, so that there is the fullest extent of mutual recognition between EU regulators. A foreign-owned financial services provider wishing to enter the EU market need only be established and supervised in one member-state to operate across the entire EU market.

## Overview of the International Insurance

Like other financial services suppliers, insurers provide essential finance, risk transfer, and investment management tools to help economies grow, diversify, and become more competitive. Foreign insurers can contribute to financial market stability by providing locally unavailable pools of capital, innovative risk-management, and new technologies. According to a World Bank report, countries with open financial services sectors grow an average of one percent faster than other countries.

Insurers offer similar types of functions and generic benefits to a national economy as do other financial intermediaries. At the same time, their role in individual and corporate risk management means that their contributions to growth will differ. Nonlife insurance, life insurance, and banking are all shown to be important predictors of economic productivity. Evidence exists of synergies among financial intermediaries. Each sector fuels economic growth independently, but together the whole gives an impetus to growth greater than the sum of the parts.

Today's world insurance market is characterized by increasing interdependencies both between insurance and other financial services and between previously distinct insurance markets. The post-9/11 world insurance market differs markedly from its pre-9/11 counterpart. Today's world insurance economy is truly global, with effects on all national and regional insurance markets. The global market is under unprecedented pressures to be both deep and broad, unconstrained by artificial or outdated supervisory practices tending to fragment it or reduce its capacity to offer innovative insurance and reinsurance cover on an available, affordable, and acceptably regulated basis. Such a global market requires national regulators to meet requirements of scale and standing that are proof against regulatory capture by protectionist interests and capable of holding their own in a world where a degree of regulatory competition is inevitable and healthy.

### Insurance Terminology

In US parlance, an **admitted insurer** is licensed to sell insurance in a particular US state. A **non-admitted insurer** is not licensed to do business in that state. Also, a **domestic insurer** is one domiciled (incorporated) in the same state in which it sells insurance. A **foreign insurer** is one domiciled in a US state different from that in which it sells insurance. (In other countries, it is one domiciled in another country.) Finally, in the US, an **alien insurer** is one domiciled in a country other than the US. International trade conventions recognize only "domestic" and "foreign" to denote the nationality of insurers. So we follow those conventions here.

Insurance sold to the general public is called **direct insurance**, sold by **direct (writing) or primary insurers**, and paid for by **direct premiums**. Insurers hedge their insurance risks by buying **reinsurance**, most often from **reinsurers**. A direct insurer buying reinsurance is a **cedant**, as it **cedes** its business to the reinsurer (which may **retrocede** to spread risks still further). Reinsurance is available from **professional reinsurers** whose primary function is selling reinsurance, from direct insurers that have reinsurance departments, and in Lloyd's markets.

Foreign interests can provide insurance services in two ways. One is **cross-border** when the buyer purchases (imports) insurance from a firm domiciled in a country different from that of the buyer. The purchase can take several forms: pure, own-initiative, or consumption-abroad. The other is

**establishment**, also called **commercial presence**, when the buyer purchases insurance from a domestic, foreign-owned entity, which may be an agency, branch, subsidiary, or representative office.

### Key Insurance Markets

Table 1 lists the world's 20 largest insurance groups by revenues for 2007, with countries of domicile and main area of business. Eleven are European (nine being EU groups, including the world's top three). The remaining nine are from the US (six) and Japan (three). Reinsurers are vital to the insurance supply chain. Five of the 10 largest reinsurance groups (not shown) are European, including the top two, Munich Re and Swiss Re. The US is home to three groups, and Bermuda to two.

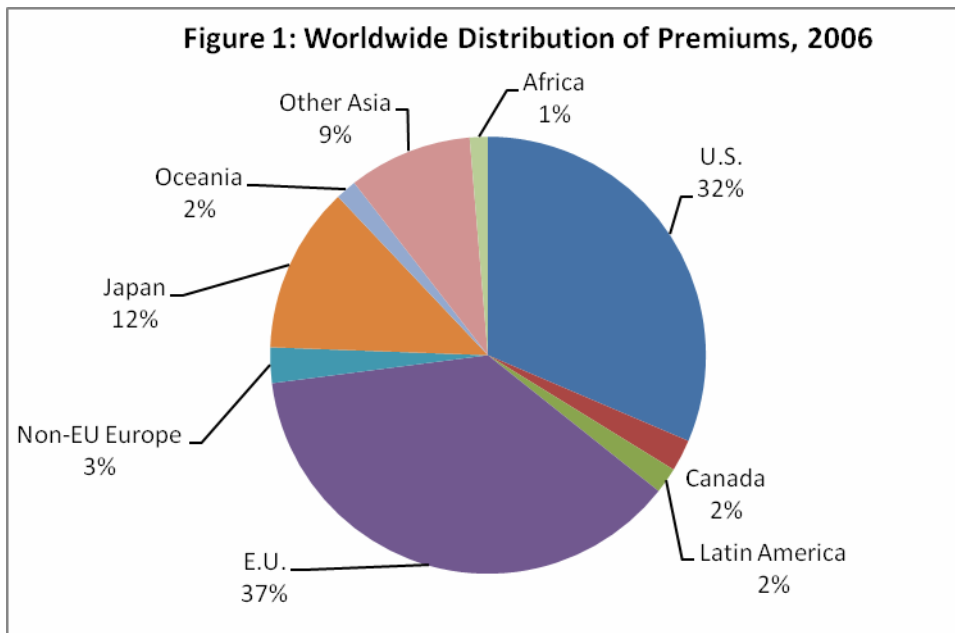
**Table 1: World's Largest Insurance/Reinsurance Groups, 2007**

Rank	Company	Revenues (1)	Country	Main Business
1	ING Group	158.3	Netherlands	Life/health
2	AXA	139.7	France	Life/health
3	Allianz	125.3	Germany	Nonlife
4	American International Group	113.2	United States	Nonlife
5	Assicurazioni Generali	101.8	Italy	Life/health
6	Berkshire Hathaway	98.5	United States	Nonlife
7	Aviva	83.5	United Kingdom	Life/health
8	Prudential	66.1	United Kingdom	Life/health
9	Zurich Financial Services	65.0	Switzerland	Nonlife
10	State Farm Insurance Companies	60.5	United States	Nonlife
11	Munich Re	58.2	Germany	Reinsurance
12	Nippon Life	56.6	Japan	Life/health
13	CNP Assurances	55.6	France	Life/health
14	MetLife	53.3	United States	Life/health
15	Aegon	45.9	Netherlands	Life/health
16	Dai-ichi Mutual Life	43.1	Japan	Life/health
17	Millea Holdings	36.1	Japan	Nonlife
18	Allstate	35.8	United States	Nonlife
19	Swiss Re	32.1	Switzerland	Reinsurance
20	Hartford Financial Services	26.5	United States	Nonlife

(1) Revenues (in US\$ billions) include premium and annuity income, investment income, and capital gains or losses but exclude deposits; includes consolidated subsidiaries; excludes excise taxes.  
Source: "Global Fortune 500," *Fortune*.

The most commonly accepted measure of insurance market size is gross direct written premiums. Globally, these totaled more than \$3,723 billion in 2006, having shown a real average annual growth rate of about 5 percent over the preceding 10 years. Figure 1 shows the regional distribution of insurance premiums. Europe was the world's largest market, accounting for 40 percent of total direct premiums written (the EU accounting for 37 percent of the world total). The US and Canadian shares are 32 and 2 percent, respectively.<sup>2</sup>

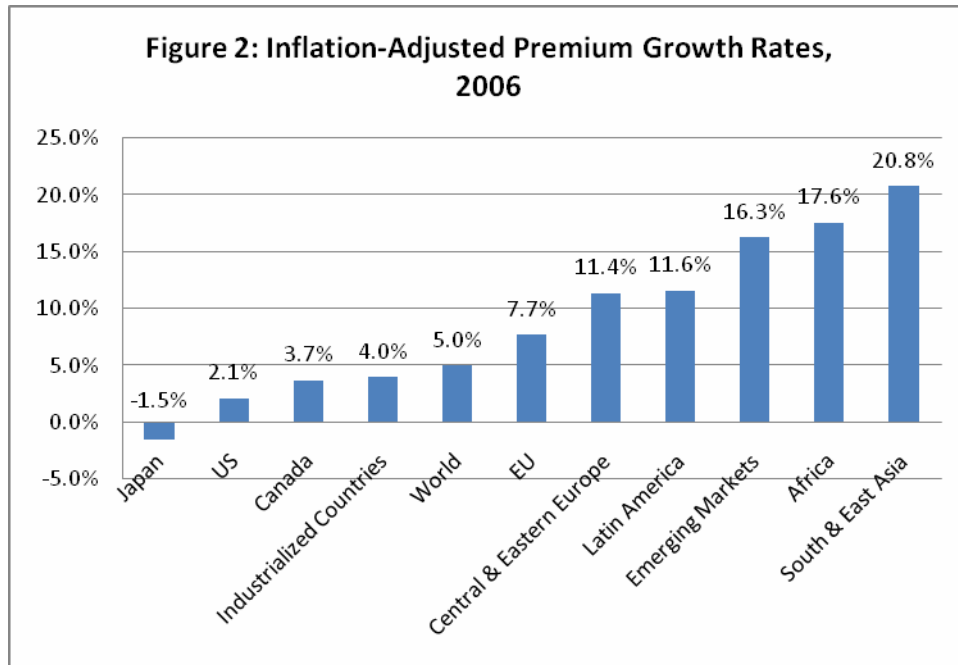
<sup>2</sup> International insurance premium data are from Swiss Re (2007).



Japan's world share (12 percent) continues to shrink. Conversely, the world share of "Other Asia" continues to rise, with double-digit growth in several markets. The 30 members of the Organization for Economic Cooperation and Development (OECD) accounted for 90 percent of worldwide total premiums in 2006 - a gradually declining share, even with OECD enlargement.

The life and nonlife sectors account respectively for about 59 and 41 percent of world direct premiums, with considerable regional diversity. Life insurance accounts for more than three-quarters of total premiums in Asia, but only for 40 percent in Latin America. The high Asian share results from a high savings propensity via life insurance and less developed financial markets. Conversely, past high inflation rates and political instability have depressed Latin American life premium growth, with the situation having recently changed dramatically for several countries.

The life and nonlife sectors continue to evolve differently. Growth in life premiums worldwide continued strong at 7.7 percent in 2006, driven by increasing incomes in emerging markets, higher life expectancies, and governments reducing the generosity of social insurance programs in the face of fiscal imbalances and demographic imperatives. The nonlife sector internationally experienced growth of only 1.5 percent in 2006, roughly in line with the past few years, despite robust growth in several markets. In general, emerging markets continue to experience more rapid nonlife premium growth than the more mature developed markets. Figure 2 shows 2006 inflation-adjusted growth rates for life and nonlife insurance combined for several countries and country groupings.



The South and East Asian, African, Latin American and Caribbean, and Central and Eastern European emerging markets have experienced particularly strong growth in recent years. Indeed, emerging markets as a whole realized 16.3 percent real premium growth in 2006, against 4.0 percent growth for industrialized countries and 2.1 percent in the US.

For US insurers, such data points to great opportunity in many markets worldwide, but weaker growth in the US and other advanced markets. Indeed, real growth in US nonlife insurance premiums in 2006 was only 1.0 percent. For the life sector, real growth of 3.6 percent was respectable, if still comparatively low. Driven chiefly by an aging population’s demand for retirement and related products, this market will likely remain robust as some 76 million baby boomers – one quarter of the US population – come face to face with retirement, the need for additional retirement security, the fiscal problems of Social Security, and fewer defined benefit pension plans.

### **The International Dimensions of the US Insurance Market**

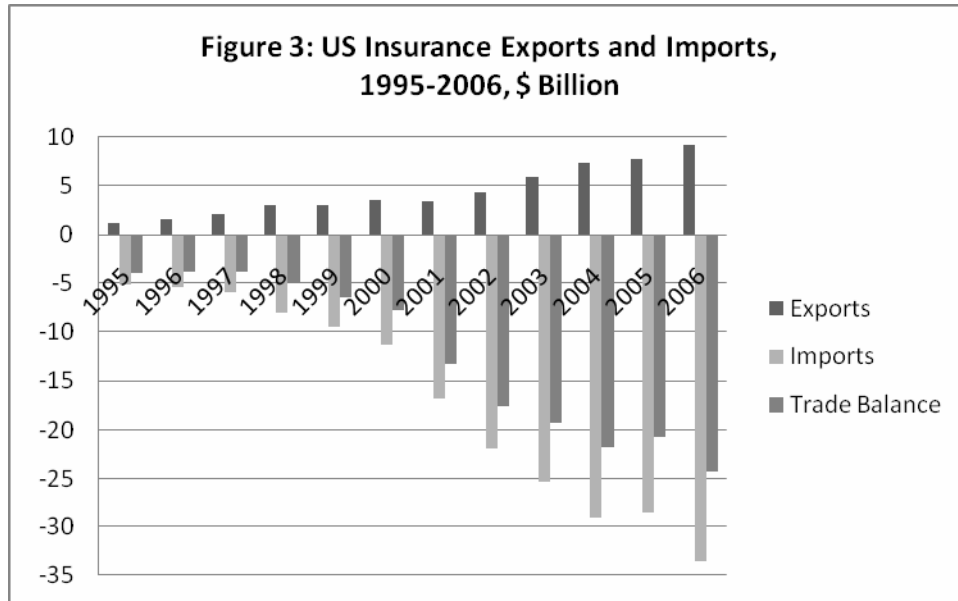
We explore the international dimensions of the US insurance market from three perspectives: first, cross-border insurance trade, both imports and exports; second, establishment (affiliate) insurance trade both by foreign interests in the US market and by US interests in foreign markets; third, foreign nonlife reinsurance, because of its importance to the US insurance market and economy.

#### **Cross-Border Insurance Trade**

Surprisingly, the US runs an overall deficit in its insurance trade with global partners. Exports of insurance by US providers increased by 19 percent in 2006 to about \$9.3 billion (\$25.8 billion premiums and related income less \$16.5 billion in losses).<sup>3</sup> Reinsurance accounted for 60 percent of the total. Canada accounted for 20.6 percent of the total, followed by the UK, Japan, and Bermuda at 13.2, 10.8, and 9.2 percent, respectively. Imports into the US increased by 18 percent in 2006 to \$33.6 billion (\$71.0 billion premiums and related income paid less \$37.4 billion in losses). Reinsurance accounted for 90 percent of the total. Bermuda (with 37.8 percent) was the largest source of US insurance imports, with Switzerland, the UK, and Germany, at 16.7, 9.3, and 9.0 percent, respectively.

<sup>3</sup> Unless otherwise noted, data are from US Department of Commerce (2007, pp. 114-115 and 132). Cross-border figures are on a net basis that includes smoothing for “normal” losses. Affiliate data reflect payment of premiums only, so the two data sets are not directly comparable.

Thus, the US ran a trade deficit on cross-border insurance business in 2006 of about \$24.3 billion. Figure 3 shows the trend in US insurance trade balances since 1995.



**Establishment Insurance Trade**

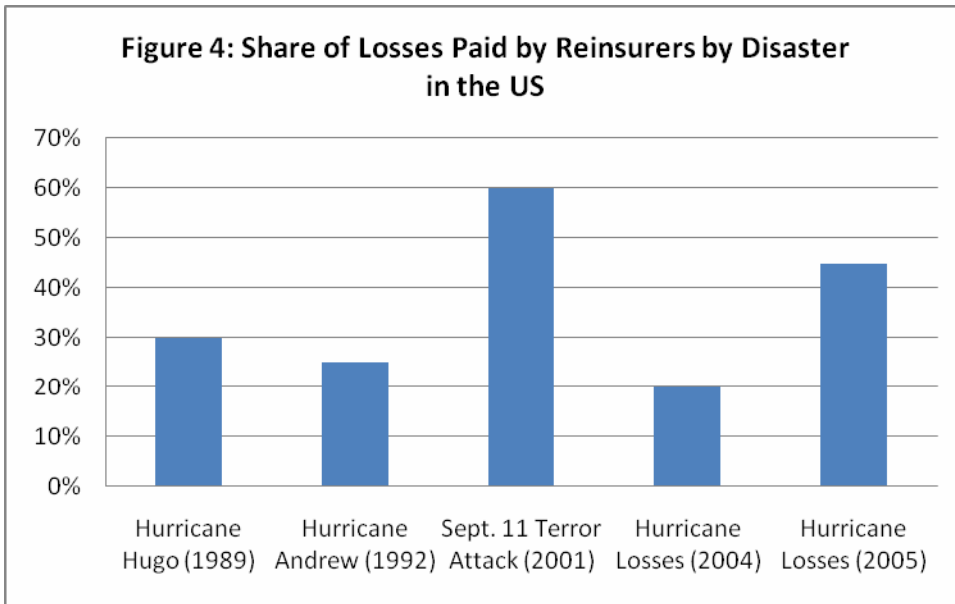
Foreign-owned insurers and reinsurers play an important role in the US market, and affiliates of US firms do likewise in foreign markets. For 2006, the National Association of Insurance Commissioners (NAIC) shows foreign-owned, locally established insurers wrote \$182.4 billion in premiums in the US. Life and nonlife insurance accounted for \$117.1 and \$65.3 billion, respectively, amounting to 23.1 and 13.6 percent of the US market. European-owned insurers accounted for 64 percent of all such premiums.

As regards overseas affiliates of US firms, the latest available US Department of Commerce data show insurance sales in foreign markets totaling \$87.7 billion in 2005. Europe was the largest market for US-owned insurers, representing 24 percent of all such foreign writings, with the UK accounting for more than one-half of the European total.

NAIC data show 969 US domestic direct life insurer groups in 2006, of which 103 were foreign-owned and 866 locally-owned, with individual and group annuities accounting, respectively, for 76.2 and 44.4 percent of their US writings. This means that foreign-owned providers wrote almost one-half of all annuity writings in the US, an increasingly important source of retirement security. Some 348 US domestic direct nonlife insurers were foreign-owned in 2006, with 2,433 owned locally.

**Reinsurance**

As with other markets worldwide, the US insurance market depends heavily on foreign reinsurers. The critical role that reinsurance plays can perhaps best be illustrated by noting that, after virtually every big US catastrophe during the past century, reinsurers have been major contributors to recovery. For natural disasters, typically one-third of direct insurers’ losses are reimbursed by their reinsurers. Figure 4 shows the share of losses paid by reinsurers from several recent disasters.



Some \$54.7 billion in nonlife premiums were ceded cross-border by US domestic insurers to 2,283 foreign-domiciled entities in 2006, accounting for 53.1 percent of total premiums ceded to professional reinsurers by US nonlife insurers, with the balance ceded to US-domiciled reinsurers.<sup>4</sup> The trend in market share for US reinsurers has been down, having been 61.6 percent 10 years earlier. Adding writings of locally established, foreign-owned reinsurers to cross-border writings reveals that foreign interests wrote some 84.5 percent of all US nonlife reinsurance in 2006.<sup>5</sup>

### The Effects of US Insurance Regulation on Foreign Involvement in the US Market

Opening financial services markets confers welfare benefits on the host economy. As countries began to recognize the benefits, liberalization progressed, but protectionist sentiments were never far below the surface. Merely agreeing to another nation’s firms entering your market need not bring a truly open market. The structure and nature of domestic regulation can thwart effective access.

Regulation exists to rectify market failures. A government ordinarily has many ways of addressing these. All may be adequate, but some will prove less burdensome on competition than others, and governments should prefer those to all others so as to minimize societal dead-weight losses. It is for this principled reason that Article VI of the General Agreement on Trade in Services (GATS) provides that any measures involving qualification requirements, technical standards, and licensing procedures should be based on objective and transparent criteria that are *no more burdensome than necessary* to ensure the quality of the concerned service and that do not, in themselves, constitute restrictions on market access or national treatment [emphasis added].

Our examination is structured around the trade concepts that have always been at the center of free trade thinking, particularly since World War II. They are embedded in innumerable trade agreements, including NAFTA and those of the OECD and the World Trade Organization (WTO). They are an accepted part of international trade negotiation.

- **Market access** is the right of a foreign supplier to enter a market, via establishment or cross border. This principle is implicit in GATS Article XVI for bound sectors.
- **Most-favored-nation (MFN) treatment** requires that no country’s services or service suppliers shall be accorded more favorable treatment than any other country’s services or service suppliers. GATS Article II establishes the MFN principle for services. But even total

<sup>4</sup> *Offshore Reinsurance in the U.S. Market* (2007).

<sup>5</sup> Nutter (2007).

adherence to the MFN principle says nothing about whether a market is truly open to foreign competitors or whether admitted foreign competitors are treated fairly.

- **National treatment** is intended to ensure equality of competitive opportunity for foreign entrants. It requires governments to operate domestic rules such that foreign suppliers receive treatment no less favorable than domestic suppliers in similar circumstances. GATS Article XVII establishes the national treatment principle with regard to bound sectors, subject to national reservations (which must be explicitly declared).
- **Transparency** requires legal provisions regarding market access and domestic operation to be clearly set out, easily ascertainable, and openly administered GATS Article III mandates core transparency requirements from which no exemptions are permitted.

Proponents of the existing state-based insurance regulatory system contend that the US insurance market treats foreign insurance providers fairly in terms of market access, MFN, national treatment, and transparency. This is reasonably accurate as regards any *individual state's* entrance requirements and operational regulations, with notable exceptions. However, two dubious assumptions underlie it. The first is that the existing sub-national regulatory regime is “no more burdensome than necessary” and does not, in itself, constitute a disincentive to entry, deny equality of competitive opportunity, or add opaqueness. The second is that an individual state with essentially the same entrance requirements for all existing and aspiring out-of-state insurers (both overseas and other states’) ensures effective market access and national treatment for foreign providers.

As for the first assumption, even if each of the 50 states’ insurance laws and regulations individually offered a full and unrestricted right of market access and national treatment, subject only to reasonable prudential measures, one could not conclude that entry disincentives were nonexistent and national treatment assured. Attempting to do so is equivalent to asserting that the number and variety of laws and regulations with which an existing provider or a potential entrant must comply are irrelevant to ease of entry and operation. Complexity, in itself, is a disincentive to entry and efficient operation: the more there is, the more significant the barrier.

As for the second assumption, even if all of the states’ laws and regulations had identical licensing and operational requirements for out-of-state insurers, one could not conclude that their collective effect would be to assure effective market access and national treatment for foreign applicants. Attempting to do so is tantamount to asserting that it is acceptable for a state to maintain trade barriers and discriminatory regulation against foreign insurers if similar barriers and regulation are maintained against US insurers domiciled in other states. The existence of *interstate* trade barriers and discriminatory regulation does not, of itself, justify *international* trade barriers and discriminatory regulation, especially if they are “more burdensome than necessary.”

These two implicit assumptions can be viewed in another way. Because the US has a domestic insurance regulatory regime under which regulation is delegated to the individual states does not mean that a trade-related evaluation of the regime falls to the individual states alone. The totality of the regime should be evaluated, requiring *both* a state-by-state *and* a national evaluation.

### Market Access Problems

Thus, consistent with the need for both a national and a state-by-state evaluation, this market access section is structured around these two classifications of barriers: (1) barriers relevant to both interstate and international insurance and (2) barriers relevant primarily to foreign entrants. Most, if not all of the issues examined below have been raised by other nations with the US Trade Representative (USTR) as barriers to entry into and often breaches of national treatment.<sup>6</sup>

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<sup>6</sup> The information presented on state practices draws mainly from USTR (2005).

### **Barriers Relevant to both Interstate and International Insurance**

This section examines those aspects of US insurance regulation that have been identified as trade barriers to both interstate insurance commerce and foreign entry, as follows:<sup>7</sup>

- Number and Variety of Insurer Licensing Requirements
- Monopoly Insurers
- Government-Owned/Sponsored Insurers
- Compulsory and Restrictive Reinsurance Cessions
- Extra-Territorial Application of State Laws
- Barriers to Exit
- Producer and Other Licensing Issues
- Domestic Preference Tax Laws
- Retaliatory Laws
- Issues for Commercial Risks

#### ***Number and Variety of Insurer Licensing Requirements***

An insurer wishing to conduct insurance business in all 50 US states must qualify for and obtain 50 separate licenses.<sup>8</sup> Licensing standards vary significantly from state to state and insurers seeking licenses in multiple states must comply with the different requirements of each as regards capital requirements, fit-and-proper standards, business plans, product lines, and processes for reviewing and approving policy forms. Some progress towards uniformity in licensing standards has been made, but unresolved issues persist, not least the failure to enact mutual recognition.

Obtaining 50 separate licenses with differing qualification requirements is costly and time consuming. While one study pegged the average direct costs of an additional state license at \$8,673, perhaps a more realistic measure of the value of state licenses is their sales prices in the market.<sup>9</sup> The state licenses of a “shell” insurance company, one with little or no business, are reportedly valued at no less than \$50,000 per license and as much as \$200,000 for some states’ licenses. An attorney specializing in insurance regulatory matters has mentioned a recent acquisition of a shell insurer licensed in 49 jurisdictions for a total sales price of \$3,125,000 (a price of \$62,500 per state license).<sup>10</sup>

Research has established a positive relationship between insurers’ costs and the number of states in which they are licensed, despite economies of scale.<sup>11</sup> The UK Financial Services Authority reports US regulatory expenditures as a percent of premium income to be considerably higher than those of France, Germany, Ireland, Sweden, or the UK.<sup>12</sup>

It remains questionable whether the NAIC’s planned reform measures will be taken up by the states. To date, results are not promising for direct insurers, with some promise for reinsurers. Streamlining the US state licensing system is a decades-long issue; and, even in areas showing some

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<sup>7</sup> Normally, states may not impose taxes or regulatory burdens that infringe upon interstate commerce, as such actions violate the Commerce Clause of the US Constitution. However, in enacting the *McCarran-Ferguson Act* in 1945, the US Congress effectively delegated authority over insurance commerce to the states, thus barring a Commerce Clause challenge of any state insurance law or regulation.

<sup>8</sup> Add six to the number of jurisdictions if Washington, D.C. and the five US territories (American Samoa, Guam, Marianas Islands, Puerto Rico, and the US Virgin Islands) are included.

<sup>9</sup> Bair (2004)

<sup>10</sup> Joseph L. Cregan, Morris, Manning & Martin, LLP (email of May 16, 2008).

<sup>11</sup> See, e.g., Grace and Klein (2000) and Pottier (2007)

<sup>12</sup> *Financial Services Authority Annual Report 2003-04* (Appendix 5).

convergence, there is no “ratchet” mechanism to guarantee against future divergence. State licensing requirements continue to be a particularly significant market access barrier.<sup>13</sup>

### ***Monopoly Insurers***

Four states (North Dakota, Ohio, Washington, West Virginia, and Wyoming) have monopolistic state funds to provide workers’ compensation insurance in their states.<sup>14</sup> Employers are required to purchase their workers’ compensation insurance from them, unless they self-insure. Fourteen other states operate state funds competing with private insurers. In the absence of market failures that would prevent a competitive market in this externality-laden line, and given that most US states and many countries have competitive workers’ compensation markets, the rationale for these monopolies seems weak. As such, they constitute entry barriers.

### ***Government-Owned/Sponsored Insurers***

It is ironic that, while most states prohibit the licensing of government-controlled insurers and reinsurers (as discussed below), one of the largest states has created both a direct insurer and a reinsurer competing with private companies. The 2007 Florida legislature authorized the expansion of the Florida Hurricane Catastrophe Fund (FHCF), which provides reinsurance, and increased the scope of the Citizens Property Insurance Corporation. Both actions followed a 2006 tightening of the Florida direct and reinsurance property markets following catastrophic hurricane losses in 2004 and 2005. Citizens is now the largest homeowners’ insurer in Florida and was authorized to write commercial nonlife cover statewide. The consensus among private insurers is that both Citizens and the FHCF enjoy privileged regulatory treatment, enabling them to compete against insurers already in the market and those that would seek entry by offering lower-than-market rates and operating with less capital than would be required of comparable private insurers.<sup>15</sup> Florida citizens and businesses are understandably among the largest insurance consumers in the US. Florida’s actions hinder market access.

### ***Compulsory and Restrictive Reinsurance Cessions***

All self-insured and insured workers’ compensation plans in Minnesota must reinsure with the Workers’ Compensation Reinsurance Authority, a nonprofit, state-created association. Compulsory reinsurance cessions are commonly explained (in developing countries) as means of minimizing foreign exchange outflow and as safeguarding markets against possible reinsurance shortages. These rationales do not seem applicable to Minnesota, with the cession barring market access to this line for other reinsurers.

In addition, insurance companies incorporated in Nevada may purchase reinsurance only from an insurer admitted to Nevada. In Texas, mutual life insurance companies may not take out total direct reinsurance with non-US companies, and Maine may restrict reinsurance for workers’ compensation. Such provisions are inconsistent with both market access and national treatment principles.

### ***Extra-territorial Application of State Law***

Thirteen states apply at least some elements of their laws extra-territorially. This means that the state applies its law not only to each licensed insurer’s and reinsurer’s in-state business but also to these providers’ operations in other states. New York is best known for this and perhaps the state that applies its laws most broadly. Obviously, the more states that apply their laws in this fashion, the more

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<sup>13</sup> The EU and likely other US trading partners have formally requested action to remove or reduce this barrier, and have made similar requests in the case of compulsory reinsurance cessions, surplus lines/large commercial risks restrictions, government ownership restrictions, initial entry license requirements, and citizenship/residency requirements.

<sup>14</sup> Insurance Information Institute, “Workers Compensation” ([www.iii.org/media/hottopics/insurance/workerscomp](http://www.iii.org/media/hottopics/insurance/workerscomp) [May 2008]). West Virginia is in the process of privatizing its fund, after issuing a special revenue bond to cover the fund’s \$3.0 billion deficit, to be paid off by taxes and other special levies over 30 years.

<sup>15</sup> Towers Perrin (2007, p. 2).

confusion and opportunity for conflict are created. This is especially challenging for reinsurers, which often are licensed in all US jurisdictions. In economic terms, the application of extra-territoriality can be expected both to render regulatory compliance more complex (a transparency issue) and to discourage both domestic and foreign insurers and reinsurers from entering such states' markets. Indeed, so onerous is the application of New York law that many large insurers opt to create New York-only subsidiaries rather than submit their entire group to such dual (at the least) oversight.

### ***Barriers to Exit***

Barriers to exit can discourage market entry in the first place. If an insurer wishes to withdraw from a market or from a line of business, it is usual for the supervisor to have to be satisfied that the legitimate expectations of the insurer's existing policyholders will be met and that long-term contracts will be satisfactorily catered for. In current US practice, the rule has been applied in arbitrary ways going beyond existing policyholders' interests. For instance, in some states where price suppression has been introduced, insurers have been known to threaten or actually to cancel their licenses to write the suppressed line in the state. Often, including in New Jersey and Florida, regulators have responded by raising barriers to exit, such as requiring insurers to cease writing all lines if they withdraw from the objectionable line. Measures of this kind appear to go beyond ordinary prudential requirements or the protection of policyholders. Such penal measures for market-exit discourage market-entry.

### ***Producer and Other Licensing Issues***

**Prior out-of-state Licensing Requirements.** Twenty-eight states issue nonresident licenses for individuals to engage in certain services auxiliary to insurance only if the individual is already licensed in another state. The services to which the prohibition applies vary, but most apply it to producers and/or reinsurance intermediaries while others extend it to consultants and adjusters.

**Residency Requirements.** Thirty-four states require in-state residency for surplus lines brokers and 34 require it for surplus lines agents. Additionally, 17 states will not issue licenses to nonresidents for various service functions that require licensure such as adjuster, solicitor, services representative, bail bondsman, and customer representative.

**Producer License Fees.** Non-residents may be charged higher fees for agent and/or brokers licenses in 22 states.

**Countersignature Laws.** Until recently, most states had countersignature laws requiring nonlife insurance contracts sold by a nonresident producer to be countersigned by a resident agent, who was entitled to share in the writing producer's commission. Almost all of these laws have recently been revoked, either after successful legal challenges or through seemingly voluntary state action.<sup>16</sup> Nonetheless, they have been a fixture of state insurance regulation for decades, favoring "home team" producers over those from elsewhere. This and the previous three restrictions restrain market access.

### ***Domestic Preference Tax Laws***

The great majority of states tax licensed insurers on the premiums written in the state. For decades before 1981, 34 states provided for higher taxes on out-of-state companies than on companies domiciled in the state. In 1985, the US Supreme Court, in a five to four ruling, rejected Alabama's two arguments in support of its discriminatory tax law, ruled the law in violation of the Equal Protection Clause of the US Constitution, and remanded the case to the Alabama courts for a further hearing on other purposes proffered by the state.<sup>17</sup> Most states thereafter eliminated most of the discriminatory elements of their tax laws, although nine states retain them. Two aspects are

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<sup>16</sup> The cases have been won through Equal Protection Clause challenges, which are far more difficult to sustain legally than Commerce Clause challenges which are impossible because of *McCarran-Ferguson*.

<sup>17</sup> *Metropolitan Life Insurance Company v. Ward*, 105 S.Ct. 1676.

relevant for this paper. First, nine states still levy higher taxes on out-of-state, including foreign, insurers than on their domestic insurers. The economic effect is the same as a tariff; i.e., an obvious entry barrier. Second, neither the pre-1985 nor the present discrimination by the states would have been legally permissible in any financial sector except insurance, because of *McCarran-Ferguson*.

### ***Retaliatory Laws***

Typically, a host state, in addition to imposing a premium tax on both out-of-state and domestic insurers, will impose a retaliatory tax on an out-of-state insurer if that insurer's domiciliary jurisdiction imposes taxes and fees on the business in that jurisdiction of the host state's insurers that are higher than those of the home state. It is difficult to assign an exact cost to this system, but its very complexity imposes costs. State tax rates and fee schedules vary, so that retaliatory laws entail complicated rate/fee calculations for any insurer transacting business in multiple states, raising questions about transparency and ascertainability of the costs of doing business. Despite the system's complexities and the element of double taxation of corporate earnings, individual states are unlikely to make unilateral changes. Retaliatory laws are barriers to entry into insurance markets.

### ***Issues with Large Commercial Risks***

The classical model of state-by-state insurance supervision evolved from a perceived need to protect local interests and policyholders by insisting that risks be covered locally. The need to facilitate insurance for large commercial risks has led to adaptations of the classical model through exemptions, variations, and initiatives towards deregulation. Their general effect is to alter the overarching requirements that insurance should be placed with admitted insurers, in three broad ways:

- **Economic Needs Test.** Where it can be proved that the admitted market has declined to take on a risk ("declinature"), the risk may be placed with surplus lines insurers. These placements are subject to an additional premium tax and have to satisfy certain other rules.
- **Exemption of Certain Insureds.** Some states exempt larger commercial insureds meeting certain criteria from compliance with state laws, enabling them to make direct placements of both licensed and surplus lines business (including with their own captives). Such direct insured placements are subject to additional reporting and taxation requirements.
- **Exemption of Certain Insurance Lines.** Some states exempt certain insurance lines from their laws. The most common exemption (variable in scope from state to state) relates to marine, aviation, and transport insurance business.

Common to all three approaches is the recognition that a state's admitted market may be unable to cater for all large risks and that large commercial insureds are likely to be least in need of the full protection of the state supervisory system in its plenitude. Although the surplus lines regime is common to virtually all states (albeit with varying declinature rules), the other exemptions are not applied consistently across the states, and the definitions of large industrial insureds and MAT business vary from state to state, requiring complex analysis by insurers before accepting such risks. Furthermore, some states do not recognize these exemptions or grant only partial or conditional exemptions. Finally, most states require surplus lines insurers to keep trust funds in the US as a pre-condition for surplus lines eligibility. Despite the degree of partial flexibility applying to large commercial risks, the pattern of continuing restrictions means that overseas insurers' market access to the large commercial risks market remains heavily circumscribed and, where higher premium taxes apply, subject to fiscal penalties.

### **Barriers Relevant Primarily to Foreign Entrants**

This section examines those aspects of US insurance regulation that have been identified as being trade barriers primarily for foreign entry. The examination covers the following:<sup>18</sup>

- Government-Ownership Restrictions
- Initial Entry Licensing
- Citizenship/Residency Requirements
- Seasoning Requirements
- Reciprocity Laws
- Trusteed Surplus Funds Requirements

#### ***Government-Ownership Restrictions***

At least 27 states bar government-owned or controlled insurers and reinsurers from securing licenses, whether for cross-border or establishment purposes. Control is presumed to exist if any government or government agency directly or indirectly owns, controls, or holds the power to vote shares or proxies representing 10 percent (5 percent in Alabama) or more of the voting securities. The policy concern with such insurers is said to revolve around the potential for unfair competition by invoking sovereign immunity and through subsidized pricing or from using confidential information. Only three states (California, Colorado, and Pennsylvania) allow a government controlled insurer to demonstrate that it will not engage in prohibited activities and, thereby, to obtain a license.

Even if the policy concern were justified, less burdensome approaches exist. Such prohibitions restrict market access and deny the US insurance market additional capacity. Such insurers and reinsurers have competed fairly for years in several national markets and presumably in the 23 US states with no prohibitions.

#### ***Initial Entry Licensing***

Four states (Maryland, Minnesota, Mississippi, and Tennessee) provide no mechanism for licensing initial entry of a non-US direct insurer or reinsurer as a subsidiary unless the company is already licensed in some other US state. An additional 11 states provide no mechanism for licensing initial entry of a non-US direct insurer or reinsurer as a branch unless that company is already licensed in another US state. No economic logic has been found for these market access restrictions. They appear to be free-riding by the four states, effectively denying direct access to their markets.

#### ***Citizenship/Residency Requirements***

US citizenship is required of all incorporators of insurance companies in Hawaii, Idaho, South Dakota, and Washington. For an additional 11 states, either two-thirds or a majority of incorporators must be US citizens or state residents for all or most forms of insurers. Sixteen states, including New York, have various forms of US citizenship and/or residency requirements for membership to the board of directors. Additional or different citizenship and/or residency requirements are found in several more states for various specialty forms of insurers, such as reciprocals and farm mutuals.

The justification offered for their existence centers on the desirability of board members/executives having local knowledge and commitment when forming or operating insurance businesses, and of state authorities being able more easily to assert jurisdiction over them. The first argument – redolent of paternalism (if not protectionism) – is not sustainable: local residency is no

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<sup>18</sup> We do not cover the US federal excise tax (FET) on premiums as the subject of this paper is state regulation and taxation, not federal taxation. This tax is 1 percent of premiums on life insurance and reinsurance and 4 percent on nonlife insurance premiums paid to foreign-domiciled insurers (i.e., cross border trade) on US risks. A recent ruling by the IRS held that such taxes were to be assessed each time business was retroceded, thus resulting in a cascading effect. Under Double Taxation Treaties between the US and some countries, those countries' insurers and reinsurers may be FET-exempt. As the FET is levied on a gross basis and only on foreign insurers, it is essentially an ad valorem tariff on cross-border services.

guarantee of market knowledge, and professional knowledge of the market is in any case required of directors, controllers, and senior staff of an insurer as “fit and proper persons.” The jurisdiction contention too seems unsustainable. Formerly, it was common worldwide, but its incidence is now declining. US states with such requirements are progressively fewer. It does not follow that such requirements will be eliminated. If they remain, they will continue to be both barriers to entry and national treatment inconsistencies.

### ***Seasoning Requirements***

Certain states have traditionally applied “seasoning requirements,” which prevent a foreign insurer from becoming licensed in their jurisdictions until it has been in business for a minimum period. These requirements do not apply to insurers domiciled in another US state. As with countersignature laws, they appear to have market access and national treatment implications under the GATS.

### ***Reciprocity Laws***

Thirteen states have reciprocity laws enabling insurance commissioners to retaliate against perceived unfair insurance trade rules in other countries.

### ***Trusteed Surplus Funds Requirements***

Twenty-five states require US branches of non-US firms to maintain surplus funds in excess of deposits. These trusteed surplus funds are usually held in trust by either a state or a US-incorporated trustee such as a bank and are barriers to market access.

## **Most-Favored-Nation Treatment Problems**

No MFN inconsistencies seem to attach to state insurance regulation and taxation. (FET is another matter.<sup>19</sup>) In other words, we find no evidence that states accord more favorable treatment to some countries’ insurance services or suppliers than to others’. The position may change in the future, in ways that would be permitted under GATS, if the expanding web of US bilateral trade agreements were to accord special treatment to certain countries’ services or providers.

Stated differently, the US insurance regulatory regime, whether viewed nationally or at individual state level, appears to apply all of the market access restrictions discussed above equally to all trading partners. That said, MFN is no panacea as noted earlier.

## **National Treatment Problems**

The concept underlying national treatment is that foreign and domestic services and goods and suppliers should be treated equally, at least after they have entered the market. As noted in the introduction to this section, the economically correct way to examine the US situation is from both the individual state and national perspectives. As such, we follow the same generic bifurcation for national treatment analysis as we did for barriers to market access; to wit: (1) inconsistencies relevant to both interstate and international insurance and (2) inconsistencies relevant primarily to foreign insurers.

### **Inconsistencies Relevant to both Interstate and International Insurance**

Most national treatment inconsistencies in the US that are relevant for both interstate and international insurance were identified in the market access discussion. These include the following:<sup>20</sup>

- Compulsory and restrictive reinsurance cessions that apply differentially as between domestic and out-of-state reinsurers are departures from national treatment;
- Extra-territorial application of state laws can create differential requirements for insurers and reinsurers and in doing so are inconsistent with national treatment;

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<sup>19</sup> See the previous footnote. Insurers and reinsurers from countries with whom the US has a tax treaty typically enjoy preferential treatment.

<sup>20</sup> See f. 17 on the FET. By applying only to business written by foreign providers, FET is clearly discriminatory

- Producer and other licensing issues as discussed above are clearly national treatment inconsistencies as they are administered;
- Domestic preference tax laws create different burdens on a state's domestic insurers from those domiciled in other jurisdictions; and
- Commercial insurance treatments often impose differential burdens as between domestic and out-of-state insurers, so are national treatment problems.

#### **Inconsistencies Relevant Primarily for Foreign Insurers**

As with the previous subsection, we have already identified several national treatment inconsistencies applicable to operations by foreign firms. In addition, a major challenge has been the US approach to extending credit for reinsurance purchased by primary insurers.

#### ***Previously Discussed Inconsistencies***

The US government has notified OECD of the insurance exceptions that it is taking in the OECD National Treatment Instrument. Three areas are covered, each of which was introduced earlier:

- Non-admission of foreign-government-owned/controlled insurers in states which prohibit licenses for such insurers. Interestingly, only 13 states are notified to the OECD whereas the USTR lists 27. Of course, such prohibitions are inconsistent with national treatment;
- Reciprocity laws could amount to withholding national treatment if the relevant measure is directed against foreign providers; and
- Trusteed surplus fund requirements, irrespective of whether justified under the GATS Prudential Carve-Out, withhold national treatment as they are specifically directed against foreign providers.

Three other areas have national treatment effects, as noted in the market access discussion:

- Initial entry licensing, where states provide no mechanism for licensing initial entry of a non-US direct insurer, reinsurer, or individual engaged in business auxiliary to insurance unless first licensed in another state, constitutes discrimination against non-US providers;
- Citizenship/residency requirements for incorporators and board members are inconsistent with national treatment; and
- Seasoning requirements for foreign but not domestic insurers clearly are discrimination against affected non-US providers.

#### ***Credit for Reinsurance and Collateralization***

For a US insurer to receive credit for reinsurance, the assuming reinsurer must either be authorized or post security to cover its obligations to the cedant. For authorization, a reinsurer must be licensed in at least one state and meet the relevant capital and surplus requirements. A reinsurer doing business cross-border is not authorized and must post security in the US through trust funds, letters of credit (LOCs), or other collateral. Regulators' prime concern in requiring such "situs funds" was ease of securing recoverables (amounts due) from reinsurers beyond the state's reach, effectively via a deposit guaranteeing payment in a possible reinsurer insolvency. The resultant system bears down most on foreign insurers and reinsurers (although the US has taken no reservation in GATS).

The system is at odds with virtually all other major insurance markets, which have safely relied on domestic primary insurers' capacity to assess for themselves whether to require collateral in a business-to-business contract, without interposing state requirements with their attendant costs for reinsurers, primary insurers, or insurer's clients. We are unaware of any damage to these markets from such a pro-competitive practice. Even so, substantial opposition exists to changes in this practice.

Collateralization is costly. Both LOCs and trust funds carry direct costs and compliance burdens. The New York State Insurance Department has estimated that "foreign reinsurers had an estimated \$120 billion in collateral posted in the US in 2005...on which they pay about \$500 million a year in

transaction costs.”<sup>21</sup> There are also indirect costs, through forcing reinsurers to segment investment portfolios on a non-commercial and localized basis, harming their scope for optimum portfolio management to secure the highest expected rate of return consistent with safety and geographical diversification. Unless all these costs are absorbed (which is unlikely) they are borne by direct insurers and their customers.

Many years’ negotiations to modify the system have proved inconclusive. US insurance regulators are proposing a system that would allow a single state with the appropriate regulatory capacity to be the sole US regulator to supervising all of a national reinsurer’s or a Port of Entry reinsurer’s US reinsurance business. Depending on its scope, the proposal would partially address collateralization by easing its burden for the world’s most financially secure reinsurers. But market-distortions could remain, and most unlicensed non-US reinsurers would still need to post collateral.

What is the system’s effect on the global insurance economy? The US market accounts for about one-half of total reinsurance premiums worldwide. In 2005, US gross reinsurance premiums to offshore reinsurers totaled almost 39 percent of the world’s total gross reinsurance premiums. Thus, 38 percent of all ceded reinsurance premiums worldwide was potentially subject to US collateralization requirements. On such a scale, the market-distorting implications must be significant. To what extent does the continuous collateralized guarantee for US cedants - equivalent to 70 percent of global gross reinsurance premiums in 2005 - impose negative spillover effects on the world reinsurance market by raising reinsurance costs, aggravating the insurance cycle, increasing the cost of capital, and cramping expansion of worldwide reinsurance capacity? Further, what is the effect especially on emerging markets, without other risk-sharing options, where the burden of increased volatility and higher insurance and reinsurance costs is likely to fall most heavily? Does the US have a responsibility for taking corrective action?

### **Transparency Problems**

There is an overarching issue of transparency. It cannot be said that the US insurance regime is not transparent, in the strict sense of GATS Article III. The US is a positive law country, and all the relevant federal and state laws are published and freely available in hard copy texts and on the web. Court and other interpretative findings are similarly easy to access. On these grounds, US insurance regulation as viewed on a state-by-state basis suffers no meaningful transparency problems.

However, as stated earlier,<sup>22</sup> the totality of the regime requires *both* a state-by-state *and* a national evaluation. On a national basis, the transparency aspect becomes more ambiguous. From an economic viewpoint, the US system is opaque, as it requires trading partners to take account of dozens of parallel sets of changing laws and regulations. From a GATS viewpoint, the notification rules of GATS Article III then become important: the more complex a regime for a significant services market, the greater a WTO member’s duty to notify all regulatory changes promptly (and at least annually) to the WTO Council for Trade in Services.

### **An Optional Federal Charter in a Competitive World Insurance Market**

Both opponents and proponents of an optional federal charter (OFC) approach to federal insurance regulation acknowledge that the current stated-based insurance regulatory system has serious problems. Among the agreed problems are:

- The need for more efficient, effective, and timely product reviews and improved time-to-market;

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<sup>21</sup> New York State Insurance Department, Press Release: “New York Modernizes Regulation on Reinsurance Collateral,” (October 2007).

<sup>22</sup> See page 6 above

- Improvement in producer licensing with an eye toward reciprocal licensing in all jurisdictions and greater uniformity;
- The need to streamline company licensing;
- The need for more effective and coordinated market conduct oversight;
- Elimination of price controls that reduce competition and consumer choice;
- The need for a means of reducing or eliminating some or all reinsurance collateral requirements; and
- The need to eliminate the extra-territoriality aspect of state insurance laws, at least with respect to reinsurance.

OFC proponents contend that their approach is the most effective and efficient means of addressing the problems (trade and other) identified earlier. They also argue that, by establishing a federal institution concerned with insurance, an OFC would bring about some regulatory parity between insurance and other regulated financial services, provide an effective voice in support of the US insurance industry's interests internationally, and, ultimately, through a more pro-competitive regulatory environment, allow a more competitive, innovative domestic insurance industry to emerge in which international players enjoy strong market access and national treatment.

Opponents contend that it would spur a regulatory "race to the bottom," expand federal bureaucracy, lead to lower state tax revenues, cause legal and regulatory conflicts, and fail to take account fully of local needs and preferences. They also contend that the agreed benefits could be secured by a combination of new, targeted federal laws and the NAIC and the states being more attuned to the problems. They have not explained whether or how all of the international trade problems identified earlier would be rectified. Both opponents and proponents agree that the states cannot alone solve the problems listed above and that federal legislation is necessary to tackle at least some (opponents) or all (proponents) of them.

This section examines the international implications of an OFC from two perspectives: first, its possible implications for US insurers and reinsurers seeking international expansion and, second, its implications for foreign insurers and reinsurers in the US market.

### **US Insurers and Reinsurers in International Expansion**

Future demand in numerous insurance markets worldwide is expected to far outstrip that of the US as a consequence of robust economic growth and a low level of insurance density and penetration. A greater international presence by US insurance specialists holds the potential for high rewards, aiding the US economy and balance of payments, assisting US multinationals worldwide, and helping other nations and their businesses and citizens to achieve the greater growth and wealth-creation that will permit them to buy further US goods and services. Yet a recent study suggests that US insurers and reinsurers have fallen behind European insurers in exploiting such opportunities.<sup>23</sup>

In his study, Outreville examines the largest 45 insurers and reinsurers worldwide in terms of premiums written in 2003, the latest year for which data were available for other analysis in his study. At that time, 22 companies were European (18 from EU), 15 from the US, seven from Japan, and one from Korea. He first compares this list with one developed in 1986, taking only the top 20 in each listing. In 1986, eight companies were from the US with six each from Japan and Europe. For 2003, the top 20 comprised 12 companies from Europe, five from Japan, and only three from the US. The story here is that, comparatively, US insurance providers did not grow as rapidly as those in Europe.

This leads to his second examination which involves paring down the 2003 listing of 45 to the 30 most international companies using weighted measures of "international." The number of US

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<sup>23</sup> Outreville (2008, pp. 465-469)

companies in the most international listing falls by more than one-half to seven. Japan has but a single company. All 22 of the European companies from the listing of 45 make the top 30 most international listing, and they occupy the top five positions, with the US company, AIG, sixth. The ranking of the next US company is 18<sup>th</sup>. Leaving aside definitions and research methodology, it seems plain that US insurers are falling behind European insurers in international expansion, however measured.

This is borne out by current surveys: “global insurance industry acquisitions in 2007 were driven by non-U.S. insurers—primarily Western European firms—who clearly see value in this market. In fact, only 20% of primary and reinsurer transactions involved a U.S. entity at all.... We expect that U.S. firms will continue to be domestically focused in their acquisitions....”<sup>24</sup> The obvious question for both federal policymakers and US insurance executives is “Why?”

Many observers place much of the blame on the absence of a US insurance regulatory presence at the strategic federal level coupled with reliance on a system of state-based regulation with 19<sup>th</sup> century roots that demands disproportionate amounts of executive time. As if to reinforce this point, EU Commissioner McCreevy, introducing the Solvency II proposal to the European Parliament, said:<sup>25</sup>

Financial services is one of Europe’s great success stories globally. European insurers are world leaders. If we are to maintain our position and to build on it, Europe needs to be prepared to step up its game and take the lead globally when it comes to the regulation of financial services. One cannot achieve this without being ambitious.

He could have been writing about the US when he observed: “[N]ational differences distort and undermine the Single Market, as well as hinder effective competition. This results in increased costs for EU insurers, and higher premiums for European consumers and businesses, thus hampering growth.” And, finally, “There is growing nervousness in the US about the EU surging ahead while the US itself is stuck with a highly fragmented insurance regulation.” Proponents of an OFC contend that it would, in effect, “step up” the US game by, among other things, assisting international expansion efforts through representation and advocacy, enhancing insurer efficiency, and minimizing retaliation.

### **Providing Representation and Advocacy**

The right to enter into international agreements, relations, and trade negotiations rests exclusively with the US federal government. Neither state insurance regulators nor the NAIC have the constitutional authority to enter into international agreements of mutual recognition or joint supervision on behalf of the US. Similarly, while regulators and the NAIC may represent their own perspectives within the International Association of Insurance Supervisors (IAIS), they cannot represent the US government. Nor can they do so in the Insurance Committee of the OECD, the Joint Forum, any WTO negotiations, or any other bilateral or multilateral forum or negotiation.<sup>26</sup> No insurance supervisor or the NAIC has the legal mandate to represent the government or the interests of the US insurance industry in responding to an international crisis or maintaining stability.

This lack of formal representation has always been a challenge for federal authorities and US insurance interests with an international orientation, especially in international trade negotiations. The practical effect, as the USTR has no authority to bind the several states, is a constraint on the USTR’s capacity to reach negotiated settlements on matters touching on insurance regulation. Thus,

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<sup>24</sup> Manetta and Christiansen (2008).

<sup>25</sup> Among other things, Solvency II will provide for consolidated supervision of insurance firms at the financial holding company level and a risk-based approach to capital requirements. McCreevy (2007, pp. 2 and 4)

<sup>26</sup> Hearing such observations from informed foreign experts and friends can reinforce their effects. Two former UK regulators recently wrote: “In the absence of a federal regulator there is no strong American voice in the International Association of Insurance Supervisors. Nor is there a centre of research and expertise on the financial stability implications of developments in insurance markets.” Davies and Green (2008, p. 167).

the USTR cannot promise any US insurance market-opening in return for market-opening by a trading partner. Indeed, the USTR can only “bind the status quo” in state insurance regulation, to the great frustration of US trading partners (and the USTR).<sup>27</sup>

Having a federal insurance supervisory authority would solve these problems of representation. Both the US insurance industry and national economic interests would then be represented in the growing collaborative interactions of global financial services regulators covering broad economic, fiscal, regulatory, and trade matters, removing what has been characterized as “a distinct competitive disadvantage” for US insurers.<sup>28</sup>

Moreover, state insurance regulators are not tasked with promoting global regulatory cooperation or the international expansion of their domestic insurers, and their budgets typically cater for them only to a limited extent. Indeed, were state funds regularly deployed for such activities, one could expect criticism from state legislators and citizens for “wasting” state resources on non-state matters. A state-based system provides little or no incentive, and no legal *locus standi*, for regulators to heed the international impact of their actions, or leave their state oversight duties to travel internationally. A federal regulator, by contrast, could assume such responsibilities.

### **Enhancing Efficiency**

US insurers and reinsurers are said to be at competitive disadvantage vis-à-vis their international competitors. The direct and indirect costs of US insurance regulation are high, as noted, and deflect financial and managerial resources that otherwise could be used for competitive purposes in the US and internationally. Their global competitors, by contrast, can operate in more efficient regulatory environments and explain (and cost) their national and international business plans and strategies to a single home regulator possessing informed expertise in global insurance issues.

Increasing numbers of US businesses have exposures that transcend both state and national boundaries. Globalization of business is a reality. Greater US insurer international expansion should make for more efficient risk management services to US and other countries’ multinational corporations, reducing costs to both users and suppliers, given that a client’s global business risks, wherever located, must be covered seamlessly. This reality differs markedly from that of the 19<sup>th</sup> century when the US insurance regulatory pattern grew out of the view that risks and insurance markets were small and local. As the former Maine Insurance Commissioner and President of the NAIC testified in 2007: “The need to operate within the state patchwork of regulation in the US means that insurers with customers with worldwide operations are hindered in their efforts to keep pace with the complex risk issues confronting clients doing business on a national and international basis.”<sup>29</sup>

Moreover, a federal insurance regulator could be recognized internationally as strengthening the US financial services regulatory framework, currently perceived as fragmented and lacking effective consolidated conglomerate supervision. A single agency responsible for maintaining high and uniform standards of supervision and leading global best practice could enhance the competitiveness of US insurers with global operations by altering that perception.

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<sup>27</sup> Of course, the USTR and other relevant federal officials consult with the NAIC and key state regulators in formulating and negotiating US positions, and state officials often serve as advisory members of US delegations. Even so, no state regulator (and certainly not the NAIC) can promise to bind even his or her own state to recommended positions, let alone bind other states. Moreover, the high turnover in state insurance regulators – some 23 were new to their offices last year – greatly inhibits meaningful “learning by doing” in international forums.

<sup>28</sup> Condrón (2007, p. 8).

<sup>29</sup> Iuppa (2007, p. 4).

A state-based regulatory system seems, on its face, incompatible with increasingly global insurance markets and customers. The US insurance industry must have an insurance supervisory system capable of matching its global reach and future potential.<sup>30</sup>

### **Minimizing Retaliation**

Internationally oriented US insurers and reinsurers have reported for years that other countries threaten or actually retaliate against US insurance interests because of the barriers arising from the fragmented US regulatory system. The most pressing risks of retaliation today come from the EU, where US interests face two possible areas of retaliation because of the US system.

The first relates to the “equivalence” provision within Solvency II. This requires a non-EU-owned insurer with operations in the EU to show that the country in which its parent undertaking’s head office is located has a supervisory system meeting an EU equivalence test or face unspecified measures. Large US insurers operating in Europe fear that the EU will find the US insurance supervisory regime not equivalent and that they will then be unable to count group-level capital against their European liabilities (unlike their EU competitors) resulting in higher capital costs.

The second relates to the EU Reinsurance Directive, which has a reciprocity provision targeting non-EU reinsurers doing business within the EU. Under this provision, EU member states reserve the right to “mirror” the regulatory requirements to which EU reinsurers are subject in any non-EU reinsurer’s domiciliary country. Thus, if US regulators require EU reinsurers doing business on a non-admitted basis to post collateral for their US liabilities, EU regulators could insist that unlicensed US reinsurers doing business in the EU must do likewise for their EU liabilities (currently not required).

The EU Commission has engaged in an informal Bilateral Dialogue with state regulators for some 10 years in an effort to resolve these and other issues. Little seems to have been accomplished. Additionally, in an effort to resolve insurance-related regulatory matters, the EU has for five years sent representatives to meetings of both the NAIC and NCOIL (National Conference of [State] Insurance Legislators). One has the distinct impression of frustration among EU officials at US state insurance regulators’ inability to progress their own reform agenda, the more so as reform of reinsurance collateralization has been discussed on the US side for so many years.

### **Foreign Insurers and Reinsurers in the US Market**

An OFC seems to offer the potential - and the institutional mechanism - for rectifying all the trade inconsistencies identified earlier and opening the US market. US insurance buyers and sellers, and the US economy as a whole, would then reap benefits.

### **Benefits to US Insurance Buyers**

Both individuals and businesses should benefit from a stronger US insurance industry and a stronger international presence in the US insurance market. Additional penetration should produce more competition, lower prices, new operational techniques, and more innovative services and products, including introducing techniques and products successfully tested in other markets worldwide. Commercial insurance customers should benefit from easier access to the business risks market, matched by lower premiums and greater flexibility (but with corresponding need to check insurers’ financial security carefully). Both personal and commercial lines offered by life insurers should become more competitive with products offered by other financial institutions.

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<sup>30</sup> In his recent remarks before dozens of CEOs of the world’s most important insurers and reinsurers, the CEO of the Bermuda Monetary Authority defended Bermuda’s looking to the EU and not the US as a model for the future of dynamic insurance regulation. He observed: “I hope it is not too undiplomatic to state the obvious truth that the requirements to operate by consensus [in the US] and then hope for changes at the state level inhibits dynamism. The disappointing pace of change on reinsurance collateral rules is an obvious case in point.” Matthew Elderfield, Remarks at the Meeting of the Geneva Association (28 May 2008), p. 1.

A deeper foreign involvement in the US insurance market also has the potential to help the market become less volatile for consumers because of increased capacity. This could be especially true if federal supervision introduced premium deregulation that allowed for more accurate risk-based pricing and avoided politically motivated redistributive pricing that distorts consumers' insurance costs. Similarly, international reinsurers, already important to the US nonlife market, could bring increasing capacity to bear, both in catastrophe-prone areas, such as along the US coasts, and in fields with special insurance problems, such as terrorism insurance.

### **Benefits to the US Economy and Economic Management**

An OFC also holds the potential to benefit the larger US economy in several ways, going beyond the scope for gains to buyers, an inflow of additional insurance capital, and enhanced tax revenues. By creating a federal body, an OFC would serve as a mechanism for facilitating dialogue, cooperation, and coordination among various federal agencies and departments. This should facilitate the federal government's proper task of monitoring the economy and attendant risk trends in financial markets. The conventional consensus is that the insurance sector (unlike banking) is unlikely to present systemic risks, but this has been questioned as global insurance entities grow in size and global asset values become more volatile. For instance, there is increasing concern that the failure of a very large reinsurer could have systemic consequences. No supervisory system can be assured of being robust against such risks, but national authorities need to be able to play an informed role in addressing them. At present, US insurance industry data are either not timely or are oriented toward monitoring solvency rather than possible systemic effects. Neither the Treasury Department nor any other federal entity routinely gathers data that would be relevant for this. Finally, a federal insurance presence would enhance the ability to coordinate overall financial regulation where coordination is warranted (e.g., with respect to data security, privacy, PATRIOT Act compliance).

### **Benefits to the US Insurance Market**

Every business decides how much capital to commit to each of its markets. This decision is influenced by innumerable factors, regulatory burdens and costs being important among them. Entry barriers, national treatment inconsistencies, and transparency issues all penalize market capacity-building and lessen competition. If regulation is perceived as being unnecessarily strict, rigid, complex, or irrelevant to the market issues needing to be addressed, insurers and reinsurers can be expected to position their capital elsewhere or demand higher returns or both.

Inappropriate regulatory requirements "can result in difficulties in establishing optimum global group structures, leading to unnecessary costs and constraints for insurance business managers and insurance buyers. Moreover, given the nature of insurance as a risk business, these constraints may interact in unforeseen ways with other hazards of globalization, particularly exposure to new risks."<sup>31</sup> Naturally, global businesses avoid such constraints when they can. That the present US regulatory regime might discourage new foreign direct investment into the US insurance market is supported by the observation that most new insurance and reinsurance capacity aimed at the US market has recently been located in Bermuda, not the US.

New reinsurers are often formed after catastrophic events. Following the 1992 hurricane season, eight new reinsurers were formed reflecting \$4.0 billion of new capital. After the September 11 attacks, 12 new reinsurers were formed with capital of \$10.6 billion, and following Hurricane Katrina, at least 38 new reinsurers were formed with \$17.0 billion of new capital. Nearly all this new funding came from US capital markets, yet not one of these new reinsurers was established in the US. In fact, other than US subsidiaries of the newly formed reinsurers, no new US-domiciled reinsurer has

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<sup>31</sup> De la Martinière (2003)

been formed since at least 1992. This is not for want of skills, know-how, or financial resources. The reasons that new reinsurers are established outside the US has been attributed to "...the ease of establishment, capital formation, and regulatory approvals in non-US jurisdictions contrasted with the cumbersome and protracted nature of getting licensed in multiple US states."<sup>32</sup>

That virtually no new funds have been allocated directly toward areas in the US risk market where they are most needed suggests the existence of major problems, and the existing regulatory system is a major suspect on many observers' lists. This suggestion gains traction with the realization that the dollar is at an historic low against the Euro and other major currencies, and stock prices are depressed in the US, thus providing a seemingly opportune time for foreigners to acquire existing insurers or augment existing capacity. Further, it has been argued that the current regulatory system depresses the value of domestic insurers and reinsurers, which ought to spur further foreign M&A activity in the US market. Yet, this is not happening.

Clearly, the current environment is a spur to regulatory forum-shopping, and insurers and reinsurers can be expected to continue in their efforts to avoid or at least minimize interaction with the existing US regulatory system through new reinsurance capital investment outside the US, more offshore captives, and enhanced use of the surplus lines market and pure cross-border trade. Conversely, another kind of forum-shopping - the growth of US domestic captive markets in several states - is encouraging. This is directly attributable to those states legislating to lower captives' tax burdens, ease formation requirements, and allow form and pricing freedom, as enjoyed, for example, in Bermuda. There could be similar positive reactions by commercial and personal insurance suppliers if adopting the OFC proposals heralded a more attractive on-shore environment.

An OFC, with federal institutional underpinning, could benefit the domestic US insurance market by facilitating convergence of international and US insurance accounting and solvency standards. The International Accounting Standards Board is advancing toward international accounting standards, including for insurers, and the IAIS is moving towards somewhat less ambitious harmony in solvency standards. These are increasingly pressing matters as financial markets become less and less isolated. As with international trade negotiations, state insurance regulators' lack of authority to represent or commit the US or, in some instances, to present a clear, unified position on attendant issues, means that US national and US insurance industry interests are not advanced effectively.

In all these areas, a state-based insurance regulatory system leaves the US insurance industry at a serious competitive disadvantage against other segments of the financial industry. More than ever, insurers compete directly with other forms of financial intermediation, as reflected in the repeal of Glass-Steagall and the greater competitive freedoms conferred under the Gramm-Leach-Bliley Act. This intra-industry competition in investment, savings, and retirement products can be expected to intensify as the 76 million baby boomers approach retirement. Other US financial markets operate under less fragmented, less costly, and more efficient regulatory systems, usually with a single federal regulator. This translates into marketplace advantages, which could be made equally open to insurers.

## Conclusions

The US knows from painful experience that terrorism, floods, hurricanes, earthquakes, wildfires, and other risks respect no state's borders. Today's risks are regional, national, and global. A regulatory structure needs to be capable easily of adapting to this challenging reality. The OFC proposal addresses several of the challenges. It would establish a federal competency in insurance that would strengthen the impact of US insurance interests in international forums and trade negotiations while

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<sup>32</sup> Nutter (2007, p.5)

simplifying federal policymaking as regards international insurance issues. The US should be better able to grasp and respond quickly and effectively to international regulatory developments.

An OFC should facilitate the beneficial internationalization of the US financial markets because of improved coordination of federal financial regulation across financial sectors, with better assessment of overall financial risk, creation of a level playing field between financial institutions, and establishment of a US federal competency for insurance within financial conglomerates. An OFC should also greatly facilitate establishment of mutual recognition while avoiding retaliation, especially as between the EU and US and likely other jurisdictions as well, allowing greater regulatory efficiency and less costly insurance and reinsurance.

The extent to which state insurance regulation restricts foreign entry and operations in the US and impedes US insurer involvement in international markets ultimately is an empirical question. Evidence and testimony from both actual and potential foreign entrants and large US firms with existing or potential international operations provides almost unanimous support for the proposition that the existing system is unnecessarily costly, acts as a barrier to effective market access, and fails to provide true equality of competitive opportunity. Economic logic supports this point of view.

Finally, long experience with the state-based regulatory system provides sadly little reason for optimism that the states can achieve workable mutual recognition or reform the existing system meaningfully and successfully. Its problems seem to be systemic. As in the past, the threat of federal action could spur moves towards reform in some key areas. But, even with the most optimistic take on reform, the trade barriers and restrictive practices would largely persist. So too would their costly and time consuming burdens on insurance providers (whether US or foreign) and their US customers.

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