

# **Potential Consequences of Dual Insurance Chartering**

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**Note:** The views expressed in this paper are solely those of the author and do not necessarily reflect the views of the National Association of Mutual Insurance Companies (NAMIC) or any other person or organization.

## Abstract

This paper critically examines the proposition that an optional federal charter (OFC) would bring needed reforms to property-casualty insurance regulation. The *sine qua non* of an OFC is regulatory competition—the notion that by offering insurers the choice of being regulated under the existing state-based regulatory system or by a newly-created federal regulatory agency, an OFC would foster jurisdictional competition that would lead to the development of market-oriented insurance regulatory regimes at both the state and federal levels. The paper identifies several factors that suggest that the likelihood of such regulatory competition under an OFC is remote. It notes that the dual bank regulatory system upon which the OFC proposal is based shows little evidence of regulatory competition, and that both the purpose and effect of dual bank chartering was to establish the federal government as the dominant regulator of banks. The paper argues that property-casualty insurance differs from other financial services in that it is inherently susceptible to regulation driven by egalitarian ideology and political opportunism. The paper then examines recent federal regulatory and judicial encounters with property-casualty insurance, and concludes that federal insurance regulation would likely replicate, rather than reform, retrograde regulatory practices such as rate regulation and restrictions on the use of risk-based underwriting variables.

## Introduction

The release in March 2008 of the U.S. Treasury Department's "Blueprint for a Modernized Financial Regulatory Structure"<sup>1</sup> has added fuel to a long-simmering debate over the relative merits of state versus federal insurance regulation. The report was conceived in response to concerns among policymakers and participants in the capital markets that the current financial services regulatory structure is ill-suited to the globalization of capital markets and the increasing complexity of new products. It is thus unsurprising that such a report—prepared, after all, by an agency of the federal government—would regard this country's multi-jurisdictional, state-based approach to insurance regulation as a quaint anachronism that is ripe for overhaul.

The solution Treasury proposes is an optional federal charter (OFC) for insurance companies that would allow insurers to choose federal rather than state-based regulation. As it happens, a nearly-identical OFC proposal, the National Insurance Act of 2007 (NIA), has been introduced in both houses of Congress.<sup>2</sup> To explain how an insurance OFC would work, proponents typically draw analogies to the dual chartering structure under which banks operate. The dual-banking system is said to have promoted competition between state and federal bank regulators that "keeps both sets of regulators alert to changes in the economy and financial system that alter the competitive environment for banks."<sup>3</sup> Such regulatory competition is fostered by the ability of banks to readily switch their charters from state to federal, and from federal to state. According to its proponents, an insurance OFC "will set up a similar competitive environment in the

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<sup>1</sup> Department of the Treasury, "Blueprint For a Modernized Financial Regulatory Structure," (March 2008).

<sup>2</sup> S. 40, 110th Cong. 1st. Sess., May 24, 2007; H.R. 3200, 110th Cong. 1st Sess., July 26, 2007.

<sup>3</sup> Peter Wallison, "Competitive Equity: An Optional Federal Charter for Insurance Companies," American Enterprise Institute (March 2006), p. 4.

insurance industry, improving conditions for all insurers, even those that remain state-chartered and regulated.”<sup>4</sup>

While the concept of an OFC seems simple enough, the National Insurance Act in which it is embodied is a testament to the extraordinary complexity surrounding its implementation. The bill weighs in at 330 pages, nearly a third of which describe the powers of the “Office of National Insurance” (ONI), a new regulatory agency that would take its place within the sprawling federal bureaucracy. In their assessments of the OFC proposal, advocates and scholars alike have focused heavily on the structural and jurisdictional features of an OFC regime, assuming that salutary policy outcomes will result if the implementation of an OFC is handled correctly.<sup>5</sup> In this paper, I examine several problems associated with the OFC proposal that have generally been overlooked.

Any discussion of insurance regulation must begin by acknowledging the remarkable heterogeneity of the insurance enterprise. The functional and operational differences among the three basic types of insurance—life, health, and property-casualty—are substantial enough that they are best understood, at least for regulatory purposes, as distinct industries. Thus, structural regulatory reform that leads to generally positive outcomes in the life insurance market may have negative consequences for the property-casualty market, and vice versa.<sup>6</sup> This stark reality is not easily reconciled with the current enthusiasm in some quarters (and nowhere more evident than in the Treasury

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<sup>4</sup> Ibid.

<sup>5</sup> See, e.g., Catherine England, “Federal Insurance Chartering: The Devil’s in the Details,” Competitive Enterprise Institute (January 10, 2005).

<sup>6</sup> Indeed, the most persuasive arguments for an OFC have focused primarily if not exclusively on life insurance. See, e.g., Martin G. Grace and Robert W. Klein, “The Effects of an Optional Federal Charter on Competition in the Life Insurance Industry,” (October 24, 2007); Sheila Bair, et al., “Consumer Ramifications of an Optional Federal Charter for Life Insurers,” Isenberg School of Management, University of Massachusetts, Amherst (March 2004). Available at [www.isenberg.umass.edu/finopmgt/uploads/basicContentWidget/863/bair-cons-ramifications.pdf](http://www.isenberg.umass.edu/finopmgt/uploads/basicContentWidget/863/bair-cons-ramifications.pdf).

Blueprint) for new approaches to financial services regulation designed to streamline or consolidate existing regulatory structures, agencies, and jurisdictions.

Furthermore, while overall dissatisfaction with the current state of insurance regulation in the U.S. is probably as widespread among property-casualty insurers as it is among life and health insurers, the relative significance of particular sources of discontent vary considerably across the three insurance types. For example, while both life insurance and property-casualty insurance markets are harmed by cumbersome and time-consuming multi-jurisdictional licensing requirements and speed-to-market impediments, property-casualty insurance markets are particularly distorted by rate suppression and restrictions on underwriting freedom. This type of regulation leads to adverse selection, moral hazard, cross-subsidization of risk among insureds, and reduced availability of insurance, particularly for personal automobile and homeowners coverage. Such regulation exists to varying degrees in nearly every state, especially in those with large markets.

The specific question addressed by this paper is whether an OFC will significantly reduce the extent of harmful, politically opportunistic regulation of rates and underwriting practices in the property-casualty insurance industry. I argue that an OFC will almost certainly not have this effect. Instead, it is far more likely that over time, an OFC would replicate many of the same market-distorting inefficiencies currently found in the most dysfunctional state regulatory regimes.

The Dual Banking System as a Model for Competitive Insurance Regulation

Henry Butler and Jonathan Macey have argued convincingly that the United States never intended to have a dual-chartering system for banks, nor was the system intended to engender competition between state and federal regulators—if by competition one means an environment in which each regulator would attempt to increase its share of the “market” for regulation by attracting additional chartered entities.<sup>7</sup> Rather, the dual banking system is a residue of a deliberate effort by the federal government to usurp state authority over banking regulation and extract rents from banks.

The first banks in the U.S. were established under state charters. While Congress eventually chartered several banks, state-chartered banking remained the norm throughout the first half of the nineteenth century. However, as has happened frequently in American history, the onset of war precipitated a major expansion of the size of the federal government and the scope of its authority. Thus, Congress passed the National Bank Act in 1863, mainly for the purpose of raising funds to finance the Union effort in the Civil War. It would do so by creating a uniform currency of national bank notes and selling these notes to the public. To maximize revenue, the Act also imposed a two percent tax on state bank notes. Congress expected that state banks would switch to a national charter and issue national bank notes to avoid paying the tax.<sup>8</sup> The resulting federal bank monopoly would generate even more revenue for the federal government. When the two percent tax turned out to be an insufficient inducement to state banks to switch their charters, Congress in 1865 increased the tax on state bank notes to 10 percent. The clear intention of Congress was not to offer banks a federal charter as an

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<sup>7</sup> Henry N. Butler & Jonathan R. Macey, “The Myth of Competition in the Dual Banking System,” 73 *Cornell L. Rev.* 677 (1988), p. 678.

<sup>8</sup> Lissa Lamkin Broome, “A Federal Charter Option for Insurance Companies: Lessons from the Bank Experience,” University of North Carolina, Chapel Hill (2002), p. 13-14. Available at <http://ssrn.com/abstract=334440>.

*option* to state charters, but rather to have federal regulation of banks replace state regulation of banks.<sup>9</sup> The strategy failed only because of the advent of checking accounts, which banks were able to offer as inexpensive substitutes for bank notes.<sup>10</sup>

Today, according to Butler and Macey, competition between state bank regulators and federal bank regulators is a chimera. In reality, the dual bank regulatory system is one in which “Congress delegates the authority to regulate banks not only to federal regulators such as the FDIC and the Comptroller of the Currency, but also to individual states and state banking authorities.”<sup>11</sup> They attribute the dominance of federal authority in bank regulation to several factors that are unique to banking, such as the necessity of obtaining federal deposit insurance, but also to at least one factor that is relevant to insurance regulation: the Supremacy Clause of the U.S. Constitution, which Congress uses “to force the states to accept their limited role in the regulation of banks.”<sup>12</sup>

Indeed, the threat of federal preemption would loom large under an OFC, not least because state-based insurance regulation would continue to operate under the provisions of the McCarran-Ferguson Act.<sup>13</sup> Far from constituting a form of “reverse preemption,” as some commentators have averred,<sup>14</sup> McCarran-Ferguson provides for a limited delegation of federal authority to the states that is fully consistent with Congress’s preemption authority under the Supremacy Clause. The Act permits state insurance law to override federal law, but only to the extent that states actively regulate insurance.

Moreover, the Act preserves Congress’s ability to trump state insurance regulation at any

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<sup>9</sup> *Ibid.*

<sup>10</sup> Butler and Macey, “The Myth of Competition in the Dual Banking System,” p. 681.

<sup>11</sup> *Ibid.*, 679.

<sup>12</sup> *Ibid.*

<sup>13</sup> Pub. L. 15, March 9, 1945. (Codified at 15 U.S.C. §§1101-1115.)

<sup>14</sup> Hal Scott, “Optional Federal Chartering of Insurance: Design of a Regulatory Structure,” paper presented at symposium on “Insurance Markets and Regulation,” Northwestern University School of Law, April 14-15, 2008, p. 1.

time; Congress need only enact statutes that pertain specifically to the business of insurance. Indeed, even as this article is being written, Congress is considering legislation that would profoundly affect the business practices of insurers.

It is important to remember that the federal system established by the U.S. Constitution assigns primacy to Congress in the exercise of its enumerated powers. That Congress's authority to regulate interstate commerce permits it to regulate the business of insurance has not been in doubt since 1944, when the U.S. Supreme Court decided the case of *United States v. South-Eastern Underwriters Association*.<sup>15</sup> Any attempt to create a regulatory system that assigns a formal role to both the federal government and the states must take account of the inherent primacy of federal authority.

#### Prospects for Regulatory Competition under an OFC

In theory, regulatory competition between the states on the one hand and the federal government on the other would create a powerful incentive for state-based reforms, and at the same time deter federal regulators from launching their own politically opportunistic market interventions. The result of such competition, according to the competitive-regulation theory advanced by OFC proponents, would be a more efficient regulatory regime at both the federal and state levels that would increase insurance availability and reduce or eliminate the pathologies associated with rate suppression and underwriting restrictions.

True regulatory competition will occur, however, only if most insurers can switch charters at relatively low cost. Unfortunately, the administrative cost to an insurer of adopting a federal charter and adapting to the federal regulatory compliance regime is

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<sup>15</sup> 322 U.S. 533 (1944).

likely to be quite high, and switching back to a state charter could be still more expensive. While it is true that charter-switching occurs with some frequency among banks, this can be attributed in large measure to the fact that a multi-state bank that decides to switch from federal regulation to state regulation need obtain a charter in only one state, thanks to the state regulators' acceptance of branch banking across state lines. Because there is no insurance equivalent of branching, a multi-state insurer that wished to jettison its federal charter would have to apply for charters in each of the states in which it does business. This process could prove daunting even for large companies.

As a practical matter, then, many insurers that opted for a federal charter would find themselves permanently trapped in the federal regulatory regime. This alone would undermine the goal of regulatory competition, but the other dynamic to which we have alluded—the prospect of federal preemption of state insurance regulation—would preclude any semblance of regulatory competition. That is, even if federally-regulated insurers could bear the expense of returning to state regulation to escape an unexpectedly onerous federal regime, they would have no incentive to do so if the federal government were to use its preemption authority to impose federal rules and standards on the states. Indeed, the mere threat of federal preemption would likely cause the states to enact their own versions of whatever underwriting restrictions or rate regulation that Congress or the ONI might impose on insurers. This scenario has become institutionalized in bank regulation through state “wild card” statutes, which provide for the automatic adoption at the state level of new federal banking regulations, thereby “discourag[ing] the provision of diverse legal rules and lead[ing] to federally-imposed uniform regulations.”<sup>16</sup>

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<sup>16</sup> Butler and Macey, “The Myth of Competition in the Dual Banking System,” p. 678-679.

## The Egalitarian View of Insurance and its Impact on Insurance Regulation

The reader may object that our discussion thus far reflects an overly pessimistic view of federal insurance regulation under an OFC. Even if the optional federal charter turned out not to be optional in practice, what is the basis for doubting that a federal regime will not be superior to the flawed state-based regime it replaces? The answer becomes apparent when one considers a fundamental difference between property-casualty insurance and other financial service products. Property-casualty insurance operates as a mechanism for distributing risk, and risk distribution is closely aligned with wealth distribution. Hence, to the extent that regulation can redistribute risk, it can also redistribute wealth. The likelihood that property-casualty insurance regulation will become politicized is thus very great, regardless of the source of regulatory authority.

State insurance regulators and legislators are forever confronting the question of whether particular underwriting and pricing practices are “fair” to consumers. The reason insurance practices are so often scrutinized for fairness has to do with the risk-distributing nature of the insurance enterprise, and the different purposes that people think insurance should serve. Many consumer activists, regulators, and politicians conceive of insurance as a scheme for broadly redistributing risk, so that the cost of protecting those most vulnerable to loss is disproportionately absorbed by those less prone to loss. Following Kenneth Abraham, we may think of this as the *egalitarian* standard of insurance fairness.<sup>17</sup>

In its purest form, an egalitarian standard of fair risk-distribution in insurance would lead to regulation that encouraged universal risk spreading, with the result that all

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<sup>17</sup> Kenneth S. Abraham, *Distributing Risk: Insurance, Legal Theory, and Public Policy* (Yale Univ. Press, 1986), pp. 26-29.

policyholders would pay the same rate for identical coverage, without regard to variations in the risk presented by individual policyholders. A less extreme version of egalitarian insurance would prohibit insurers from charging different rates for insurance coverage based on risk factors that are thought to be beyond the insured's control. In personal auto and homeowners insurance, such factors might include where a person lives, or the fact that he has a low consumer credit score.

This view of insurance owes much to the work of John Rawls, a philosopher of justice who developed an influential justification of the modern welfare state. Rawls asked what standard of social justice people would adopt if they were shrouded behind a "veil of ignorance" that prevented them from knowing in advance the personal attributes and experiences that would shape their life prospects. Rawls reasoned that most people would opt for a system that used redistributive means to bring about conditions of equality, lest they find themselves among those less generously endowed with respect to intelligence, physical attractiveness, family influences, and so forth. This exercise served to make Rawls' point that an individual's life prospects should not be affected by contingencies of birth or accidental endowments of skill and intelligence. Applied to insurance, Rawls' position implies that one's ability to obtain affordable insurance should not be affected by the presence or absence of particular characteristics that are beyond his control.

An egalitarian insurance regulatory regime would regard relative disparities in individual risk as the product of a natural lottery over which people have little control, and for which they should not be held accountable. If an insured has no means of controlling a risk he poses, it would violate egalitarian principles to charge him more for

insurance coverage than those who are fortunate enough to be free of that risk. Thus, egalitarian insurance would at the very least prohibit such immutable characteristics as race, ethnicity and sex from being considered in setting insurance premiums—even if these characteristics were strongly associated with risk. Moreover, an egalitarian view of insurance could entail the prohibition of risk variables that are facially neutral with respect to these characteristics, but which have a disproportionate adverse impact on particular racial or ethnic groups.

Other characteristics that may also appear to be beyond the insured’s control would likewise be prohibited. For example, it could be argued that an individual cannot control the risk associated with the physical environment in which he resides, whether the risk stems from natural factors such as earthquakes, windstorms, and floods, or social factors such as crime and traffic congestion. Under an egalitarian risk-distribution standard, these characteristics could be precluded from consideration in the issuance and pricing of insurance coverage, notwithstanding their association with risk.

Of course, insurance regulators and politicians seldom express their conception of insurance in such rarefied terms. But anyone who has spent much time in their company knows that even those who do not consciously subscribe to egalitarian principles of insurance are influenced by this way of thinking. It usually manifests itself in the rhetoric of “consumer protection”—a catch-all term that comprises not just matters such as insurer insolvency, fraudulent claim handling, and deceptive marketing practices, but issues of insurance “affordability” and “availability” as well.

Importantly, egalitarian notions of fairness applied to insurance risk classification and pricing provide a normative framework that serves to rationalize support for laws and

regulations that serve nakedly political ends. It is a familiar truism that the public policies most likely to be enacted and sustained over time are those that concentrate benefits and disperse costs. “Because the benefits are concentrated,” explains political scientist James Q. Wilson, “the group that is to receive those benefits has an incentive to organize and work to get them. But because the costs are widely distributed . . . , those who pay the costs may be either unaware of any costs or indifferent to them. . . .”<sup>18</sup>

Insurance regulation that suppresses rates and impedes risk-based underwriting concentrates benefits among a relatively small cohort of high-risk individuals and disperses costs among a relatively large cohort of low-risk individuals in precisely the manner described by Wilson. Thus, insurance regulation—regardless of its source—is likely to be influenced by two complementary forces: the pursuit of “fairness” defined according to egalitarian principles, and the desire of regulators and politicians to placate one constituency at the expense of another.

#### Previous Federal Regulatory Encounters with Property-Casualty Insurance

There is, to be sure, considerable uncertainty as to what would actually happen if an OFC proposal were enacted, although for the reasons cited earlier, it is a reasonably safe bet that no meaningful competition between federal and state regulators will occur. Likewise, federal regulation will almost certainly dominate either by supplanting state regulation altogether, or by dictating the content of state regulation through the threat (or use) of federal preemption. Speculating about the nature of particular rules that might emerge—and their likely effect on property-casualty insurance markets—necessarily

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<sup>18</sup> James Q. Wilson, *American Government: Institutions and Policies*, 5<sup>th</sup> ed. (Lexington, Mass.: D.C. Heath and Co., 1992), p. 435.

involves some guesswork. There are, however, historical antecedents that offer clues as to how a federal insurance regulatory agency might behave. Particularly relevant in this regard are the experiences of the Department of Housing and Urban Development (HUD) and, to a lesser extent, the Department of Justice (DOJ). We turn first to HUD.

As the federal agency with jurisdiction over a broad range of housing issues, HUD could be said to have a legitimate interest in issues related to homeowners insurance. Thus in 1994, the agency announced that it was forming a special task force to investigate allegations of “redlining”—that is, practicing unfair discrimination against a particular geographic area—in the sale of homeowners insurance, citing its responsibility for implementing the Fair Housing Act of 1968 (FHA). The Act prohibits certain discriminatory housing practices, making it unlawful:

(a) To refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or refuse to negotiate for the sale or rental of, or otherwise make unavailable or deny, a dwelling to any person because of race, color, religion, sex, familial status, or national origin.

(b) To discriminate against any person in the terms, conditions, or privileges of sale or rental of a dwelling, or in the provision of services or facilities in connection therewith, because of race, color, religion, sex, familial status, or national origin.<sup>19</sup>

While obviously concerned with discrimination in the sale and rental of housing, nowhere does the FHA specifically mention insurance. Under the McCarran-Ferguson Act, this omission should mean that the law does not apply to insurance. That conclusion is bolstered by the fact that since its enactment in 1968, Congress had on four occasions rejected attempts to extend the FHA’s coverage to include insurance. In 1980, for example, the Senate rejected an amendment that sought to make it “unlawful for property

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<sup>19</sup> 42 U.S.C. Sec. 3604.

insurers to discriminate ....” In a speech on the Senate floor following the vote, Senator Howell Heflin (D-AL) declared:

I am aware HUD has proposed regulations under Title VIII that would cover the business of insurance—a business the Senate has decided should not be addressed by this legislation. I hope it is clear from these proceedings that HUD should not attempt to achieve by regulation what the Senate has declined to do, namely, to amend Title VIII to cover the business of insurance.<sup>20</sup>

Senator Orrin Hatch (R-UT) added his concern that if HUD’s authority under the FHA were expanded to include property-casualty insurance, the agency might use “disparate impact” analysis to allege that property insurers were engaging in unfair discrimination:

If Title VIII is extended to property insurance, insurers might be forced to underwrite unsound risks to avoid the wrath of overzealous HUD officials armed with oversimplified statistics.<sup>21</sup>

Nevertheless, in 1989 HUD promulgated new regulations that addressed “other prohibited sale and rental conduct.” These included: “Refusing to provide municipal services or property or hazard insurance for dwellings or providing such services or insurance differently because of race, color, religion, sex, handicap, familial status, or national origin.”<sup>22</sup> When insurers cited the McCarran-Ferguson Act to challenge the validity of the regulations, both the sixth and seventh circuits of the U.S. Court of Appeals sided with HUD.<sup>23</sup>

When the Clinton administration assumed power in 1993, the stage was set for HUD to begin doing exactly what Sen. Hatch had feared. In December of that year, HUD Assistant Secretary Roberta Achtenberg sent a memorandum to regional directors

<sup>20</sup> 125 *Cong. Rec.* 25, 32991 (1980).

<sup>21</sup> *Ibid.*

<sup>22</sup> 24 C.F.R. Sec. 100.70(d)(4).

<sup>23</sup> *Nationwide Mutual Insurance Co. v. Cisneros*, 52 F.3d 1351 (6th Cir. 1995), cert. denied, 116 S. Ct. 973 (1996); *NAACP v. American Family Mutual Insurance Co.*, 978 F.2d 287 (7th Cir. 1992).

of the agency's Office of Fair Housing and Equal Opportunity. The memo instructed that:

Cases which have been brought under the Fair Housing Act should now be analyzed using a disparate impact analysis, to the extent that this theory is applicable to a particular case.

Under a disparate impact analysis, a policy, standard, practice or procedure which, in operation, disproportionately adversely affects persons protected by the Fair Housing Act coverages may violate the Act.<sup>24</sup>

The memorandum went on to note that “a respondent may rebut a *prima facie* case by evidence that the policy is justified by a business necessity which is sufficiently compelling to overcome the discriminatory effect. The business necessity justification may not be hypothetical or speculative.” The memo admonished HUD investigators to wield the disparate-impact weapon aggressively, and to regard claims of “business necessity” with a high degree of skepticism:

Each [respondent] should be investigated to determine if there are genuine business reasons for the policy. The respondent should also be queried as to whether or not the respondent considered any alternatives to the particular policy, and what the reasons for rejecting the alternatives, if any, were. ... [T]he investigation should consider whether there are any less discriminatory ways in which the respondent's business justifications may be addressed. These steps are important because if there is a less discriminatory way by which genuine business necessities may be addressed, it may be argued that the respondent should have adopted a less discriminatory alternative.<sup>25</sup>

HUD swiftly moved to apply this strategy in cases involving property insurers that considered the age, market value, and location of a home to determine the type of policy they would offer and the premium they would charge. The agency's use of disparate-impact analysis allowed it to accuse insurers of unlawful race-based

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<sup>24</sup> HUD Memorandum to All Regional Directors, Office of Fair Housing and Equal Opportunity, on “Applicability of Disparate Impact Analysis to Fair Housing Cases,” December 17, 1993, p. 1.

<sup>25</sup> *Ibid.* p. 2.

discrimination merely because their application of these risk-based underwriting criteria happened to yield statistical disparities among racial and ethnic groups. It was not necessary for HUD to show that the insurers intended to unfairly discriminate, nor that they had treated policyholders or applicants for homeowners insurance “differently *because of race, color, religion, sex, handicap, familial status, or national origin*” (to quote from the 1989 HUD regulations). The result was a series of consent decrees, settlements, and negotiations with HUD and DOJ that essentially forced property insurers to abandon the use of these “unfairly discriminatory” risk factors in underwriting and pricing.<sup>26</sup>

HUD’s aggressive use of disparate impact analysis in the 1990s to effectively prohibit the use of risk-based underwriting criteria in homeowners insurance markets should not be viewed as an aberration. Indeed, HUD’s actions during that time foreshadowed current federal efforts to apply disparate-impact analysis to the use of property insurers’ use of consumer credit information to underwrite and price automobile and homeowners insurance coverage. The Federal Trade Commission is currently conducting a congressionally-mandated study analyzing whether the use of credit information affects the affordability and availability of insurance and other financial services products, including the degree to which it may have a disparate impact on various demographic groups. Meanwhile, two bills have been introduced in the 110<sup>th</sup>

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<sup>26</sup> See Consent Decree, *U.S. v. American Family Mutual Insurance Co.*, (E.D. Wis. 1995) No. 9-C-0759; “State Farm Unit Seeks Bias Settlement With HUD,” *Washington Post*, April 8, 1995, p. E10; “Allstate Relaxes Standards on Selling Homeowners’ Policies in Poor Areas,” *Wall Street Journal*, August 14, 1996, p. A3.

Congress that would effectively impose a nationwide ban on the use of credit information for insurance underwriting purposes.<sup>27</sup>

An additional clue as to how the federal government would approach property-casualty insurance regulation can be found in its handling of a dispute involving insurers' statutory reporting obligations when they use credit information for underwriting and pricing purposes. In *Safeco v. Burr*,<sup>28</sup> the U.S. Supreme Court overturned key elements of the U.S. Court of Appeals for the Ninth Circuit's ingenious construction of a provision in the Fair Credit Reporting Act (FCRA) that requires property-casualty insurers to send written notices to consumers who are adversely affected by an insurer's use of a credit report.<sup>29</sup>

In January 2006, the Ninth Circuit ruled that the FCRA's "adverse action" notice provision requires insurers to notify current policyholders, as well as applicants for new policies, if the insurer's use of a credit score adversely affects the premium amount that an individual is charged for coverage.<sup>30</sup> Since the Act defines an adverse action as "an increase in any charge for ... any insurance,"<sup>31</sup> many insurers assumed that the notice requirement applied only to cases in which an unfavorable credit report caused an existing policyholder to experience a rate increase. Since "increase" implies a rise in the price currently charged, insurers reasoned that the notice requirement could not logically apply to new customers, since they were being charged for the first time.

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<sup>27</sup> See H.R. 5633, "Nondiscriminatory Use of Consumer Reports and Consumer Information Act of 2008," and H.R. 6062, "Personal Lines of Insurance Fairness Act of 2008."

<sup>28</sup> *Safeco Ins. Co. of America v. Burr*, 127 S. Ct. 2201 (2007).

<sup>29</sup> 15 U.S.C. § 1681 et seq.

<sup>30</sup> *Reynolds v. Hartford Fin. Servs. Group, Inc.*, 435 F.3d 1081, 1091 (9th Cir. 2006).

<sup>31</sup> 15 U.S.C. § 1681a(k)(1)(B)(i).

The Ninth Circuit disagreed, based on a novel definition of “increase” in the context of the FCRA. A premium increase, said the court, occurred whenever a consumer fails to qualify for the insurer’s lowest possible rate.<sup>32</sup> Hence, the FCRA requires adverse action notices to be sent to every consumer—whether new applicant or existing policyholder—who is subjected to such an “increase,” even in instances where the insurer’s use of a credit report resulted in a rate *lower* than the rate that would have been charged if the credit report had not been considered. But few consumers’ credit scores are so high as to qualify them for an insurer’s best possible rate. In essence, the court declared that the 90 percent or more of consumers who were not given the highest discount offered to customers with unusually high credit score had, in reality, experienced a rate increase, and had therefore suffered an adverse action due to insurers’ use of credit reports. Moreover, under the FCRA, every one of them would have to be notified.

The Supreme Court agreed to review the Ninth Circuit’s decision, prompting the DOJ to enter the case as *amicus curiae* in support of the appellate court’s “best rate” construction of the notice requirement, as well as its conclusion that a rate “increase” could apply to a first-time customer. The DOJ explained how even in the absence of any prior dealing, a new applicant for insurance could experience a rate “increase” based on the insurer’s use of a credit report:

Had Edo [the plaintiff] pulled into a gas station and been charged ten cents a gallon more because of his race, gender, or the fact that his license plate ended in an odd, rather than an even, number, Edo would have suffered an

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<sup>32</sup> *Reynolds* at 1093.

‘increase[d]’ charge for gasoline, regardless of whether he had ever purchased gasoline at that station before.<sup>33</sup>

This analogy seems highly inapt as applied to insurance. Unlike commodities such as gasoline, insurance policies do not come with a fixed, predetermined price. The premium for each policy is determined by a multitude of individual risk factors (one of which could be a credit report), and thus will vary significantly from one policyholder to the next. Since there is no “posted price” for insurance coverage (as there is for gasoline), the only reference point for determining whether an individual has experienced a price “increase” is the price previously paid by that same individual.

The Justice Department also supported the Ninth Circuit’s theory that every consumer who fails to qualify for an insurer’s lowest possible rate suffered an adverse action if the proffered rate was based, at least in part, on a credit report. Noting that the FCRA defined “adverse action” as an insurance price increase “based in whole or in part on any information contained in a consumer report,”<sup>34</sup> the automobile insurer GEICO concluded that an adverse action would occur only if the use of a credit report caused it to charge a rate higher than it would have charged had it not considered the customer’s credit report.<sup>35</sup> GEICO sent adverse action notices to all such customers, but it did not send notices to customers who were charged a rate equal to or lower than the rate it would have charged but for its use of a credit report. Edo, the plaintiff in the GEICO case, was in this latter category; his premium was unaffected by his credit score.

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<sup>33</sup> Brief for United States as *Amicus Curiae* at 26, *Safeco Ins. Co. of America v. Burr*, 127 S. Ct. 2201 (2007) (Nos. 06-84 and 06-100). Ajene Edo was the named plaintiff in *GEICO v. Edo*, the companion case to *Safeco v. Burr*.

<sup>34</sup> 15 U.S.C. § 1681m(a).

<sup>35</sup> GEICO was the defendant in *GEICO v. Edo*, the companion case to *Safeco v. Burr*.

But the DOJ emphasized that GEICO had “in fact, obtained and used Edo’s actual credit score and, on that basis, charged him a higher rate for insurance than what was offered to certain other customers and what would have been offered to him if his credit score had been better.” But this hardly constitutes an adverse action based on Edo’s credit score. GEICO did charge Edo more than it charged customers who had better credit scores; it also charged him more than what it would have charged him had his credit score been better. But the fact remains that GEICO did not increase Edo’s rate based on his credit score. In his opinion for the Court, Justice David Souter observed that the FCRA plainly says that a notice is required only when the adverse action is “based in whole or in part on” a credit report.<sup>36</sup> He further noted that:

In common talk, the phrase “based on” indicates a but-for causal relationship and thus a necessary logical condition. Under this most natural reading of Sec. 1681m(a), then, an increased rate is not “based in whole or in part on” a credit report unless the report was a necessary condition of the increase.<sup>37</sup>

Justice Souter’s scrutiny of the relevant semantics is surely correct, but even he failed to pinpoint the DOJ’s main error. Both the Ninth Circuit and the DOJ seem to have based their analyses on the notion that if an insurer charges different premiums commensurate with different levels of risk, all but those with the lowest risk (and hence the lowest possible premium) are paying “more” for coverage. But if I install storm shutters on the windows of my home to reduce the risk of damage from a windstorm, and my property insurer reduces my premium to reflect my decreased risk of loss, this does not mean that my neighbor, who did not install storm shutters and whose rate therefore remains unchanged, has experienced a premium increase because my premium was

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<sup>36</sup> *Safeco* at 2205.

<sup>37</sup> *Safeco* at 2212.

lowered. Similarly, if I conduct my financial affairs in a way that raises my credit score and thus lowers my insurance premium, my lower premium does not constitute a rate increase for anyone else.

The goal of risk-based underwriting and competitive pricing is to ensure that similar risks are treated similarly; it is not to create a zero-sum game that pits insurers against insureds. The DOJ seems to think otherwise. Its brief declares that “if an insurance company opts to use the credit reporting system *and enjoy its benefits*, it must also comply with the FCRA’s obligations.”<sup>38</sup> The implication that consumers do not also enjoy the benefits of accurate pricing based on actuarially sound risk analysis betrays a glaring misunderstanding of how insurance markets work.

#### Prospects for Market-Oriented Regulatory Reform under an OFC

In light of the foregoing discussion, three questions about the OFC proposal seem paramount. First, will the proposal’s promise of rate deregulation for federally-chartered insurers be realized over time? It is tempting to imagine that the federal government that abolished price controls in the trucking, railroad and airline industries during the 1970s would do the same for insurance today if given the chance. But it seems unlikely that the same political dynamic that makes it so difficult to achieve price competition in the states will not also manifest itself at the federal level. Just as political opportunism and an egalitarian view of insurance regularly lead some state office-holders and regulators to call for insurance price controls and rate rollbacks, so too will there inevitably be occasions when their federal counterparts do the same. If the dual chartering scheme

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<sup>38</sup> Brief for United States at 28 (emphasis added).

fails to promote robust regulatory competition between the state and federal governments—as it almost certainly will—the political and ideological appeal of rate regulation at the federal level will go unchecked. Sooner or later, whatever measure of pricing freedom insurers are afforded under the current versions of the National Insurance Act is likely to disappear.

The second question that must be addressed is whether Congress and the Office of National Insurance will recognize that unfettered risk discrimination is essential to accurate underwriting and competitive pricing. The examples reviewed in this paper of the federal government’s regulatory encounters with property-casualty insurance provide ample reason to suspect that the eventual erosion of pricing freedom under federal regulation will be accompanied by measures that will restrict insurers’ ability to use risk-based underwriting variables that are deemed “unfair” by federal regulators and members of Congress.

Many politicians—especially those whose constituents include large concentrations of high-risk insureds—find it easy to ignore compelling evidence that restrictions on risk-based underwriting discourage risk mitigation, force low-risk consumers to subsidize the insurance costs of high-risk consumers, and decrease the availability of insurance. It is important to note that the House and Senate OFC bills do nothing to protect underwriting freedom. The bills’ promise of rate deregulation for federally-chartered insurers will mean little if federal regulators are allowed to impose underwriting restrictions that impair the ability of insurers to charge premiums based on risk.

Finally, one should reflect on the human element that inevitably drives the behavior of all federal bureaucracies. This means asking about the kind of person that will self-select into a career as a federal insurance regulator. As the familiar themes of “protecting consumers” and “making insurance available and affordable” inexorably make their way into presidential and congressional election campaigns, what promises will candidates make to voters on issues related to property insurance? What assurance do we have that the men and women appointed by future administrations to lead the Office of National Insurance will be knowledgeable, principled devotees of free markets and regulatory forbearance?

#### If Not OFC, Then What?

Discussion of an alternative means of federal insurance regulatory reform is beyond the scope of this paper. Indeed, in light of the foregoing discussion, it would appear that the most prudent course is to continue the pursuit of market-oriented reforms at the state level, state by state. This approach has yielded significant reforms of state rating laws in recent years that should not be discounted by proponents of reform. With that said, one possible federal approach that warrants serious consideration is the “primary state regulator” or “single license” concept, which was recently illuminated in an important paper by Henry Butler and Larry Ribstein.<sup>39</sup> The authors explain that “an alternative to the federal domination that is likely to occur under OFC or the other federalization of insurance proposals ... is to model federal insurance regulation after

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<sup>39</sup> Butler and Ribstein, “A Single-License Approach to Regulating Insurance,” paper presented at symposium on “Insurance Markets and Regulation,” Northwestern University School of Law, April 14-15, 2008. Available at <http://ssrn.com/abstract=1134792>.

corporate chartering” rather than bank chartering.<sup>40</sup> Their proposal “would allow an insurer to be chartered in a primary state of their choice, and then would be licensed to sell in any state provided the insurer met minimum federal standards.”<sup>41</sup> Significantly, the Butler-Ribstein proposal would create genuine regulatory competition among 56 state and territorial insurance regulators.

### Conclusion

History teaches that once established, federal agencies tend inexorably to grow in size and to expand their authority—often at the expense of state and local governments. When the U.S. Department of Education was created in 1980, critics warned that it would eventually usurp authority that historically belonged to the states. One of those critics was Ronald Reagan, who promised during his presidential election campaign to abolish the department. Today, after nearly three decades, it is larger and more intrusive than ever, embraced and further aggrandized by recent administrations.

There is every reason to believe that a federal insurance regulator would follow a similar path. Viewed superficially, the optional federal charter proposal precludes a federal takeover of insurance regulation by allowing insurers to eschew federal regulation in favor of state regulation. This notion is belied, however, by the experience of the dual banking regulatory system on which the OFC proposal is based. Likewise, the notion that an OFC would foster competition between state and federal insurance regulators,

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<sup>40</sup> Ibid., p. 14.

<sup>41</sup> Ibid. Also see Scott Harrington, “Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation,” Networks Financial Institute at Indiana State University, 2006-PB-02 (March 2006).

which in turn would lead to salutary regulatory reform, is also contradicted by the experience of the dual banking system.

Federal regulatory encounters with the business of property-casualty insurance during the past twenty years suggest that rate regulation and underwriting restrictions that exist to varying extents in the states today would not disappear under a federal regulatory regime. To the contrary, there is ample reason to believe that federal regulation of property-casualty insurance markets would be driven by political opportunism and egalitarian ideology, leading more often than not to regulatory zealotry rather than regulatory forbearance.