Instead of federal chartering, states should compete with each other to produce efficient insurance regulation.

The Single-License Solution

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State regulation of insurance companies has been criticized for many years. Forcing firms to comply with regulations that differ from state to state increases costs, limits product innovation and rate competition, and inhibits companies from exiting jurisdictions that impose burdensome regulation. Thus, despite its appearance of being decentralized federalism, the current state-based regulatory system does not capture the benefits of jurisdictional competition that are found in other areas of the law, notably corporate law.

The problems with state regulation and concerns about the competitiveness of U.S. insurers in global financial markets have led to several proposals to federalize insurance regulation. The most seriously considered proposal calls for optional federal chartering (OFC) of multi-state insurers. Although OFC was recently endorsed by the U.S. Department of Treasury, the insurance industry is divided in its support of OFC.

All proposals to centralize insurance regulation in Washington fail to recognize the potential downsides of federal regulation. A major problem with federal chartering is that it does not take advantage of the potential for jurisdictional competition to generate a more efficient regulatory structure. We propose that insurers could operate nationally with only a single license granted by one state. Unlike OFC, which adds only the federal charter option, our single-license solution would provide 50 new licensing options for multi-state insurers. The single-license solution has the potential for triggering competition and innovation on insurance products and rates while preserving a role for meaningful state regulation.

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WHY REGULATE INSURANCE?

Insurance regulation is rationalized as protecting consumers from unfair insurance contracts and ensuring the safety and soundness of the companies themselves. Consumer protection regulation attempts to protect consumers from their limited ability to bargain over the terms of insurance contracts. The contracts use arcane language that even many lawyers have difficulty understanding. At the time they buy their policy, consumers may be unable to evaluate their coverage for the risk that eventually occurs. As a result, insurers have an incentive to overcharge for coverage. Safety-and-soundness regulation arises from the concern that the insurance company will not be able to pay when it is called upon to do so. Insurers have an incentive to charge low prices to attract customers in the short run, which increases the likelihood of default when the claims come due. Thus, while consumer protection–oriented regulators are worried about rates being too high for the amount of coverage, safety-and-soundness regulators are concerned about rates being too low.

State guaranty funds protect consumers when insurers default. But the funds also may encourage excessive investment risk by insurance companies. Thus, just as bank regulation attempts to offset the moral hazard created by federal deposit insurance, state insurance regulation attempts to offset the risk created by state guaranty funds.

The rationales for regulation of insurance are not universally accepted by scholars. Even if many individual consumers do not have the time or expertise to track solvency or figure out policies, some do, and the size of the market justifies the entry of expert intermediaries who help consumers to find coverage. Moreover, insurers' emphasis on standard-form con-

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tracts and pricing makes price discrimination difficult. Accordingly, competition gives insurers an incentive to offer terms acceptable to the more sophisticated buyers. Thus an important goal of insurance regulatory reform should be to set up an institutional framework that allows financial markets and products to evolve in response to already-present market forces.

THE STRUCTURE OF INSURANCE REGULATION

The tensions in the current regulatory structure have been present for at least 140 years. When insurance companies expanded across state lines during the middle of the 19th century, they sought federal regulation to relieve them from the burdens of complying with regulations in multiple jurisdictions. The U.S. Supreme Court's decision in *Paul v. Virginia* halted that effort in 1869 by holding that insurance contracts were not interstate commerce. However, the Supreme Court reversed course in 1944 in *United States v. South-Eastern Underwriters Association* where it held that insurance was interstate commerce and thus subject to federal antitrust regulation.

Though insurers favored a single federal regulator of insurance prior to *Paul v. Virginia*, they changed their tune after *South-Eastern Underwriters* presented them with the specter of federal antitrust regulation. Antitrust regulation threatens insurers' ability to enhance actuarial projections by cooperating through rating bureaus on the collection and dissemination of risk information. The insurance industry was anxious to remove the potential antitrust threat but did not have enough clout to get the federal regulation it wanted. The industry, therefore, joined with the state regulators through the National Association of Insurance Commissioners (NAIC) to obtain passage of the McCarran-Ferguson Act of 1945. McCarran-Ferguson provided limited antitrust immunity for the insurance industry and confirmed the states as the primary regulators of the insurance industry.

The era of regulation by dispersed state regulators was made somewhat palatable to insurers by state cooperation through the NAIC. However, several insurer failures in the late 1980s and early 1990s cast doubt on the adequacy of state guaranty funds and triggered renewed interest in federal regulation of insurance. Congress considered several proposals for federal chartering and regulation and the establishment of a federal guaranty fund. The NAIC successfully

resisted that incursion onto their turf by encouraging state regulators to enact their own risk-based capital requirements for insurers, modeled after federal risk-based capital requirements for banks. However, political support may be shifting toward an increased emphasis on federal regulation.

ARGUMENTS FOR FEDERAL REGULATION

Insurance is a national business. There are obvious scale economies in the sale of insurance, particularly the cost advantages of a large risk pool and standard-form policies. But as long as states have the power to bar firms from selling in their states, insurers must pay a regulatory tax in order to enter state markets. This gives states — particularly those like California with the most lucrative markets — the ability and incentive to impose inefficient regulation at the behest of local interest groups.

Current regulation of insurance creates three problems:

- States suppress rates below market levels.
- Insurers must get each state's regulatory approval for every policy they sell. States thus impose restrictions on insurers' standard underwriting and risk classification, which undercuts insurers' ability to achieve economies of scale.
- States impose a variety of consumer-protection rules that interfere with the functioning of competitive markets.

Unlike many types of contracts, insurance policies cannot effectively designate the law of a particular state as governing the contract. If insurers could exit insurance markets in states that impose excessive burdens, state regulation would be of less concern. But states bar the doors by imposing restrictions on insurer exit — and they sometimes impose those exit barriers only after the insurer has entered the state. And exit is already an expensive option. For example, an insurer may spend years developing a distribution system and customer base, only to find itself subject to burdensome rates and regulations. Because it is so costly for insurers to exit, they are at the mercy of rent-extracting state regulators.

Calls for federal regulation are motivated by longstanding problems of duplication and overregulation that result from the current state-based system. The aggressive behavior of Mississippi and Florida regulators, who basically attempted to force insurers to renew homeowners' policies at low rates following severe hurricane damage in 2004 and 2005, has added urgency to the reform effort.

TREASURY PLAN The Treasury plan for optional federal chartering is similar to the proposed National Insurance Act of 2007 and other legislative proposals that would create an optional federal charter. The Treasury plan would give multistate insurance companies the option of obtaining a federal charter that would allow them to operate throughout the country without regard to state licensing and entry restrictions. The plan would create a new Office of National Insurance within the Treasury Department that would be headed by a commissioner. The plan would also establish an Office of Insurance Oversight to address international regulatory issues and advise the secretary on major domestic and international policy issues. Nationally chartered insurers would be exempt from state rate regulations.

OFC proposals are premised on the assumption that national regulators will provide more balanced and reasonable regulation than decentralized state regulators. Supporters of OFC argue that establishing an optional federal charter would not supplant state regulation or state premium taxation because OFC would allow insurers to choose between state and federal regulation.

FALSE PROMISE The central problem with OFC is that — like the current regulatory structure — it preserves only the mirage of competition. The proposed National Insurance Act would let multi-state insurers either choose a single federal charter or continue to be subject to multiple state regulators. Given the high costs of the state system, large national insurers would be highly likely to choose the federal charter. Thus, OFC is likely to evolve into an all-federal system for the large national insurers. Ultimately, insurers would gain little from this "choice." Federal politicians would engage in "rent extraction" up to the difference between the regulatory costs under the federal regime and those under the state regime. Insurers could lose the benefit of the gains associated with opting into federal regulation plus the transaction costs of resubmitting to licensing in each state.

Of course, the large insurers are not stupid and they likely recognize the risk of lock-in and rent extraction. They are willing to take the risk of federal control because of their frustration with the current regulatory regime. State guaranty funds are part of the problem. As Bert Ely has explained, "if government wants to be in the business, for whatever reason, of regulating financial institutions, then it has no choice but to provide a warranty for the service that business supposedly provides to the general public." The problem is that as long as consumers demand a warranty, they are likely to insist on the stronger warranty the federal government can provide. And once the federal guarantee exists, state funds will disappear just as non-federal deposit insurance for banks almost completely disappeared in the wake of federal insurance.

Reform proponents overestimate the likelihood that their favored proposal will work as intended. The task of determining appropriate or optimal standards under federal charters may appear simple and straightforward. After all, state regulators and the NAIC have been promulgating rules and regulations for a long time. Law professors and other experts may find it difficult to believe that smart, well-intentioned federal regulators could reach bad conclusions. But reform of a complex system is immensely difficult to get right, even under the highly unrealistic assumption that current conditions will not change. If conditions do change, today's panacea will become tomorrow's problem. Meaningful reform requires establishing a system that will reach the right solutions today and tomorrow.

Federalism can be a dynamic regulatory regime that provides important benefits: experimentation and regulatory

evolution in response to changes in exogenous and endogenous forces. In particular, a state-based system facilitates reversal of inevitable policy mistakes that can easily become permanent at the federal level. Consider, for example, the Sarbanes-Oxley Act, a hastily adopted law that brought increased federalization of previously state-dominated corporation law. Almost from the moment of its enactment, Sarbanes-Oxley has caused costs and problems for publicly traded firms and their shareholders. Yet no serious attempt to reform the legislation exists. Similarly, federal controls on interest rates outlasted their usefulness to the point that they bankrupted the entire savings-and-loan industry.

The objective in reforming insurance regulation should be to fix the problems of state law without imposing the potential costs of federalizing insurance law. Under a federal regime, insurers would be forced to deal with a single legislature and perhaps a single regulatory agency. They would be vulnerable to repeated threats of additional costly regulation and attempts to extract rents, with little ability to respond to the threat through exit to another regime.

Insurance regulation reform should strive to fix the problems of state law without imposing the potential costs of federalizing insurance law.

THE SINGLE-LICENSE SOLUTION

An alternative to the federal domination that is likely to occur under OFC is to model federal insurance regulation after corporate chartering, which takes advantage of jurisdictional competition. Under the regulatory federalism of the corporate chartering system, most internal governance is left to the chartering state, with a federal minimum standard that takes the form of disclosure regulation. An analogous proposal for insurance regulation would allow an insurer to be chartered in a primary state of its choice, and sell in any state provided the insurer met minimum federal standards.

The single-license system would not require creating new entities or massive new federal regulatory bodies. Because the federal government excluded itself from this regulatory area by McCarran-Ferguson, there is no federal regulatory apparatus to dismantle in order to institute effective state competition. The single-license approach would, however, require federal legislation. The states have had 60 years since McCarran-Ferguson to evolve toward jurisdictional competition and have instead embraced a state cartel under the NAIC. Insurance is a national market, and Congress must not allow the states to continue to disrupt interstate commerce.

REMOVING BARRIERS The jurisdictional competition approach to insurance regulation could, in theory, evolve through reciprocal and multi-state agreements among states to recognize licenses granted by other states. This has not happened, and it is not obvious that it would ever happen with the provincial nature of current state-based insurance regulation.

Accordingly, federal legislation mandating jurisdictional choice is necessary. Specifically, the federal statute should clearly authorize a state to charter insurance companies that can operate in all other states, subject only to non-discriminatory solvency regulation that the non-chartering state imposes on insurers chartered in that state. This would enable consumers in every state to shop for insurance from companies regardless of where they are chartered, based on price, quality, and type of product.

In order for meaningful jurisdictional competition to occur, insurers must be able to exit their licensing state at low cost. The concern is that states might require insurers to pay a large exit fee if they want to reincorporate in another state. Firms can protect themselves to some extent by refusing to enter states that impose such restrictions. The danger is that states will impose restrictions for the first time after the insurer enters the state. To protect against that risk, any federal choice-of-law or single-licensing enabling statute must include provisions designed to facilitate low-cost exit.

TAX INCENTIVES A robust market for insurance regulation requires that states have an incentive to compete to provide such regulation. That incentive can be provided by properly allocating state tax revenue from insurance sales. However, it is unlikely that the states will agree on their own to such a reallocation because many — perhaps most — states will be net losers under the system. Accordingly, designing a federal jurisdictional choice statute requires considering the appropriate allocation of state tax revenues.

The most straightforward allocation would be for the insurance tax revenue to go to the chartering state of the insurance company that sells the policy. Because a substantial amount of revenue is at stake, it seems likely that several states would be willing to invest in the creation of a regulatory environment that makes their state an attractive primary state. Other states would have some incentive to keep up with regulatory changes in other states in order to avoid losing revenues.

The problem with this straightforward proposal is that representatives from states that expect to lose revenues from the proposal would likely oppose it. A 50-50 allocation of the tax base (i.e., the premium paid) between the state of the insured and the state of the insurer accordingly might be politically

more feasible. The states would determine their own tax rates. Under this approach, states have an incentive to compete because they lose tax revenue if their insurers charter elsewhere or lose market share from operating under inefficient regulation. However, even the least competitive states would not lose all tax revenues because they would share the tax revenues earned from firms chartered in the dominant states.

A potential problem with this approach is that a sudden shift to the new regime could benefit the states that are in position to gear up for competition most quickly. First-mover advantages may stunt the development of vibrant jurisdictional competition. The problem might be mitigated by phasing in the allocation. For example, under a six-year phase-in, the split would go from 100-0, 90-10, 80-20, 70-30, 60-40, to 50-50 in the sixth year.

It is difficult to predict the type of interstate market for insurance licenses that might evolve. States with smaller markets might have a stronger incentive to specialize in the market for insurance regulation because their potential payoff is a larger share of total tax revenues than for larger states. On the other hand, states where major insurance companies are headquartered may take the lead in order to capture an incumbent advantage. The jurisdictional competition under a single-license approach might lead to overall lower insurance rates because dominant states have an incentive to attract firms by reducing their chartering firms' operating costs. Also, it is likely that jurisdictional competition will lead to the demise of rate regulation in much the same way that jurisdictional competition increased the availability of the corporate form in the late 1800s.

SOLVENCY A key aspect of state insurance regulation is setting solvency standards that ensure that insurers can pay insured claims. An alternative mechanism that would provide safety comparable to state funds without federalization would be federal regulation that requires insurers to issue solvency bonds that default if the state guaranty fund fails. The bonds' yield would reflect the dispersed information available in the market rather than investigation by individual bond rating agencies. The information-sensitive bonds would provide a market-based monitoring mechanism that would be independent of rating agencies and free from political influence. A state's temptation to regulate rates or lower solvency standards would be disciplined by the increase in the cost of the bond for firms chartered in the state. Firms would avoid states whose charters increase the cost of the bond, thereby removing states' incentives to race to the bottom by under-regulating solvency.

CONSUMER PROTECTION The single-license solution ultimately provides consumer protection through nationwide rate competition, incentives and ability to offer new products, and increased information in national advertising. Our proposed statute provides that the state law designated in the insurance policy would apply to all matters concerning the application and validity of the insurance policy. The insurer could designate the consumer protection law of any state, including but not limited to the chartering (licensing) state. However, the regulation of a state in which the policies are sold could trump the designated state law if the regulating state explicitly prohibits enforcement of the choice-of-law clause. That would enable companies to choose the single law that best suits their business and to have that law govern its policies wherever they do business. This proposal helps to ensure a competitive interstate market that would make transparent the costs of inefficient, rate-increasing "consumer protection" regulation.

One potential criticism of this approach is that states might seek to attract insurers by offering unduly lax consumer protection laws. Our proposed federal statute addresses this concern by permitting states to override contractual choice of law. At the same time, our proposal protects insurers from excessively burdensome multiple-state regulation by

- requiring any state override to be by the legislature;
- making the override effective only if enacted by a state where policies are sold and as to policies sold after the legislation is enacted; and
- giving the insurer a clear right to exit the state.

The requirement of enactment by the legislature serves two purposes. First, it gives insurers certainty and *ex ante* predictability. Insurers will know before selling policies in a particular state whether their chosen law will apply, rather than having to wait for a judicial determination of the effect of the state on choice-of-law contracts under vague choice-of-law rules. Second, it provides an implicit political check on state incentives to override contractual choice of law. An interest group that seeks to regulate insurance policies in the state must bear the burden of getting political support not only for the regulation itself, but also for invalidating attempted avoidance of the regulation through contractual choice of law. This forces the full effect of the law to the enactment stage rather than deferring the validity of choice-of-law clauses to the courts.

The stipulations that state override applies only to policies sold in the regulating state after the passage of the regulation and ensuring insurers' right to exit maximize insurers' ability to avoid oppressive state laws. That raises the political ante for pro-regulatory interest groups because exit can impose costs on local consumers and others. Legislatures would have to take into account at the time of enactment lobbying, not only by the insurers that would be subject to the regulation, but also by consumers and others who would be hurt if firms left the state in order to avoid the law.

ADDRESSING CONCERNS

Critics of our single-license approach are likely to raise two general objections. First, consumer advocates may argue that legislators and regulators would try to attract insurers (and the tax revenues they bring with them) by promising not to regulate strictly. This "race-to-the-bottom" would destabilize insurance guaranty funds and put consumers at risk. Second, insurers may fear that our proposed qualifications on sin-

gle licensing would leave the door open for continued aggressive regulation by multiple state regulators.

RACE TO THE BOTTOM The appropriate starting point in addressing the race-to-the-bottom argument is whether the risk of such a race is greater for insurance regulation than for corporate law, which provides the model for state chartering. Corporate legal scholarship has generally supported the conclusion that the competition between the chartering states benefits shareholders. Do the same considerations apply to single-state licensing of insurers?

One might argue that the corporate internal affairs doctrine (IAD), which is the basis of state competition in corporate law, is stable precisely because it does not attempt to invade traditional areas of state regulation. The IAD is fairly narrow and excludes controversial aspects of regulating corporations, such as securities fraud and disclosure, antitrust law, bankruptcy, and myriad types of corporate conduct, for treatment by federal law or state law that is not within the IAD. The IAD's triviality may partly explain why Congress has not preempted the field, though it clearly has the power to do so.

Insurance regulation arguably bears a closer resemblance to traditional consumer protection law and therefore is likely to trigger much stronger objections to applying firms' chosen state law. We think such concerns are unwarranted, but we have attempted to mitigate this risk through federal market-based constraints on solvency regulation and by allowing for limited state override of the licensing state to protect consumers.

EXCESSIVE STATE REGULATION Insurers may object that the limitations we propose on state competition allow aggressive state legislatures to take advantage of their power to override the single license and impose multiple regulatory burdens on insurers. But aggressive states understand that insurers not only can exit their markets, but also will respond by continuing to lobby Congress for the federal charter option.

Given the persisting pressure for federal intervention, our single-license approach could be viewed as a kind of second coming of state regulation. The problems of state regulation have led to loud calls for federal regulation from both consumers and insurers. We argue for rehabilitation of state regulation by opening regulation to jurisdictional competition. But if the rehabilitation does not work, state regulators understand that the calls for a federal chartering option may become politically irresistible.

Under the single-license approach, lax or aggressive state regulators would be disciplined by jurisdictional competition from other states.

OFFICE OF NATIONAL INSURANCE

The Treasury plan's proposed Office of National Insurance could play an important role in our single-license scheme by collecting, disseminating, and analyzing information about the effectiveness of state jurisdictional competition. The data would indicate if state regulation has been too lax or if states are imposing excessive regulatory burdens on insurers. If, after a period of several years, it appears that the single-license approach has not improved the functioning of insurance markets, then the Office of National Insurance could recommend that Congress provide for a federal charter option.

The National Insurance Office would have the additional function and benefit of better enabling U.S. insurers to enter foreign markets. Critics of state law have suggested that U.S. insurers are at a competitive disadvantage in attempting to enter foreign markets because it is hard for dispersed state regulators to offer reciprocal privileges to foreign insurers entering the United States. This problem would be alleviated under our approach because the foreign insurer would only have to obtain a single license. However, the problem would continue to some extent because no one regulator would represent U.S. interests in international negotiations. The proposed National Insurance Office could not only be a way to clarify the state licensing alternatives available to foreign entrants, but a mechanism for negotiating international treaties.

TRULY OPTIONAL FEDERAL CHARTERS

Under the single-license approach, lax or aggressive state regulators would be disciplined by jurisdictional competition from other states. The threat of a federal charter option might offer some discipline as well. As discussed above, the current proposal for optional federal chartering does not offer a true option for several reasons:

- Insurers' only other choice is continued exposure to regulation in each state in which they sell insurance.
- The federal government is likely to be able to back up its regulation with a better solvency guaranty fund than any state regulator
- The federal government would be able to quickly offer higher quality regulation than any state under the weak incentives of the current state regulatory system.

The single-license proposal would give states a competitive incentive to offer superior regulation, thereby arguably making optional federal chartering unnecessary.

Although optional federal chartering may be unnecessary

under a favorable view of state competition, it offers a potential alternative for insurers or consumer groups that object to our single-license alternative. It is important to emphasize that we are referring to truly optional chartering, in which the federal charter competes on a level playing field with state chartering.

Leveling the playing field would involve not only offering the possibility of a single state license, but also giving the states the opportunity to develop viable regulation under competition before the federal government can enter the competition. Making the federal option available immediately may stifle the development of jurisdictional competition by the states. Accordingly, we suggest making the federal charter available after a reasonable transition period of five years or so. An alternative would be to empower the Office of National Insurance to recommend the desirability or need for a federal charter option after five years' experience under our single-license approach.

Truly optional federal chartering could be designed to address both of the problems with single licensing identified above. Federal chartering might deal with the problem of multiple state regulators overriding chartering state law by providing that the federal charter preempts state consumer protection regulation. Preemption is arguably justified on the basis that the federal government has less revenue incentive than a small state to race-to-the-bottom to attract chartering business.

Federal chartering also could address state laxity by providing a superior guaranty fund as a "warranty" to back solvency and rate regulation. This would not only protect consumers, but also could attract chartering business from insurers. Insurers could decide whether they want the most efficient state regulation that has developed under single-license competition, backed by market-based solvency protection, or to offer their customers the security of a federal guaranty, presumably at a higher price.

It is important, however, to keep in mind the caveat that the federal option always has the potential to overwhelm even efficient state competitors, resulting in a non-competitive system with a single federal regulator. Because of this danger, federal chartering should be made available only if there is a finding by an independent commission or the National Insurance Office that there are defects in the competitive single-license state system that are likely to be solved by making the federal charter available

Making the federal option available immediately may stifle the development of jurisdictional competition by the states

CONCLUSION

All proposals to federalize insurance regulation — whether through mandatory or optional federal laws — create opportunities for abuse at the hands of the federal government. Monopoly national regulation of the insurance industry should be viewed with skepticism by both industry and consumers. Insurance carriers could be subject to rent extraction by the federal regulator, while consumers should be concerned about industry capture of the centralized regulatory agency.

This article proposes a state-based regime that both protects insurers from the worst effects of multiple regulators and creates a real opportunity for jurisdictional competition and experimentation. Given its strong potential benefits, state competition, under our single-license approach, should be tried before a single federal regulator. If the large multistate insurers prevail in their push for optional federal chartering, the legislation should be supplemented with our single-license solution. R

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