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*The Fatal Flaw of Proposals to
Federalize Insurance Regulation*
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ABSTRACT

*While the federal government has had the option of regulating insurance since the decision by the U.S. Supreme Court in the *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944), the states have retained almost exclusive control over insurance regulation. Within the past seven years, Congress, however, has considered three different methods of federalizing insurance regulation. In March 2008, the U.S. Treasury Department endorsed the idea of optional federal chartering of multi-state insurers. Some members of the insurance industry see these efforts to federalize insurance regulation as a means of eliminating the problems in the current state system, which they view as costly, cumbersome and confusing.*

In the Congressional hearings on federalizing insurance, both opponents and proponents of federalizing insurance have discussed insurance as if was a completely, “unique” financial service. Both sides, however, are mistaken to hold this view of insurance. Insurance is no longer a unique financial service. Today it is part of a continuum of financial services and products that are increasingly fungible with one another. None of the current proposals to federalize insurance recognizes the extent to which the boundaries between insurance products and other financial services products have disappeared. As a result, the current proposals will not adequately address the problems facing regulators in the future.

This article will discuss three alternative structures that would place the regulation of insurance in the context of the evolving financial services industry. Each of these structures offers advantages over both the other proposals to federalize insurance and the current system of state regulation. These structures offer several advantages over the current structure and the proposals to federalize insurance, because, among other things, they would better reflect how the financial services industry operates than the existing structure, would reduce the total number of agencies regulating financial services, and would reduce the problem of agency capture. If the United States is going to federalize insurance, it should adopt a structure that recognizes the current realities of

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the financial services industry and not one that memorializes how the industry operated decades ago.

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INTRODUCTION

Since the adoption of the Financial Services Modernization Act of 1999, also known as the Gramm-Leach-Bliley Act (GLBA),¹ Congress has considered several proposals to federalize insurance regulation either by creating a federal charter for chartering insurance companies or by requiring the states to adopt uniform insurance regulations. Insurance is the one area in financial services² in which the states are the primary regulators. Some elements with the insurance sector increasingly find the state regulatory regime cumbersome, confusing and costly.³ They have advocated federal regulation as one means of fixing this problem.

In response to these pressures, members of Congress have announced three different proposals to federalize insurance within the past seven years. These proposals include the Insurance Consumer Protection Act of 2003 (ICPA),⁴ the National Insurance Act

¹ PUB. L. NO. 106-102, §1, 113 Stat. 1338 (1999) (codified at scattered sections of 12, 15, 16, 18 U.S.C.).

² In this article, financial services refers to any of the activities considered financial in nature pursuant to Section 103 of the Gramm-Leach-Bliley Act of 1999 (“GLBA”), which include banking, securities, merchant banking, and insurance products and services. GLBA, 12 U.S.C.S. §1843 (2007)). This definition of financial services is not universally applied by other organizations. For example, the Basel II Capital Accord excludes insurance activities from the definition of “financial activities” and excludes insurance entities from the definition of “financial entities.” BANK FOR INTERNATIONAL SETTLEMENTS, BASEL COMMITTEE ON BANKING SUPERVISION, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS – A REVISED FRAMEWORK 7 n. 5 (June 2004) (hereinafter BASEL II CAPITAL ACCORD).

³ The following organizations have supported some form of federal regulation of insurance: the American Council of Life Insurers (ACLI), the American Insurance Association (AIA), the Council of Insurance Agents and Brokers, the American Bankers Insurance Association (ABIA) and the Financial Services Roundtable. The major opposition to federalizing insurance comes from the following groups: the National Governors' Association, the National Association of Insurance Commissioners (NAIC), the National Conference of Insurance Legislators (NCOIL), the National Conference of State Legislators (NCSL), the Independent Insurance Agents and Brokers of America, the National Association of Mutual Insurance Companies (NAMIC), the National Association of Professional Insurance Agents (PIA), the National Association of Professional Surplus Lines Offices and the Property Casualty Insurers Association of America (PCI). Ethan D. Lenz and Joseph J. Lotus, *Proposed Federal Regulation: A Bird's Eye View of the Battle*, FOCUS ON THE INSURANCE INDUSTRY, FOLEY & LARDNER (Sept. 16, 2006).

⁴ Insurance Consumer Protection Act of 2003, S. 1373, 108th Cong., 1st Sess. (July 8, 2003).

(NIA),⁵ and the State Modernization and Regulatory Transparency Act (the SMART Act).⁶ In addition, in March 2008, the U.S. Department of the Treasury weighed in favor of federalizing insurance regulation in its *Blueprint for a Modernized Financial Regulatory Structure*.⁷

The ICPA and the NIA would allow the federal government to give companies a federal insurance license that would allow them to operate throughout the country rather than obtaining a license from each state in which they want to operate. Both of these acts would essentially recreate the dual banking regulatory structure in the insurance industry context. The Treasury also favored creating an optional federal chartering system. The SMART Act, however, would not create a new federal charter option but would require all states to adopt certain uniform laws regarding market conduct examinations, rules and regulations.

The vast majority of state insurance regulatory regimes and the proposed federal regulation approaches to regulating insurance are fatally flawed. They start from the assumption that insurance is a completely, unique financial service that is so fundamentally different from other financial services, such as banking and securities, that it needs to be regulated by a regulator that is different from the state or federal banking or securities regulators. The comments made by Alessandro Iuppa, the former Maine

⁵ National Insurance Act was first introduced into Congress as the National Insurance Act of 2006, S. 2509, 109th Cong., 2d Sess. (April 5, 2006). Senators John Sununu (R-NH) and Tim Johnson (D-SD) co-sponsored this bill. A companion bill that is virtually identical to this bill was introduced into the House of Representatives by Rep. Edward Royce (R-Cal). NIA was reintroduced to Congress as the National Insurance Act of 2007, S. 40, 110th Cong., 1st Sess. (May 24, 2007) and by Rep. Royce and Rep. Melissa Bean (D-Ill) as H.R. 3200, 110th Cong., 1st Sess (July 25, 2007). The major change between the National Insurance Act of 2006 and that of 2007 is that the 2007 bill makes clear that health insurance is included among the types of insurance that can receive a federal charter. For purposes of this article, NIA will refer to the language in S. 40.

⁶ State Modernization and Regulatory Transparency Act, Staff Discussion Draft (August 18, 2004).

⁷ U.S. Dept. of Treasury, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE (March 2008).

Superintendent of Insurance and President of the NAIC, when he testified before the Senate Committee on Banking, Housing and Urban Affairs on July 11, 2006, reflect this view that insurance is a unique product.⁸ He stated:

[I]nsurance is a unique and complex product that is fundamentally different from other financial services, such as banking and securities. Consequently, the state based system has evolved over the years to address these fundamental differences. Unlike banking products, which provide individuals up-front credit to obtain a mortgage or make purchases, or securities, which offer investors a share of a tangible asset, insurance products require policyholders to pay premiums in exchange for a legal promise rooted in the contractual and tort laws of each state. It is a financial guarantee to pay benefits, often years into the future, in the event of unexpected or unavoidable loss that can cripple the lives of individuals, families and businesses.⁹

The assumption that insurance represents a completely unique financial service is no longer true. Both consumers and regulators find it increasingly difficult to discern meaningful differences among insurance, banking and securities products. From the consumer's standpoint, many of these products are fungible with one another. In addition, the financial services industry is extremely innovative and has produced a myriad of hybrid products in recent years. These hybrid products combine elements of banking and insurance products or securities and insurance products.

⁸ Alessandro Iuppa, Maine Superintendent of Insurance and President of the NAIC, Testimony of the National Association of Insurance Commissioners before the Committee on Banking, Housing, and Urban Affairs, United States Senate regarding "Insurance Regulation Reform", 3 (July 11, 2006). Mr. Iuppa left his position as NAIC president in the middle of his term in 2006 to become the chief lobbyist for Zurich Financial Services Group. J. Robert Hunter, Director, Consumers Federation of America, Statement before Committee on Commerce, Science and Transportation, U.S. Senate 12 (April 11, 2007).

⁹ Iuppa, *supra* note 8, at 3.

Insurance regulation focuses on the same policy objectives that other financial services regulations address: financial solvency and consumer protection.¹⁰ All financial services regulators are concerned to a greater or lesser degree with whether the financial service providers will still exist when it is time to deliver on their contracts and are therefore concerned about regulating prudential risks. Buyers of financial services are not always sophisticated enough to understand the complex financial instruments that they are being offered. As a result, all financial services regulators need to be concerned about consumer protection. The regulatory structure should be organized to focus on regulating for these risks rather than building or reinforcing a regulatory structure around making fine but not particularly helpful distinctions between insurance and other financial products.

This article will outline briefly the history of the current regulatory structure for insurance and the problems that led to calls to federalize insurance in Part II. In Part III, the article will describe in more detail each of the three Congressional proposals that would federalize insurance regulation. Part IV will discuss why treating insurance as unique and fundamentally different from other financial services is a fatal mistake given the problems of defining insurance and the variety of products that straddle the traditional definitions for banking, securities and insurance products. In Part V, the article will outline alternative structures for federalizing insurance that would not rest on viewing insurance as a unique product but would recognize the extent to which it is now fungible with banking and securities products.¹¹

¹⁰ Hal Scott, *Optional Federal Chartering of Insurance: Design of a Regulatory Structure*, Draft Paper 4 (March 2007).

¹¹ As I have indicated in another article, I think that the creation of a single, federal agency, a US Financial Services Agency (“US FSA”), similar to the United Kingdom’s Financial Services Authority

I. THE EXISTING U.S. INSURANCE REGULATORY REGIME: ITS HISTORY, STRUCTURE AND PROBLEMS

To understand the problems of the current structure, one must first look at the history of insurance regulation in the United States, which will provide insight into why the states dominate the insurance regulation of this sector. It will also provide insights as to why some insurance companies are now pushing for federal regulation of insurance.

A. History of U.S. Insurance Regulation

For most of the history of the United States, state and federal regulators have regulated financial services primarily based on the institution providing the financial service or product. This type of regulation is referred to as institutional regulation. The states established separate regulators to regulate first banks, then insurance companies, and later securities firms.

States began regulating insurance during the latter half of the 1800s. The first state board established to regulate insurance was the New Hampshire Board of Insurance Commissioners formed in 1851.¹² In 1873, only 12 states had some form of

(“UK FSA”), would be the best solution to the challenges facing the U.S. financial regulatory regime. Conventional wisdom on the U.S. financial regulatory structure rejects the idea of creating a single, federal agency either on the grounds that it is undesirable because the United States benefits from regulatory competition or that it is politically unfeasible because the United States fears big government and favors federalism. HELEN A. GARTEN, *US FINANCIAL REGULATION AND THE LEVEL PLAYING FIELD* 135-138 (2001) (describes opposition to a single regulator because of a “preference for federalism, fear of big government and faith in the power of regulatory competition”); *Panel I (Part 2): A Comparative Analysis of Consolidated and Functional Regulation: Super Regulator: Keynote Address by Peter R. Fisher, Undersecretary for Domestic Finance, U.S. Department of Treasury*, 28 *BROOK. J. INT’L L.* 455, 458 (2003) (comments that concentrating power in a single regulatory violates U.S. political tradition). I have addressed these objections to a single financial regulator at length in my article, *E Pluribus Unum – Out of Many One: Why the United States Needs a Single Financial Services Agency*, XIV *U. MIAMI BUS. L. R.* 1 (Fall/Winter 2005). In addition, others, including Harvey Pitt, Senator Charles Schumer of New York, and New York Mayor Michael Bloomberg, are beginning to advocate that the United States model its regulation of financial services after the UK FSA. Rachel McTague, *Pitt, Wilson: Unified Regulatory Structure Needed for U.S. Financial Services Industries*, *SEC. L. DAILY* (Oct. 23, 2006); Charles Schumer and Michael Bloomberg, *To Save New York, Look to London*, *WALL ST. J.* (Nov. 1, 2006).

¹² Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 *FLA. ST. U.L. REV.* 625, 630 n. 18 (Spring, 1999).

institutionalized insurance regulation; by 1905, 22 states had such regulation.¹³ State insurance regulation during this period was not exactly effective due, in part, to the fact that many administrators were either corrupt, halfhearted or ineffectual.¹⁴ In addition, no coherent economic theory underlay most insurance regulation. Instead, most regulations were a product of interest group politics and fears on the part of policyholders concerning the economic power of the insurance companies and a belief that such companies were out to defraud the public.¹⁵

State regulations have never been completely consistent or uniform. In fact, as the insurance companies expanded across state lines, some within the industry sought federal regulation as a means of supplanting the burden of complying with different state regulations.¹⁶ It was presumed that federal regulation would be weaker than the existing state regulations.¹⁷ Movement in the direction of seeking federal regulation was halted by the decision of the U.S. Supreme Court in *Paul v. Virginia*, 75 U.S. 169 (1868), that held that “[i]ssuing a policy of insurance was not a transaction of commerce” and, therefore, the federal government lacked the power to regulate insurance under the Commerce Clause.¹⁸

In 1944, however, the U.S. Supreme Court in *United States v. South-Eastern Underwriters Ass’n*, 322 U.S. 533 (1944), reversed its earlier decision in *Paul v. Virginia*

Many of the first commissions were not independent agencies or entities, but were instead comprised of other state officials with other duties. *Lawrence M. Friedman, A History of American Law 2nd ed.*, 443 (1985).

¹³ Friedman, *supra* note 12.

¹⁴ *Id.* at 444.

¹⁵ *Id.* at 443-445.

¹⁶ Randall, *supra*. note 12, at 630.

¹⁷ *Id.*

¹⁸ *Paul v. Virginia*, 75 U.S. 169, 183 (1868).

and instead held that insurance did constitute interstate commerce and was subject to federal regulation under the Commerce Clause.¹⁹

In spite of the decision in *South-Eastern Underwriters*, insurance was the only area of the financial services industry that did not come under at least partial federal regulation as part of the New Deal.²⁰ This circumstance was due largely to the efforts of the NAIC. NAIC, a voluntary body comprised of the insurance commissioners from all of the states, the District of Columbia, and the U.S. territories, viewed the decision in *South-Eastern Underwriters* as an assault on the states' power to regulate insurance and proposed a bill to reserve the power to regulate insurance to the states.²¹ The bill was enacted in 1945 as the McCarran-Ferguson Act²², which provided that federal law would only supersede state law if federal law specifically related to the "business of insurance."²³ NAIC drafted model laws governing insurance with the All-Industry Committee, a group of insurance industry representatives organized by NAIC, and worked to see that most of the states had adopted these laws by the early 1950s.²⁴

In the 1960s, the insolvencies of several property-liability insurers sparked interest to regulate insurance at the federal level.²⁵ Senator Edward Brooke, a Republican from Massachusetts, proposed the Federal Insurance Act, which would have allowed insurers to seek either a federal or a state charter.²⁶ Congress did not enact this proposal. Instead,

¹⁹ United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 552-53 (1944).

²⁰ SHEILA BAIR, CONSUMER RAMIFICATIONS OF AN OPTIONAL FEDERAL CHARTER FOR LIFE INSURERS, 6-9 (2004) (available at <http://www.isenberg.umass.edu/finopmgt/uploads/basicContentWidget/8631/bair-cons-ramifications.pdf>) [also referred to as the "Massachusetts Study"]; Randall, *supra*. note 12, at 633.

²¹ Randall, *supra*. note 12, at 633.

²² Ch. 20, §1, 59 Stat. 33 (1945)(codified 15 U.S.C.S. §1011 (2004)).

²³ Randall, *supra*. note 12, at 633.

²⁴ *Id.* at 634.

²⁵ BAIR, *supra*. note 20, at 7.

²⁶ BAIR, *supra*. note 20, at 7; S. 3884, Federal Insurance Act, introduced Oct. 1976.

in 1969, NAIC proposed model legislation for state guaranty funds.²⁷ By 1982, all 50 states, the District of Columbia, and Puerto Rico had adopted some form of state guaranty fund legislation, although not all of these laws followed the NAIC model act.²⁸ The Federal Insurance Act bill was not the last time that the insurance sector faced the threat of federal regulation of insurance.

The federal government became involved in regulating employer-sponsored retirement plans as well as medical insurance, life and disability insurance following the enactment of the Employee Retirement Income Security Act (ERISA) in 1974.²⁹ ERISA's requirements supersede any other applicable state insurance requirements. ERISA is administered through the Pension Benefit Guaranty Corporation, which is a federal agency that provides insurance to guarantee future pension payments.³⁰

In the 1980s and early 1990s, several insurance company bankruptcies prompted renewed interest in federal regulation of insurance.³¹ In 1990, a report by the House Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce found that the existing state regulations regarding insurance company

²⁷ BAIR, *supra*. note 20, at 7; Insurance Information Institute website, Hot Topics & Issues Update <www.iii.org/media/hot_topics/insurance/insolvencies/> (accessed Dec. 29, 2004).

²⁸ Insurance Information Institute website, *supra*. note 26. For example, New York's law uses a pre-assessment or pre-insolvency method for raising the necessary financing to pay off claims rather than the post-assessment or post-insolvency method proposed in the NAIC model act. *Id.* Under the New York law, the guaranty fund requires each insurance company to pay an amount into the fund based upon a percentage of the net direct premiums written by the company during the year and these funds are held to pay off future claims that may arise if an insurance company becomes insolvent. Under the NAIC model act, the state guaranty fund does not make any assessments until an insurance company becomes insolvent and then only assesses the amount needed from the other insurance companies to pay the claims of the policyholders of the insolvent company. In addition, the NAIC model act does not create a state guaranty fund for annuities, life, disability, accident and health, surety, ocean marine, mortgage guaranty, and title insurance, but some state guaranty funds do cover claims against companies that do write these types of insurance. *Id.*

²⁹ BAIR, *supra*. note 20, at 7.

³⁰ KENNETH J. MEIER, THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE 39 (State University of New York Press, Albany: 1988).

³¹ Jonathan R. Macey and Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U.L. REV. 13, 15 (April, 1993).

solvency were inadequate.³² Representative John Dingell, a Democrat from Michigan, proposed creating a dual system for insurance company solvency regulation, including the creation of a federal guaranty fund for federally chartered insurance companies.³³ This proposal also failed to be enacted after NAIC and the many states adopted risk-based capital requirements for insurers similar to the banking requirements, a financial regulation accreditation program, and an initiative to codify statutory accounting principles.³⁴

As a result of the decline in profitability of commercial banking, commercial banks sought to expand their products and services into more profitable financial services.³⁵ Beginning in 1983 with South Dakota, many states liberalized the rules governing state banks to permit them to carry on insurance activities.³⁶ In 1991, Congress adopted the Federal Deposit Insurance Corporation Improvement Act³⁷ that prohibited banks from engaging in insurance underwriting even if permitted under state law. The Office of the Comptroller of the Currency (OCC) in the U.S. Treasury Department through an interpretative release allowed national banks to sell annuities and act as an Insurance agent if located in a town with less than 5,000 residents.³⁸

³² BAIR, *supra*. note 20, at 8; U.S. House, Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, Failed Promises: Insurance Company Insolvencies, 1990 (also known as the “Dingell Report” after Representative John Dingell, a Democrat from Michigan, who was the principal author of the report).

³³ BAIR, *supra*. note 20, at 8.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.*

³⁷ Pub. L. No. 102-242, §303, 105 Stat. 2236, 2350 (codified 12 U.S.C.S. §1831a).

³⁸ 12 C.F.R. §7.1001; OCC Interpretive Letter No. 753 (Nov. 4, 1976).

B. The Current Regulatory Structure

In 1999, Congress enacted the GLBA, which repealed portions of the Glass-Steagall Act of 1933³⁹, the Bank Holding Company Act of 1956⁴⁰ and other laws in order to permit banks, securities firms, insurance companies, and other entities engaged in the provision of financial services to become affiliated with one another in order to form financial conglomerates⁴¹ that would enable them to cross sell each other's products and services. With GLBA, Congress essentially ratified the movement away from institutional regulation towards functional regulation and the dismantling of the barriers between banks, securities firms, and insurance companies that had already begun to take place through rulemaking by the existing state and federal financial service regulatory agencies.⁴²

Functional regulation focuses on the products or services being offered rather than the institution offering them to determine which regulator ought to regulate the products or services. For example, under GLBA, Congress envisioned the SEC regulating

³⁹ The Glass-Steagall Act is the name given to four sections of the Banking Act of 1933, Ch. 89, 48 Stat. 162 (1933). GLBA repealed Section 20 of Glass-Steagall, which prevented any Federal Reserve member bank from being affiliated with an entity principally engaged in securities and Section 33, which banned interlocking managements between Federal Reserve member banks and securities firms. GLBA, 12 U.S.C.S. §377(a) and 12 U.S.C.S. §78(b)(2004).

⁴⁰ Ch. 240, 70 Stat. 133 (1956) (codified at 12 U.S.C. §§1841-49).

⁴¹ The Basel Committee on Banking Supervision and the Joint Forum on Financial Conglomerates defines financial conglomerates as "any group of companies under common control whose exclusive or predominant activities consist of providing significant services in at least two different financial sectors." TRIPARTITE GROUP OF BANK, SECURITIES, AND INSURANCE REGULATORS, THE SUPERVISION OF FINANCIAL CONGLOMERATES ¶136 (July 1995). This article will use this definition when referring to financial conglomerates. Financial conglomerates are distinguishable from "mixed conglomerates", in which groups of commercial or industrial enterprises include a financial institution as part of their structure. *Id.* While mixed conglomerates may raise some of the same regulatory and supervisory issues as financial conglomerates, such concerns are beyond the scope of this article.

⁴² For example, investment banks attempted to offer products and services similar to those offered by commercial banks when they created products, like money market accounts, that mimicked the features of demand deposits offered by banks and began to invest in nonbank banks, which could make commercial loans like banks but could not accept deposits. See *infra.* text accompanying notes 150-154. Beginning in the 1980s, commercial banks were allowed to offer some investment banking services and to provide insurance. See *infra.* text accompanying notes 155-157.

investments in securities regardless of whether the investment services were offered through a bank or through an independent brokerage firm. Under the institutional regulatory regime, banking regulators traditionally regulated securities offered through banks.

Under GLBA, Congress, however, left insurance regulation primarily in the hands of the state insurance commissions. Section 104 of the GLBA reaffirmed that the states would retain control over the regulation of insurance products and services.⁴³ GLBA did put a few limitations on the otherwise unfettered ability of the states to regulate insurance. For example, GLBA §104(c) prohibits states from preventing or restricting a depository institution or an affiliate of such institution from being affiliated with any person except in certain limited circumstances related to insurers.⁴⁴ GLBA permits states to still collect, review and take actions (including the approval or disapproval) on applications concerning the proposed acquisition of, or change or continuation of control of, an insurer domiciled in the state, or to require a person seeking to acquire control of an insurer to maintain or restore the insurer's capital requirements under the state's capital regulations, or to restrict the change in control in the ownership of stock in the insurer, or a company formed for the purpose of controlling the insurer, after the insurer has converted from a mutual to a stock form so long as such restrictions do not discriminate against depository institutions or their affiliates.⁴⁵

⁴³ GLBA §104.

⁴⁴ GLBA §104(c).

⁴⁵ GLBA §104(c)(2). In the event of a dispute between federal regulators and state insurance regulators regarding insurance, GLBA provided for a dispute resolution mechanism under which either the federal or the state regulator may seek expedited review from the U.S. Court of Appeals for the circuit in which the state is located or from the U.S. Court of Appeals for the D.C. Circuit. GLBA §304, 15 U.S.C.S. 6714 (2004).

GLBA also required states to establish uniform or reciprocal requirements for licensing of insurance agents.⁴⁶ GLBA mandated that the NAIC had to determine whether a majority of states had to meet this requirement within three years after the enactment of GLBA.⁴⁷ If NAIC was unable to do so, then the National Association of Registered Agents and Brokers (NARAB) would be established as a non-profit corporation to act as a mechanism through which “uniform licensing, appointment, continuing education, and other insurance producer sales qualification requirements and conditions” could be adopted.⁴⁸

Perhaps not surprising, when given a choice between reciprocity and uniformity, the states chose reciprocity over uniformity.⁴⁹ Reciprocity only required that states accept the licensing decisions of other states, even though their requirements might be different, while uniformity would have required the same set of requirements to be applied by the states. As of December 29, 2004, NAIC had certified 41 states as meeting the reciprocity requirements under the GLBA.⁵⁰

Nevertheless, major states, like California, New York and Florida, still have not complied with the reciprocity requirements.⁵¹ The major stumbling blocks against reciprocity between all 50 states concern fingerprinting and surplus lines bond

⁴⁶ §321, 15 U.S.C.S. 6751 (2004).

⁴⁷ *Id.*

⁴⁸ §322-323, 15 U.S.C.S. 6752-6753 (2004).

⁴⁹ Richard J. Hillman, Director, Financial Markets and Community Investment, General Accounting Office, Testimony Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives, State Insurance Regulation: Efforts to Streamline Key Licensing and Approval Processes Face Challenges 2 (June 18, 2002).

⁵⁰ Responding to the NARAB Requirement <<http://www.naic.org/GLBA/narab.htm>> (accessed Dec. 29, 2004).

⁵¹ *Id.*

requirements for nonresident producers, which are considered important consumer protection issues in the states that require them, particularly California and Florida.⁵²

Finally, GLBA permitted banks, securities firms, insurance companies and other entities engaged in financial services to become affiliated under the umbrella of a financial holding company (FHC) and to cross sell each other's products.⁵³ GLBA designated the Federal Reserve, which supervises bank holding companies, to become the supervisor for the FHCs.⁵⁴ The vast majority of the companies registered as FHCs had previously been bank holding companies before the enactment of GLBA.⁵⁵

Only a few insurance firms that had not previously been affiliated with a commercial bank before the enactment of GLBA, elected to become FHCs.⁵⁶ MetLife falls into this category.⁵⁷ Many of the largest financial conglomerates with substantial insurance businesses have not registered as FHCs, including American International Group.⁵⁸ Just because insurance companies are not registering as FHCs does not mean that they are engaging in a range of financial services. For example, at least 34 insurance companies have entered into banking related activities by acquiring thrifts.⁵⁹

GLBA specified that FHCs may engage in certain activities that are financial in nature, including securities underwriting and dealing, insurance underwriting, insurance

⁵² *Id.*

⁵³ GLBA, §103(a), 12 U.S.C.S. §1843(k) (2004).

⁵⁴ *Id.*

⁵⁵ *Id.* at 3.

⁵⁶ *Id.*

⁵⁷ *Id.*

⁵⁸ Financial Holding Companies as of August 6, 2004, Federal Reserve Board <www.federalreserve.gov/generalinfo/fhc/> (accessed Aug. 12, 2004); INSURANCE INFORMATION INSTITUTE AND THE FINANCIAL SERVICES ROUNDTABLE, THE FINANCIAL SERVICES FACT BOOK 2003 9 (2003) (hereinafter FINANCIAL SERVICES FACT BOOK 2003). In fact, only two the top ten companies classified as diversified financials by Fortune have registered as FHCs. Financial Holding Companies as of August 6, 2004, Federal Reserve Board <www.federalreserve.gov/generalinfo/fhc/> (accessed Aug. 12, 2004).

⁵⁹ FINANCIAL SERVICES FACT BOOK 2003, *supra* note 58.

agency activities, and merchant banking.⁶⁰ A FHC also may engage in any activity that the Federal Reserve, in consultation with the Secretary of the Treasury, determines to be financial in nature, incidental to finance, or complementary to a financial activity, provided that such activity does not pose a substantial risk to the safety and soundness of the FHC.⁶¹

C. Why the Current System Has Led to Calls for Federal Action

While the federal government attempted to move away from institutional regulation to functional regulation by enacting GLBA, state insurance commissions as the primary insurance regulators generally were free to retain their institutional regulatory regimes. With the exception of Michigan, no state has attempted to move away from an institutional regulatory regime towards a functional regulatory regime or a risk-based regulatory regime.⁶² Allowing states almost exclusive authority to regulate insurance using an institutional regulatory regime has created numerous problems that have led some financial service firms to advocate for federal regulation of insurance.

Three major problems with the current system are spurring some elements of the insurance industry to seek federal regulation. Under the current system, insurance providers deal with: (1) regulations that sometimes lack uniformity and at other times are duplicative, (2) long time commitments to obtain regulatory approvals, and (3) significant compliance costs.

⁶⁰ GLBA, §103 (codified at 12 U.S.C.S. 1843 (2004)).

⁶¹ *Id.*

⁶² The Michigan Office of Financial and Insurance Services (“OFIS”) employs a risk-based regulatory model, in which it structures its divisions based upon the risks that they are seeking to control. As a result, it has a division that is concerned with regulating prudential risks and another one that is concerned with regulating market conduct risks.

To understand how these problems affect financial service firms, imagine for a moment that an entrepreneur who wants to start a financial services company that will provide a new product that he refers to as “home equity insurance”.⁶³ This product would allow homeowners to protect against adverse fluctuations in the value of their home. He believes that there is a market for this product given that for most Americans their home is their largest asset and the instability in the real estate market in certain areas across the United States. As a result, he wants to be able to offer it nationwide.

1. The Current Regulations Lack Uniformity and Sometimes are Duplicative

The entrepreneur will immediately be befuddled by the lack of uniformity among state insurance regulatory regimes. In order to offer this product in all 50 states and the District of Columbia, the entrepreneur will need to determine if this product meets the definition of insurance in all of those jurisdictions.⁶⁴ Determining whether his new product qualifies as insurance in all 50 states is not an easy process because no clear, universally accepted definition for insurance exists. Several states do not even try to define insurance within their statutes.⁶⁵ In those states, one must look to state common

⁶³ Home equity insurance has only been offered in about 10 locations within the United States, five in the Chicago area including Oak Park, Illinois in the 1970s, one in Baltimore, Maryland, two in Missouri, one in Syracuse, New York and one in Pittsburgh, Pennsylvania. Andrew Caplin et al, *Home Equity Insurance: A Pilot Project* (Yale Int’l Ctr. For Fin. Working Paper No. 03-12, 2003); C. Theodore Koebel, Robert E. Lang, and Karen A. Danielson, COMMUNITY ACCEPTANCE OF AFFORDABLE HOUSING: REPORT TO THE NATIONAL ASSOCIATION OF REALTORS 34 (Center for Housing Research and Metropolitan Institute, Virginia Tech: June, 2004) [available at: [http://www.realtor.org/Research.nsf/files/koebellangfr.pdf/\\$FILE/koebellangfr.pdf](http://www.realtor.org/Research.nsf/files/koebellangfr.pdf/$FILE/koebellangfr.pdf)]. Usually, it was offered by nonprofit corporations, who were seeking to revitalize distressed neighborhoods by alleviating some of the concern that people had about losing money on the resale of their homes. In order for it to be more widely offered, it needs to be provided by private insurance companies. It may require states to change their insurance laws in order to permit its sale. Koebel, et. al., *supra*, at 35. Right now only Illinois has adopted a law to make it widely available. *Id.*

⁶⁴ Caplin, *supra* note 63. New York ultimately concluded that home equity insurance was not insurance as New York defined it and so did not need to be licensed as such in New York.

⁶⁵ Appleman on Insurance 2d §1.3 (2007)

law for how the courts have defined insurance.⁶⁶ In those states that do define insurance or a contract of insurance within their statutes, many of the definitions are generally short and cryptic. The California Insurance Code, for example, defines insurance as “a contract whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event.”⁶⁷ This definition is extremely broad and could encompass a variety of other financial services products. Guaranties, warranties, suretyships, indorsements, pledges, mortgages, conditional sales, indemnity and insurance all have the common purpose of protecting someone from harms of possible future events.⁶⁸ Not all of these products, however, are regulated by state insurance commissioners.

How states define insurance within their statutes vary widely. New York defines an insurance contract as "any agreement or other transaction whereby one party, the ‘insurer’, is obligated to confer benefit of pecuniary value upon another party, the ‘insured’ or ‘beneficiary’, dependent upon the happening of a fortuitous event in which the insured or beneficiary has, or is expected to have at the time of such happening, a material interest which will be adversely affected by the happening of such event.”⁶⁹ New York further defines fortuitous event as “any occurrence or failure to occur which is, or is assumed by the parties to be, to a substantial extent beyond the control of either party.”⁷⁰ Given these differences in how insurance is defined, states sometimes disagree over whether a particular product should be regulated as insurance, securities or banking products.

⁶⁶ *Id.*

⁶⁷ Cal. Ins. Code §22 (2007)

⁶⁸ Appleman, *supra* note 65.

⁶⁹ NY CLS Ins § 1101 (2007).

⁷⁰ *Id.*

If the entrepreneur determines that some states will consider the product to be insurance, then he has to contend with a confusing series of licensing and post-licensing requirements for both the firm offering the product and for the product in each of the 50 states⁷¹ The exact type of licenses required varies from state to state. Some states issue a general insurance producer license while others issue licenses for each different type of producer, such as individual licenses for agents, brokers, solicitors, consultants, and reinsurance intermediaries.⁷² Traditionally, states have operated their insurance commissions as regulatory monopolies. Other than the periodic threats by the federal government that it will begin regulating insurance if the states fail to adopt reciprocal or uniform licensing requirements, the states have had few incentives change their licensing procedures. If a company wants to offer insurance in a particular state, the company must comply with the licensing and post-licensing regulations for that state.

In addition to requiring different types of licenses, states require potential new insurance producers to fulfill a range of requirements when completing their applications. In some cases, these variations among the states' applications are due to important differences on policy questions. New York and California require criminal background checks before allowing a person to sell insurance within their borders but many other states do not require such checks.⁷³ In other cases, these variations have little or no rational basis. Insurance companies in Nevada must use pink paper when filing the documentation page for a filing fee.⁷⁴ Some states, such as Kentucky, Iowa and Ohio,

⁷¹ National Association of Insurance Commissioners, 2006 Insurance Department Resources Report 1 (2007). (hereinafter NAIC 2006 REPORT) at 59.

⁷² *Id.*

⁷³ Hillman, *supra* note 49 at 2.

⁷⁴ Andrew G. Simpson, *Leave-No-State-Regulation-Behind*, INS. J. (Sept. 6, 2004).

will return filings if they have not been stapled in the prescribed manner or assembled in the prescribed order.⁷⁵

Forty-one states do grant some form of reciprocity if a company has been granted a license in another state.⁷⁶ States with major markets, like California, New York and Florida, however, have not signed on to these reciprocity agreements.⁷⁷ These reciprocity agreements also do not extend to post-licensing requirements.⁷⁸

In 2004, the University of Massachusetts Isenberg School of Management completed a study (the “Massachusetts Study”), which found that the multiple state reviews resulted in duplicative and inefficient regulatory of efforts among the states.⁷⁹ States have attempted to justify these duplicative reviews as necessary to protect consumer, but the Massachusetts Study concluded that the extremely high caseloads for staff assigned to review producer licensing applications indicated that these applications may only be receiving a cursory review.⁸⁰ On average, staff member had to review 1,284 new applications per year.⁸¹ Such cursory reviews may fail to alert staff regarding producer problems, which is troubling given that producer misconduct generates the largest volume of complaints.⁸²

⁷⁵ *Id.*

⁷⁶ Responding to the NARAB Requirement <<http://www.naic.org/GLBA/narab.htm>> (accessed Dec. 29, 2004).

⁷⁷ Hillman, *supra* Note 49.

⁷⁸ *Id.*

⁷⁹ BAIR, *supra*. note 20, at i-ii. The study was funded by unrestricted grants from MassMutual, Equitable Life, Lincoln National Life, Northwestern Mutual, Principal Financial Group, Prudential Life Insurance, and the American Council of Life Insurers. The study identified several major problems with the existing state system of insurance regulation. The study focused solely on life insurance and not the other forms of insurance, although it did concede that other insurers, particularly property and casualty insurers, faced many of the same regulatory inefficiencies.

⁸⁰ *Id.*

⁸¹ *Id.*

⁸² *Id.*

The process might be a bit easier in the future for life insurance, annuities, disability income, and long-term care insurance because the Interstate Insurance Product Regulation Commission (IIPRC) began operating on June 2, 2007 and covers these products.⁸³ The IIPRC was formed under the Interstate Insurance Compact proposed by NAIC.⁸⁴ The IIPRC provides a central filing point for seeking license for insurance products from the states that are parties to the Interstate Insurance Compact.⁸⁵ The IIPRC, however, had to rely on product filing examiners and other staff, who are on loan from member states, until it hired its permanent staff, which it hoped to do so by the end of 2007.⁸⁶ In addition, only 29 states plus Puerto Rico have signed the Interstate Insurance Compact and once again the states with the largest insurance markets, New York, California, Connecticut and Florida, are not signatories to this agreement.⁸⁷ It may be some time before an assessment can be made as to whether the IIPRC has significantly improved the process for obtaining product licenses.

2. The Current System is Time Consuming

In addition to having to complete multiple producer licensing and product licensing applications, the entrepreneur will find that it may take up to two years under normal circumstances to have all of the state insurance regulators review and approve the company's applications.⁸⁸ While the NAIC has made the adoption of national, uniform

⁸³ Interstate Insurance Compact Open for Business, NAIC News Release (June 2, 2007).

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

⁸⁸ Ruth Gastel, *Optional Federal Charter*, Insurance Information Institute Insurance Issues Update (Aug., 2003); Rep. Richard H. Baker, *Insurance Product Approval: The Need for Modernization*, U.S. House of Representatives, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services (June 21, 2001).

regulations one of its goals, the states have not made significant progress towards developing such regulations.⁸⁹ Reciprocity arrangements that a majority of states adopted in the wake of GLBA, have shortened the time that it takes to complete the non-resident producer licensing process.⁹⁰ Nevertheless, the Massachusetts Study found that in 2003 insurers reported that in the five largest states in which they did business, it took them 6 to 9 months to get a product approved.⁹¹

If it takes two years for traditional insurance products to be approved by all the state regulators, it may take even longer to get innovative products approved, particularly if they are hybrid financial products that have characteristics similar to traditional banking or securities products.⁹² Hybrid products may require the approval of the federal or state banking or securities authorities in addition to the approval of the state insurance commissioners.⁹³

The problems caused by the licensing delays particularly disadvantage smaller insurance companies. These delays hinder the ability of smaller companies to expand operations.⁹⁴ Survey data indicate that under the current system, regulatory costs are proportionately higher for small insurers.⁹⁵

Licensing delays discourage some forms of product and regulatory innovation. Some products are not brought to market because the costs of overcoming the initial regulatory

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ *Id.*

⁹² The program that offered the home equity insurance in Syracuse, New York had to ensure that it complied both with New York's insurance regulations and New York's banking laws. Caplin, *supra* note 63 at 24-26. For example, the program could not include the home equity insurance policy as part of the mortgage contract because that would have violated New York's banking restrictions against Price-Level Adjusted Mortgages. *Id.* at 25.

⁹³ *Id.* at 25. For example, the program could not include the home equity insurance policy as part of the mortgage contract because that would have violated New York's banking restrictions against Price-Level Adjusted Mortgages.

⁹⁴ *Id.*

⁹⁵ *Id.*

approvals are high, but once they have been overcome other firms may easily copy the product and sell it themselves. In these instances, the first mover bears the bulk of the costs while later movers reap the rewards. In addition, difficulties and time delays in securing form filing approvals inhibits the ability of life insurers to modify products in response to consumer demand and impairs competition with banks and securities firms which do not have to undergo advance merit review of permitted product offerings.

Home equity insurance is an example of a product, which has had its development hampered by the present regulatory structure.⁹⁶ For most Americans, the equity that they own in their home is their largest asset. Nevertheless, the average family has almost no access to any form of insurance to protect against drops in the value of the home. There have been ten programs through which home equity assurance or home equity protection have been offered, including one in Oak Park, Illinois in the 1970s and Syracuse, New York beginning in 2002.⁹⁷ These programs were sponsored by nonprofit corporations that sought to revitalize distressed neighborhoods by alleviating some of the concerns that people had about losing money on the resale of the homes. Under the Oak Park program, policies would pay out based on the difference between the insured value of the home and the actual sales value of the home.⁹⁸ Under the Syracuse program, policies would pay out based on changes in a house price index rather than based on the price for which the house actually sold.⁹⁹

⁹⁶ Caplin, *supra* note 63.

⁹⁷ *Id.* at 3 and 5.

⁹⁸ *Id.* at 5.

⁹⁹ *Id.* at 1-2.

One of the difficulties encountered by the Syracuse program was whether New York would classify the home equity policy as insurance or as a mortgage.¹⁰⁰ The program ultimately received an opinion letter from the New York State Insurance Commission that the product failed to meet New York's definition of insurance, which required that the insurer pay upon the "happening of a fortuitous event in which the insured has . . . a material interest which will be adversely affected by the happening of such event."¹⁰¹ The Insurance Commission concluded that the sale of a home was not a "fortuitous event" because the homeowner controlled when he sold and that the homeowner lacked a "material interest" because he did not have a material interest in the index upon which the pay out would be based.¹⁰² The Syracuse program also ran into regulatory difficulties when it attempted to write the home equity policy directly into the mortgage for the home as this violated New York banking regulations against Price-Level Adjusted Mortgages.¹⁰³ The Syracuse program also determined that the home equity policy did not qualify as a security because it was protecting against a loss rather than in anticipation of making a profit.¹⁰⁴

3. The Current System is Expensive

The entrepreneur who was seeking to obtain the state licenses necessary to offer home equity insurance throughout the United States would have to pay a variety of fees and taxes to each of the states. Most states use these fees and taxes to cover the budgets

¹⁰⁰ *Id.* at 24-26.

¹⁰¹ *Id.* at 25.

¹⁰² *Id.*

¹⁰³ *Id.* at 26. A Price-Level Adjusted Mortgage is a mortgage that adjusts the principal of the mortgage based on an index, like inflation. *Id.* at 26 n. 14.

¹⁰⁴ *Id.* at 27.

of their insurance regulators. The states within the United States pay in aggregate considerably more than any other developed country to regulate insurance. It is questionable whether, with these higher costs, the United States is getting a proportionally better regulatory regime for its money. The UK FSA included in its Annual Report 2004/05 data that it had collected from the regulatory authorities in Australia, Canada, France, Germany, Hong Kong, Ireland, Singapore, Sweden and the United States concerning how much each spent to operate their financial regulatory agencies.¹⁰⁵

According to the data collected by the UK FSA for comparison with its 2004/05 fiscal year that was from April 1, 2004 to March 31, 2005, the total annual regulatory costs incurred by the states within the United States to regulate insurance were approximately \$1.03 billion, or 19.5 times more than the total annual insurance regulatory costs for the UK FSA, which were \$52.9 million, and 29.4 times more than the total annual insurance costs for Germany's BaFin, which were \$35.1 million.¹⁰⁶

¹⁰⁵ UK FSA, Annual Report 2004/05, 111-113 (2005). The UK FSA raised the following caveats regarding the comparability of the data collected: (1) the figures do not necessarily relate to the same accounting period and may not have been compiled on the same basis; (2) labor and other costs vary between countries; (3) variations in exchange rates will affect the results expressed in a single currency; (4) the scope of the responsibility of the regulatory authorities differ from one country to the next; and (5) material differences in the size and nature of the financial services industries in each country exist. *Id.*

¹⁰⁶ UK FSA, ANNUAL REPORT 2004/05, 111-113 (2005). The amounts cited in the report were in pounds. The total insurance regulatory costs for the United States were £546 million, the total insurance regulatory costs for the United Kingdom were £28 million, and the total insurance regulatory costs for Germany were £18.6 million. The UK FSA indicated that, in most cases, the exchange rate used to convert the amounts into pounds was the rate available on March 31, 2005, although it did not provide the exact U.S. dollar-pound exchange rate that it used. For purposes of this paper, the exchange rate used to convert the amounts cited in the UK FSA's report back into dollars was the U.S. dollar-pound exchange rate for March 31, 2005 of \$1.8888 = £1, which was recorded by the Federal Reserve in its Federal Reserve Statistical Release, *United Kingdom Historical Rates* <www.federalreserve.gov/releases/H10/Hist/dat00_uk.htm> (released dated Nov. 9, 2006). The U.S. total cited in the report was based on information provided by NAIC.

In its 2004 Insurance Department Resources Report, NAIC reported that the total insurance regulatory costs for 2004 were \$1.12 billion. NAIC, INSURANCE DEPARTMENT RESOURCES REPORT 2004, 46 (2005) [hereafter, "NAIC RESOURCES REPORT 2004"]; This amount, however, overstates the actual insurance regulatory costs because it includes the entire budget for the Michigan Office of Financial and

The differences in the regulatory costs cannot be accounted for solely by the size of the insurance markets among these nations. During roughly the same period, the total insurance premiums in the United States equaled approximately \$1.2 trillion, which was 5 times more than the \$241 billion in total premiums in the United Kingdom and 6 times more than the \$195 billion total premiums in Germany.¹⁰⁷

Simply looking at the amount that the government spends to regulate financial services underestimates the total costs to the United States of the current regulatory regime because it does not capture how much more companies and individuals must pay to operate within the system. The regulatory costs are a fraction of the fees, assessments and taxes that the state and federal governments charge financial service firms. For example, in 2006, state insurance department budgets totaled \$1.2 billion but the total revenues generated from fees, assessments, fines, penalties and taxes assessed by states on insurance companies totaled \$16.7 billion.¹⁰⁸ The state insurance department budgets represented only 7.2 percent of the total revenues generated.

In 2006, the total number of domestic insurers (insurers domiciled in the state in which the business is written) in the 50 states and the District of Columbia equaled 7,660, or an average of 139 domestic insurers per state.¹⁰⁹ The state with the fewest number of domestic insurers in 2006 was Wyoming with five and the state with the largest number

Insurance Services, the entire budget for the Florida Department of Financial Services, and the entire budget for the West Virginia Office of the Insurance Commissioner. All of these agencies regulate more than insurance.

¹⁰⁷ UK FSA, ANNUAL REPORT 2004/05, 111-113 (2005). The UK FSA used data from 2003 for Germany's premiums and for the premiums for general insurance, excluding life insurance. The UK FSA used 2004 for the life insurance premiums in the United Kingdom and for the U.S. insurance premiums.

¹⁰⁸ NAIC, INSURANCE DEPARTMENT RESOURCES REPORT 2006, 29 and 32 (2007) [hereafter, "NAIC RESOURCES REPORT 2006"].

¹⁰⁹ *Id.* at 46.

of domestic insurers in 2006 was Vermont with 585.¹¹⁰ Traditionally, New York was the state with the largest number of domestic insurers but in 2005, Vermont surpassed New York.¹¹¹ Vermont surpassed New York because New York lost over 50 domestic insurers between 2004 and 2005 and Vermont gained domestic insurers as a result of a concerted effort to market itself as a haven for businesses that wanted to set up captive insurance companies.¹¹² The captive insurance sector is one of the 10 largest employers in the Vermont and the premiums paid account for 2% of Vermont's state budget.¹¹³

The number of foreign insurers (insurers domiciled in a state different from the state in which the business is written) is larger than the number of domestic insurers in every state. The ratio of foreign insurers to domestic insurers ranges from 1.7 to 1 in Vermont and New York to 280 to 1 in Wyoming.¹¹⁴ On average, 1,279 foreign insurers operate in each state, which means that, on average, foreign insurers comprise a little over 90 percent of the total number of insurers in a state.¹¹⁵

If one assumes that states generally charge the same taxes, fees, assessments, fines and penalties to foreign insurers as to domestic insurers, than states raise \$15.0 billion of the \$16.7 billion in total revenue that states earn from taxes, fees, assessments, fines, penalties and other sources from foreign insurers.¹¹⁶ About 80% of the total revenue

¹¹⁰ *Id.* The top five states based on the number of domestic insurers were: Vermont (585), New York (576), Florida (569), Texas (466), and Wisconsin (384). *Id.*

¹¹¹ NAIC, INSURANCE DEPARTMENT RESOURCES REPORT 2005, 46 (2006) [hereafter, "NAIC RESOURCES REPORT 2005"]

¹¹² NAIC RESOURCES REPORT 2004, *supra* note 105; NAIC RESOURCES REPORT 2005, *supra* note 110, at 46; Lynnley Browning, Vermont Becomes "Offshore" Insurance Haven, NY TIMES (April 4, 2007). Captive insurance companies are subsidiaries of corporations that insure various aspects of their business.

¹¹³ Browning, *supra* note 112.

¹¹⁴ NAIC RESOURCES REPORT 2005, *supra* note 111, at 46.

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 31 and 46.

generated is from premium, retaliatory, franchise and income taxes paid by insurers.¹¹⁷ Licensing and examination fees and assessments comprise only about 16.4% of the total revenue generated by states.¹¹⁸ If insurers only had to pay fees and assessments in the state in which they were domiciled, then they would save roughly \$1.6 billion annually.

A study commissioned by the American Council of Life Insurers found that creating an optional federal charter system would result in a potential cost savings of \$5.7 billion by reducing the net premiums paid by insurance companies by 1.25%.¹¹⁹ This study was based on an analysis of 284 life insurance entities (134 groups and 150 unaffiliated insurers) that had a total of \$3.8 trillion in assets.¹²⁰

In order to assess the total costs for the current regulatory regime, however, the amount spent by firms and individuals to comply with the regulatory requirements of the system must also be taken into account. Fees and taxes only comprise a fraction of those costs. The costs incurred by companies in the insurance sector to complete state licensing requirements are illustrative.

The Massachusetts Study determined how much it costs life insurance companies on average to become licensed in another state, to license a producer in another state, and to license a product in another state.¹²¹ The industry survey data showed that life insurers now spend 65% of their regulatory dollars on “front-end” regulation presumably due to the need to deal with multiple jurisdictions in company and producer licensing and

¹¹⁷ *Id.* at 32.

¹¹⁸ *Id.*

¹¹⁹ Steven W. Pottier, Associate Professor of Insurance, Terry College of Business, University of Georgia, State Regulation of Life Insurers: Implications for Economic Efficiency and Financial Strength, Prepared for the American Council of Life Insurers, Executive Summary 2 (May 30, 2007).

¹²⁰ *Id.*

¹²¹ BAIR, *supra*. note 20, at 31 and 51-52. Out of 383 companies in the life insurance business that were sent the survey, 129 companies responded.

product filings.¹²² In addition, according to the respondents, the average cost per company of licensing in an additional state was \$8,673 while the average cost per fleet of licensing in another state was \$23,279.¹²³ The average cost of producer licensing in another state per fleet \$136 per agent, or a total of \$28,199, and per company was \$36 per agent, or a total of \$11,280.¹²⁴ The average cost of licensing another product in another state was \$12,348 per fleet and \$4,715 per company.¹²⁵ About 66 percent of the respondents to the survey considered the current state regulatory structure for insurance to impose barriers to entry, particularly for small firms.¹²⁶

The significant costs involved, both in terms of time and money, for a company to get licensed as an insurance provider and to get its products licensed have created substantial barriers to entry in the insurance industry. These barriers protect existing insurance providers from competition and deprive consumers of lower cost products and more innovative products. In addition, insurance companies will attempt to pass along to their business and consumer clients the costs that they incur to comply with the existing regulatory regime in the United States.¹²⁷ Thus, consumers and the U.S. economy as a whole pay a large price for the current state regulatory structure for insurance.

II. BRIEF SUMMARIES OF THE PROPOSALS FOR FEDERALIZING INSURANCE

Congress has considered three very different proposals to federalize insurance because of the problems with the current state insurance regulatory structure. All of these

¹²² Bair, *supra* note 20, at i-ii.

¹²³ *Id.* at 51.

¹²⁴ *Id.*

¹²⁵ *Id.*

¹²⁶ *Id.*

¹²⁷ Pottier, *supra* note 119, at 2.

proposals would give Congress and the federal government a large say regarding the regulation of insurance firms and products in the future if they were enacted. Since each bill is over 280 pages long, the following descriptions of the proposals will only touch on the major provisions of each.

These proposals try to address the problems in the current state system that some elements of the insurance industry have identified. Each proposal attempts create a set of uniform laws to govern insurers. Each proposal tries to create a licensing process that would provide a single filing point for charter and product license applications. They use very different means to achieve these common goals.

A. State Modernization and Regulatory Transparency Act (the SMART Act”)

Rep. Michael Oxley (R-OH) and Rep. Richard Baker (R-LA) conceived of the SMART Act as a means of getting the states to overcome the lack of uniform regulations and the high costs of the state regulation of insurance.¹²⁸ Rep. Oxley tried to model the SMART Act after those provisions in the GLBA that threatened to create a federal regulator within a fixed timeframe if the states failed to enact certain types of laws and regulations.¹²⁹ Those provisions in GLBA spurred the states to enter into reciprocity agreements that reduced the number of state licensing applications that insurers had to file.

The SMART Act would not have created a federal insurance agency to regulate insurance, but it would have created the National-State Insurance Coordination

¹²⁸ Rep. Oxley Outlines Road map to State-Based Insurance Regulatory Reform, States News Service (March 15, 2004).

¹²⁹*Id.*

Partnership.¹³⁰ The Partnership would have had seven commissioners, a chairman, three commissioners selected by the states, and three commissioners from the federal government.¹³¹ The chairman would be nominated by the states and appointed by the President. The three federal commissioners would be the representatives from the Department of Treasury, the Securities and Exchange Commission and the Federal Reserve. The commissioners would serve for seven years.¹³² The Partnership would have no regulatory authority but would provide a forum for state and federal regulators to coordinate efforts to promote uniform regulations and mediate conflicts.¹³³

The SMART Act, if it had been enacted, would have required the states to adopt the NAIC model laws regarding market conduct within three years or have those model acts become law at the end of the three year period automatically and preempt any contradictory laws.¹³⁴ It also required states to adopt the NAIC model laws governing licensing of insurers, producers, and reinsurers within two to three years or have their laws be preempted and the NAIC laws put in their place at the end of specified timeframe.¹³⁵ In addition, the SMART Act would have required the states to end their regulation of rates after two years.¹³⁶

The SMART Act was never even introduced into Congress as a bill. The response to it from the insurance industry was mixed and the states opposed it. What really doomed its introduction, however, was its questionable constitutionality. The U.S. Supreme Court in *New York v. United States*, 505 U.S. 144 (1992) stated that Congress

¹³⁰ SMART Act, Staff Discussion Draft, §1500 (Aug. 19, 2004).

¹³¹ SMART Act, Staff Discussion Draft, §1500(e)(1).

¹³² *Id.*

¹³³ *Id.* at §1500(e)(2).

¹³⁴ *Id.* at §204.

¹³⁵ *Id.* at §§301, 403, 900.

¹³⁶ *Id.* at Title XVI.

could not compel the states to enact or enforce a federal regulatory program. In addition, the U.S. Supreme Court in *Printz v. United States*, 521 U.S. 898 (1997) stated that the federal government could not require state officers to address particular problems. Both of these cases raised the specter that the states would be able to launch a successful lawsuit to have the SMART Act struck down as invalid.

B. Federal Charter Proposals

The federal charter proposals do not suffer from the same constitutional problems as the SMART Act. The federal government has been entitled to regulate insurance as interstate commerce since the *United States v. South-Eastern Underwriters Association* case in 1944.¹³⁷ Several different federal charter proposals have been introduced into Congress over the past seven years, but none of them were enacted. The National Insurance Act of 2007 and the Insurance Consumer Protection Act of 2003 represent two ends of the spectrum of bills that have been introduced. Looking at these bills will provide some insight as to how a federal insurance charter is being envisioned by Congress.

1. National Insurance Act of 2007 (NIA)

Since 2001, the American Council of Life Insurance (ACLI), the American Bankers Insurance Association (ABIA) and the American Insurance Association (AIA) have been lobbying Congress to enact a federal insurance charter scheme.¹³⁸ The National Insurance Act of 2007 contains many provisions that are similar to the

¹³⁷322 U.S. 533 (1944).

¹³⁸ ACLI Draft Proposal on Federal Insurance Charter, LeBoeuf, Lamb, Greene & MacRae LLP (April 20, 2001) at www.llgm.com/article.asp?article=100; Comparison of ACLI, ABIA and AIA Federal Insurance Charter/Licensing Proposals, LeBoeuf, Lamb, Greene & MacRae LLP (Updated July 30, 2001) www.llgm.com/article.asp?article=143

legislation supported by the ACLI, ABIA and AIA. The Consumer Federation of America has consistently opposed the adoption of a dual insurance chartering system on the grounds it “would create a federal regulation that would have little if any authority to regulate price or product” and would merely enact a “wish list of insurer interests”.¹³⁹

NIA provides insurers with the option of seeking a state charter or a federal charter to write insurance policies. It would create a new federal insurance agency, the Office of National Insurance (ONI), which is modeled after the Office of the Comptroller of the Currency (OCC) and is also within the Treasury Department.¹⁴⁰ ONI would be run by one commissioner who would be appointed by the President for a five year term.¹⁴¹ In addition to its headquarters in Washington, DC, ONI would operate six regional offices.¹⁴² It would be funded from the fees and assessments that it levies on the entities and persons that it regulates, although the initial start-up costs would come from a 30 year loan to the agency by the federal government.¹⁴³

ONI would regulate national insurers, national insurance agencies, federally licensed producers, and reinsurers.¹⁴⁴ Regulations promulgated by ONI would preempt state laws for the entities regulated by ONI with regard to licensing, examinations, reporting, and regulations concerning the sale or underwriting of insurance but would not preempt state laws governing property taxes, workers’ compensation, or motor vehicle insurance.¹⁴⁵ Insurers subject to state regulation would retain the antitrust exemption under the McCarran-Ferguson Act but national insurers and the other entities regulated

¹³⁹ *Insurers Split Over Federal Regulation Proposal at Hearing*, NAT’L J. (Oct. 23, 2003).

¹⁴⁰ NIA §1101.

¹⁴¹ *Id.* at §1102.

¹⁴² *Id.* at §1101.

¹⁴³ *Id.* at §§1101 and 1122.

¹⁴⁴ *Id.* at §§1121-1127, 1201, 1221 and 1301.

¹⁴⁵ *Id.* at §§1125, 1223, 1251-1253, 1304, 1404, and 1610.

by ONI would lose this exemption except in connection with the development and use of standardized forms.¹⁴⁶ The Commissioner would have no ability to set rates for insurers and national insurers would be exempt from state rate regulations. National insurers would be examined once every 36 months.¹⁴⁷

ONI will have a Division of Consumer Affairs and an Ombudsman to address consumer protection issues or issues with how the agency is operating.¹⁴⁸ NIA does not specify what types of consumer protection should be implemented but leaves it up to the Commissioner and ONI to determine what those should be.¹⁴⁹ The Commissioner may engage in negotiations regarding international or multilateral agreements covering insurance but he is required to consult with the President and the U.S. Trade Representative.¹⁵⁰

This act is still before Congress. It appears doubtful that it will pass this session, particular as Rep. Barney Frank, who chairs the House Banking Committee, is on record that he will oppose any optional federal charter bill that does not adequately protect consumers.¹⁵¹ In its current form, NIA is silent regarding what standards or regulations should be in place to protect consumers.

2. *Insurance Consumer Protection Act of 2003 (ICPA)*

Senator Ernst “Fritz” Hollings (D-SC) introduced ICPA in 2003. Senator Hollings was critical of both the insurance industry and state regulators because he felt

¹⁴⁶ *Id.* at §§1702-1703.

¹⁴⁷ *Id.* at §1121.

¹⁴⁸ *Id.* at §1105 and 1107.

¹⁴⁹ *Id.* at §1216.

¹⁵⁰ *Id.* at §1102.

¹⁵¹ Networks Financial Institute at Indiana State University, Press Release, 4th Annual Insurance Reform Summit, Optional Federal Charters, Consumer Protection and Terrorism Insurance Dominate Discussion (March 8, 2007)

that both had failed the policyholders.¹⁵² He commented that “the industry itself comes to Congress asking for bailouts and backstops with increasing regularity and then turns around and asks for further deregulation, and even the ability to pick their regulator.”¹⁵³ He further noted that the financial problems suffered by the insurance industry were due to “poor investments made by insurance companies in the 1990s that have helped drive up premium increases” and not the litigation environment in the United States.¹⁵⁴ For example, he noted that in the area of medical malpractice insurance that the profits as a percentage of premiums were nearly double the amount of profits as a percentage of premiums for property/casualty insurance in 1999.¹⁵⁵ While the Consumer Federation of America opposes NIA, they supported ICPA because they favored its strong consumer protection provisions.¹⁵⁶

ICPA differs from NIA in several substantial ways. ICPA does not allow insurers to choose whether they are subject to federal regulation or not.¹⁵⁷ Under the ICPA, only single-state insurance companies would continue to be regulated by the states.¹⁵⁸ Sen. Hollings deliberately structured it this way because he felt that there was “no doubt real federal regulation of insurance—not optional federal charter, which would allow each company to choose their regulator—would benefit industry, the consumer and the stability of our overall economy.”¹⁵⁹

¹⁵² *Insurers Split*, *supra* note 139.

¹⁵³ *Id.*

¹⁵⁴ *Id.*

¹⁵⁵ Steven Brostoff, *Senator Blasts Industry, Pushes for Federal Regulation*, NAT'L UNDERWRITER, PROPERTY & CASUALTY/RISK & BENEFITS MANAGEMENT EDITION (Oct. 27, 2003).

¹⁵⁶ *Insurers Split*, *supra* note 139.

¹⁵⁷ ICPA §201 (2003).

¹⁵⁸ *Id.*

¹⁵⁹ Brostoff, *supra* note 155.

The ICPA would form two new entities. The first new entity would be the Insurance Regulatory Commission (IRC) and would be part of the U.S. Department of Commerce, not the U.S. Department of Treasury.¹⁶⁰ The IRC would regulate all lines of insurance, including property/casualty and life insurance.¹⁶¹ The second new entity would be the National Insurance Guaranty Corporation to pay claims to policyholders if an insurance company became insolvent.¹⁶²

The IRC would have the following responsibilities under the ICPA: (1) licensing and standards for the insurance industry, (2) regulation of rates and policies, (3) annual examinations and solvency review, (4) investigation of market conduct, and (5) establishing accounting standards.¹⁶³ The ICPA would create an independent office in IRC to receive consumer complaints and represent consumers before IRC.¹⁶⁴ Consumers were also given the right to challenge rate applications filed by insurance companies. The ICPA also would have repealed the McCarran-Ferguson Act and eliminated the insurance industry's anti-trust exemption.¹⁶⁵ ICPA ultimately failed because it was strongly opposed by the states and did not garner industry support or the support of a majority of Republican senators.

3. *U.S. Department of Treasury Blueprint Proposal*

The U.S. Treasury Blueprint called for the creation of an Office of Insurance Oversight (OIO) to deal with international insurance regulatory issues and to advise the

¹⁶⁰ ICPA §101.

¹⁶¹ *Id.*

¹⁶² *Id.* at §401.

¹⁶³ ICPA, Title II.

¹⁶⁴ *Id.* at §281.

¹⁶⁵ *Id.* at §283.

Secretary of the Treasury on major domestic and international insurance policy issues.¹⁶⁶ The Treasury considered these aspects of insurance regulation ones, on which immediate attention was needed.¹⁶⁷ Nevertheless, Treasury still classified the creation of the OIO as one of the intermediate reforms to be undertaken rather than as one of its short-term recommendations.

The U.S. Treasury Blueprint also recommended as an intermediate step that an optional federal charter system should be created that would operate in a manner similar to the dual-chartering system currently used for banks.¹⁶⁸ The Treasury proposal looks more like NIA than ICPA as it calls for an Office of National Insurance to be created within Treasury headed by a single National Insurance Commissioner.¹⁶⁹ The U.S. Treasury Blueprint, however, included a disclaimer that the Treasury was not opining upon or evaluating the merits of any pending legislation before Congress to create an optional federal charter.¹⁷⁰ Treasury did recommend that any legislation authorizing the creation of an optional federal chartering system should provide for solvency, market competition, and consumer protection regulations.¹⁷¹

In the long run, the Treasury recommended that the United States adopt a multi-peaks regulatory structure in which regulatory agencies focus on particular objectives rather than particular institutions or functions.¹⁷² The Treasury laid out a five peaks model as its optimal structure for the regulation of financial services in the United States.¹⁷³ Under its five peaks model, the Federal Reserve would continue to operate as the nation's

¹⁶⁶ U.S. TREASURY BLUEPRINT, *supra* note 7, at 132-133.

¹⁶⁷ *Id.*

¹⁶⁸ *Id.* at 126.

¹⁶⁹ *Id.* at 126 and 131-132.

¹⁷⁰ *Id.* at 128, fn. 110.

¹⁷¹ *Id.* at 129-131.

¹⁷² *Id.* at 143-146.

¹⁷³ *Id.* at 13-21.

central bank and as a market stability regulator but four new agencies would be created.¹⁷⁴ A Prudential Financial Regulatory Agency (PFRA) would regulate the chartering of depository institutions and insurance companies as well as establish solvency regulations for these institutions.¹⁷⁵ A Conduct of Business Regulatory Agency (CBRA) would provide market conduct and consumer protection regulations.¹⁷⁶ A Federal Insurance Guarantee Corporation (FIGC) would be established to administer insurance for the accounts at financial services firms in the same way that the FDIC does now for banks.¹⁷⁷ Finally, a Corporate Finance Regulator would be created to handle issues related to corporate governance and oversight in the public securities markets.¹⁷⁸

The Treasury Blueprint does not specify what timeframes it considers to be intermediate or long-term. It is, thus, unclear how quickly the United States should move to adopting an ONI for insurance or move to adopting the five peaks model for regulating all of financial services.

C. The Major Objections Leveled to Date Against the Proposals to Federalize Insurance

The opponents of federalizing insurance have developed a laundry list of problems for each of the proposals. The problems include, among others:

- Create a race-to-the-bottom as federal and state agencies initiate round after round of deregulation in order to induce insurance companies to obtain a charter from them

¹⁷⁴ *Id.* at 15-17.

¹⁷⁵ *Id.* at 17-19.

¹⁷⁶ *Id.* at 19-21.

¹⁷⁷ *Id.* at 21.

¹⁷⁸ *Id.*

- May create an uneven playing field between multistate and single state insurance companies;
- Sow confusion among consumers about whether the federal or state government was responsible for regulating a particular insurance company;
- Drain funds out of the state guaranty funds into the new federal fund and force the remaining state chartered insurers to bear the burden for providing adequate funds to the state guaranty funds;
- Might create delays in getting new products to market; and
- Create a massive new federal bureaucracy.¹⁷⁹

Many of these problems at their core all rest on the same assumption – that federalizing insurance will harm consumers. Some of these claims that consumers will be harmed need to be evaluated through the lens of who is making the claim and what are their vest interests in the current system.

The states claim that they are closer to consumers and therefore would be more attentive to their needs and problems than a distant, federal regulator. The state legislators and insurance regulators, however, will lose the power and influence over the insurance lobby if the federal government begins to call the tune with regard to insurance regulation. Since some of the legislators have benefited significantly from the campaign contributions of the insurance industry, they would be sorry to see those funds dry up. They also may lose out on lucrative job opportunities with insurance firms after they leave government if the federal government because a major player in regulating

¹⁷⁹ Brostoff, *supra* note 155; Scott, *supra* note 10; Lissa Lamkin Broome, *A Federal Charter Option for Insurance Companies: Lessons from the Bank Experience*, FINANCIAL MODERIZATION AFTER GRAMM-LEACH-BLILEY, Patricia A. McCoy, ed. (LexisNexis 2002).

insurance.¹⁸⁰ In addition, some states, like Vermont, receive a substantial portion of their state budget from insurance fees and premiums. If that money began to go into federal coffers, instead of state coffers, the states might have to either cut their budgets or raise taxes.

Some consumer advocates and academics argue that dual banking system created a race-to-the-bottom, which has harmed consumers.¹⁸¹ For example, the rulings by the OCC and other federal agencies have exempted national banks and thrifts from state laws prohibiting predatory lending.¹⁸² More than 15 states and cities had adopted laws against predatory lending.¹⁸³ Consumer advocates and state regulators argue that these laws provide needed protections to consumers. Maude Hurd, national president of the Association of Community Organizations for Reform Now, noted, “States and cities have taken action because the federal government has failed, and states and cities have passed very effective laws after long, careful deliberations.”¹⁸⁴

In addition, consumer groups feel that they have more of a voice at the local level than they do at the federal level. David Swanson, ACORN spokesman, commented, “Consumer groups and ordinary people still have a strong voice at the local level, but virtually no voice in Congress. There are state laws on the books saving borrowers millions of dollars and saving people their homes, and for the federal government to pre-

¹⁸⁰ Hunter, *supra* note 9. J. Robert Hunter of the Consumers Federation of America commented in this statement to Congress that five out of the last six presidents of NAIC now work as lobbyists for insurance companies or the insurance industry. He noted that part of the reason that the states are not effective regulators as regulators was this revolving door between industry and the insurance commissions. This type of relationship provides evidence that at least some of the state regulators have been captured by the industry they are supposed to be monitoring.

¹⁸¹ Broome, *supra* note 179.

¹⁸² Predatory lending generally involves lending that targets unsophisticated borrowers, like the elderly and the poor, at high rates and fees and burdensome terms that leave borrowers unable to repay the loans; Jonathan D. Epstein, *Customers Caught in Bank Tug-of-War*, NEWS J. (Aug. 10, 2003).

¹⁸³ *Id.*

¹⁸⁴ *Id.*

empt those laws is destructive.”¹⁸⁵ Federal banking regulators have countered that the strict laws adopted by some states have forced some legitimate subprime lenders to stop doing business in those states, which makes it more difficult for borrowers with bad credit histories to borrow money, and that allowing states to apply such laws to national banks and thrifts would significantly interfere with the ability of such financial institutions to operate nationwide.¹⁸⁶

On the other hand, some believe that consumer protections may increase if regulatory power was moved to the federal level. For example, Wesley Bissett, Vice President, State Relations and Government Affairs, for the Independent Insurance Agents & Brokers of America, voiced concerns in a letter to Mike Pickens, Commissioner of Insurance in the Arkansas Insurance Department, that the creation of an optional federal insurance charter would lead to “anti-redlining provisions, unprecedented disclosure and Community Reinvestment Act-like requirements, oversight by the Federal Trade Commission and other federal agencies, expanded privacy provisions, and more.”¹⁸⁷ Most of the items cited by Mr. Bissett would be considered important consumer protection measures.

III. THE FATAL FLAW IN BOTH THE CURRENT STRUCTURE AND MOST OF THE FEDERAL PROPOSALS

While there has been extensive debate over the pros and cons of creating a federal charter for insurance companies or mandating that the states adopt uniform regulations

¹⁸⁵ *Id.*

¹⁸⁶ *Id.*

¹⁸⁷ Letter from Wesley Bissett, Vice President, State Relations and State Government Affairs, Independent Insurance Agents & Brokers of America, to the Honorable Mike Pickens, Commissioner of Insurance, Arkansas Insurance Department (June 3, 2003) (on file with author).

both before Congress and in the press, both the proponents and opponents of these measures usually take as a given that insurance is a “unique” financial service and therefore must be regulated differently than banking or securities. Focusing on the unique attributes of a financial service product is at the core of the U.S. functional regulation structure. Functional regulation focuses on regulating based on the type of product being provided and not based upon the type of institution providing the product.¹⁸⁸

If one analyzes how statutes and courts define insurance and compare those definitions with the range of financial products that are sometimes classified as insurance and other times not, one will quickly realize that insurance is part of a continuum of financial services, and not something separate and apart from the rest of the financial services industry. In addition, if one considers the types of risks that insurance regulators are concerned about, one quickly realizes that they are many of the same risks that banking and securities regulators seek to address as well.

The fatal flaw of most of the federal proposals to regulate insurance is that they are structured around functional regulation, which does not make sense when the market for financial services is a continuum, not a series of discrete baskets. Instead of being concerned about what category to place a financial service product, federal and state regulators should be more concerned about what risks it poses and regulate based on risk, not function.

¹⁸⁸ PATRICIA A. MCCOY, BANKING LAW MANUAL 2d, §12.02[2] (2003).

A. Defining Insurance

Functional regulation only works well when the definitions of banking, securities and insurance are clear and allow firms and products to be easily categorized. Unfortunately, the definitions for banking, securities and insurance do not provide hard and fast rules that enable regulators to place firms or products easily in one category or another. This situation is due in part to the fact that statutes and courts have always struggled with how to define insurance. It has been exacerbated by the fact that new hybrid financial products are constantly being devised by financial services firms.

As noted above, there is no single, all-purpose definition for insurance. The definitions that do exist grew out of the institutional regulatory regime and tend to define insurance in relation to the entity offering the product or service. For example, insurance regulators tend to exclude self-insurance that arises when an individual or an entity sets aside funds or other assets to cover any future losses or damages, as beyond the scope of their regulatory powers. They do so on the grounds that “insurance” is about risk sharing and self-insurance does not involve risk sharing, but instead involves risk retention.¹⁸⁹ On the other hand, the law does not leave self-insurance completely unregulated but instead sometimes limits the ability of individuals or entities to engage in self-insurance by mandating that everyone must obtain certain types of insurance, such as automobile insurance.

As noted above, states have incorporated a wide range of definitions of insurance in their statutes. The courts have developed three tests to determine when something is

¹⁸⁹ Appleman, *supra* note 65.

insurance and when it is not. These tests are: (1) Substantial Control Test, (2) Ancillary Test, and (3) Regulatory Value Test.¹⁹⁰

The Substantial Control Test grew out of Professor William R. Vance's description of an insurance contract in 1904.¹⁹¹ Under his definition, an insurance contract was between the insurer and the insured and required five elements:

1. The insured must possess an interest, the insurable interest, in the thing being insured and the value of that interest must be able to be assessed;
2. The insured must be subject to a risk of loss if the insured interest is destroyed or damaged by the happening of certain specified fortuitous events;
3. The insurer assumes the risk of loss (also known as risk transference);
4. The insurer assumes this risk of loss as part of a general plan to distribute actual losses amongst a large group bearing similar risks; and
5. The insured pays a fee to the insurer, which goes into a general insurance fund, as consideration for the insurer's promise to assume the risk of loss.¹⁹²

New York's statutory definition for insurance provided in the Introduction seems to be based on this test. Within this definition, the most central concept is the requirement that the event be fortuitous. Insurers are not expected to insure against risks that are reasonably certain or expected to occur within the policy period.¹⁹³ As a result, it is common for insurance policies to exclude coverage for intentional or criminal acts.¹⁹⁴

This definition does not clearly differentiate between products that are considered "insurance" and products that are considered "securities" or have elements of both. For

¹⁹⁰ *Id.* at §1.4

¹⁹¹ *Id.*

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ *Id.*

example, securitizations and some other types of derivative transactions, such as weather derivatives, could be classified as insurance under this definition.

The Principal Object or Ancillary Test requires courts and regulators to determine if the elements of risk transference and distribution of a fortuitous insured event were central and relatively significant features of the deal or just ancillary elements.¹⁹⁵ If they were not ancillary elements, then the product is defined as insurance. This definition also does not clearly differentiate between products that are considered “insurance” and products that are considered “securities.” Again many securitizations and other derivative products could be classified as insurance under this definition.

Finally, the Regulatory Value Test requires courts and others to evaluate whether a product or service ought to be regulated in the public interest as insurance.¹⁹⁶ This test is extremely broad and gives courts a great deal of discretion to determine what is in the public interest. This test provides very little guidance of when it would be in the public interest to regulate a product or service as “insurance”, instead of as a “banking product” or a “securities product.”

In addition to the state statutory and common law tests, the federal government has attempted to define insurance within several statutes in order to determine when a financial service should be regulated by the states and when it may be regulated by the federal government. The McCarran-Ferguson Act does not define “insurance” although it maintains the rights of the states to regulate “the business of insurance.” As a result, federal courts were given the task of defining “insurance” under the act. The U.S. Supreme Court defined the “business of insurance” under the McCarran-Ferguson Act as

¹⁹⁵ Appleman, *supra* note 65.

¹⁹⁶ *Id.*

being determined by (1) whether the practice has the effect of transferring or spreading policyholder's risk, (2) whether the practice is an integral part of the policy relationship between the insurer and the insured, and (3) whether the practice is limited to entities within insurance industry.¹⁹⁷ The U.S. Supreme Court has held that none of these criteria is necessarily determinative in itself.¹⁹⁸ In determining whether a product or service is insurance, this definition again looks at whether the product is offered only by insurance companies rather than any intrinsic features or characteristics of the product or service itself. So it is, at least partially, a circular definition – something is insurance because firms that we consider to be insurance companies offer it. This type of definition clearly grew out of the institutional regulatory framework that has governed insurance regulation throughout the history of the United States.

The other prongs of the definition are very broad and could encompass a number of products that usually are regulated by the SEC, the CFTC or fall between the regulatory responsibilities of the existing financial services regulators, such as securitizations, interest rate swaps, currency swaps, and derivatives. All of these products help individuals or business to spread their risks of loss to others.

The GLBA also does not really define insurance clearly. The GLBA in Title III on Insurance provides a general definition, which defines insurance as “any product, other than title insurance, defined or regulated as insurance by the appropriate State insurance regulatory authority.”¹⁹⁹ This definition basically is circular. Something is insurance if it is regulated as insurance. It also reinforces the state institutional regulatory

¹⁹⁷ *Union Labor Life Ins. Co. v Pireno*, 458 US 119, 102 S Ct 3002, 3009 (1982).

¹⁹⁸ *Id.*

¹⁹⁹ GLBA §336 (codified at 15 U.S.C.S. §6766 (2007)).

framework rather than attempting to force the states to move to a functional regulatory model.

The GLBA contains a general prohibition on banks providing insurance with only limited exceptions and provides a more detailed definition of insurance in this context as:

(1) any product regulated as insurance as of January 1, 1999, in accordance with the relevant State insurance law, in the State in which the product is provided;

(2) any product first offered after January 1, 1999, which--

(A) a State insurance regulator determines shall be regulated as insurance in the State in which the product is provided because the product insures, guarantees, or indemnifies against liability, loss of life, loss of health, or loss through damage to or destruction of property, including, but not limited to, surety bonds, life insurance, health insurance, title insurance, and property and casualty insurance (such as private passenger or commercial automobile, homeowners, mortgage, commercial multiperil, general liability, professional liability, workers' compensation, fire and allied lines, farm owners multiperil, aircraft, fidelity, surety, medical malpractice, ocean marine, inland marine, and boiler and machinery insurance); and

(B) is not a product or service of a bank that is--

(i) a deposit product;

(ii) a loan, discount, letter of credit, or other extension of credit;

(iii) a trust or other fiduciary service;

(iv) a qualified financial contract (as defined in or determined pursuant to section 11(e)(8)(D)(i) of the Federal Deposit Insurance Act); or

(v) a financial guaranty, except that this subparagraph (B) shall not apply to a product that includes an insurance component such that if the product is offered or proposed to be offered by the bank as principal--

(I) it would be treated as a life insurance contract under section 7702 of the Internal Revenue Code of 1986; or

(II) in the event that the product is not a letter of credit or other similar extension of credit, a qualified financial contract, or a financial guaranty, it would qualify for treatment for losses incurred with respect to such product under section 832(b)(5) of the Internal Revenue Code of 1986, if the bank were subject to tax as an insurance company under section 831 of that Code; or

(3) any annuity contract, the income on which is subject to tax treatment under section 72 of the Internal Revenue Code of 1986.²⁰⁰

This definition of insurance hinges in part on whether the product was regulated as insurance prior to 1999. So again this definition is somewhat circular because it defines a product as insurance because it traditionally has been regulated as insurance. The definition does attempt to deal with new products, i.e., products first offered after January 1, 1999, by requiring the state insurance regulator to classify them as insurance after determining that “the product insures, guarantees, or indemnifies against liability, loss of life, loss of health, or loss through damage to or destruction of property” and then provides a laundry list of existing product lines as examples. The definition attempts make certain the products offered through traditional insurance lines, life insurance, property and casualty insurance and health insurance, would still be regulated by the state

²⁰⁰ GLBA §302.

insurance commissions. This definition is very broad and could encompass products, like derivatives or securitizations, offered by other financial institutions.

In addition, the regulatory structure crafted by the GLBA does not work well for products or services that do not clearly fall into one of the banking, securities or insurance categories. Section 205 of GLBA defines “new hybrid product” as one that was not previously defined as securities before the enactment of GLBA and is not defined as an identified banking product within GLBA.²⁰¹

The definition for new hybrid product in Section 205 of GLBA does not mention the possibility of the product being an insurance product nor does Section 205 require the SEC to consult with the state insurance regulators before issuing rules governing hybrid products that may be combinations of insurance and securities products.²⁰² Hybrid securities and insurance products do exist. Variable annuities, which are regulated by both the SEC and the state insurance commissions, are examples of such hybrid securities and insurance products. As noted above, the GLBA does make some provision for preventing banks from offering insurance products in §302 and gives state insurance regulators the right to make the initial determination of whether a new product is an insurance or banking product.

The proposals to federalize insurance also do not provide clear definitions for what is and what is not insurance. The National Insurance Act defines the “business of

²⁰¹ GLBA §205 (codified at 15 U.S.C.S. §78o(i)(5)(D) (2007)). Section 206 of GLBA defines “identified banking product” as a deposit account, savings account, certificate of deposit, or other deposit instrument issued by a bank, a banker’s acceptance, a letter of credit or loan made by a bank, a debit account at a bank arising from a credit card or similar arrangement, a participation in a loan which the bank or an affiliate of the bank (other than a broker or dealer) funds, participates in, or owns that is sold to qualified investors or sophisticated investors, or any swap agreement, except for any equity swap sold to a person other than a qualified investor.

²⁰² GLBA §205 (codified at 15 U.S.C.S. §78o(i)(5)(D) (2007)).

insurance” as having the meaning given to it in 18 U.S.C. §1033.²⁰³ Section 1033 defines the business of insurance as:

(A) the writing of insurance, or

(B) the reinsuring of risks,

by an insurer, including all acts necessary or incidental to such writing or reinsuring and the activities of persons who act as, or are, officers, directors, agents, or employees of insurers or who are other persons authorized to act on behalf of such persons;

(2) the term "insurer" means any entity the business activity of which is the writing of insurance or the reinsuring of risks, and includes any person who acts as, or is, an officer, director, agent, or employee of that business;

(3) the term "interstate commerce" means--

(A) commerce within the District of Columbia, or any territory or possession of the United States;

(B) all commerce between any point in the State, territory, possession, or the District of Columbia and any point outside thereof;

(C) all commerce between points within the same State through any place outside such State; or

(D) all other commerce over which the United States has jurisdiction; and

(4) the term "State" includes any State, the District of Columbia, the Commonwealth of Puerto Rico, the Northern Mariana Islands, the Virgin Islands, American Samoa, and the Trust Territory of the Pacific Islands.²⁰⁴

²⁰³ NIA §3(3).

²⁰⁴ 18 U.S.C.S. §1033 (2007).

NIA, however, never defines insurance. In interpreting this act, federal courts might fall back on the definition of insurance employed under the McCarran-Ferguson Act or would be forced to use the tests developed in state courts.

The ICPA only covered a limited range of insurance products and it tried to provide relatively clear definitions for those products. The ICPA defined insurance as including life insurance and property and casualty insurance but not health insurance.²⁰⁵ The ICPA then provided definitions for both life insurance and property and casualty insurance. The ICPA defined life insurance as “insurance for which the probabilities of the duration of human life or the rate of mortality are an element or condition of insurance.”²⁰⁶ Again this definition is circular as it defines is life insurance as insurance on someone’s life without defining what “insurance” itself means. The ICPA’s definition of property and casualty is also circular. It defines property and casualty insurance as “insurance for persons or property in the United States against (i) loss of or damage to property; (ii) loss of income or extra expense incurred because of loss of or damage to property; (iii) third party liability claims caused by negligence or imposed by statute or contract, including workers compensation; or (iv) loss resulting from debt or default of another, including sureties.”²⁰⁷ Again this definition is circular as it is saying that insurance is property and casualty insurance without defining what “insurance” itself means.

Perhaps the drafters of these acts are relying on the fact that other laws exclude insurance from being regulated by securities or banking regulators and, therefore, they do not need to be precise in how they define insurance. For example, the drafters of the

²⁰⁵ ICPA §3(9).

²⁰⁶ ICPA §3(14).

²⁰⁷ ICPA §3(27).

Securities Act of 1933 (“Securities Act”) clearly recognized that securities and insurance had many features in common and a broad definition of security could end up encompassing insurance. The Securities Act provides a laundry list of instruments that could be classified as securities.²⁰⁸ It does, however, expressly exclude from the definition of security “[a]ny insurance or endowment policy or annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions. ...”²⁰⁹ The functional approaches to regulating financial services is embedded in this definition because it defines a financial product as insurance based on whether the entity issuing it is regulated by the insurance commissioner.

Applying this exclusion has become increasingly difficult over the years as more and more insurance products have contained investment features. The SEC tried to address this by adopting Rule 151 under the Securities Act in 1986.²¹⁰ Rule 151 provides a safe harbor for issuers of insurance products that contain investment features because it defines more clearly what constitutes sufficient risk-taking by the insurance company to avoid the contract being deemed a security. It declares that any annuity contract or “optional” annuity contract shall be deemed to fall within Section 3(a)(8) of the Securities

²⁰⁸ Section 2(1) of the Securities Act (15 U.S.C. §77(b)(1)(2007) defines security as: “any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a “security,” or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”

²⁰⁹ Securities Act, §3(a)(8).

²¹⁰ Robert Rapp, *1-2 Federal Securities Act of 1933 § 2.01* (Matthew Bender & Company, Inc., 2007)

Act, and thus be exempt from Securities Act coverage if certain conditions are met.²¹¹

The safe harbor generally is available where the insurer assumes sufficient investment risk, and the contract is not marketed primarily as an investment.²¹² In determining whether sufficient investment risk has been assumed by the insurer, several criteria must be met:

“(1) the value of the contract must not vary according to the investment experience of any separate investment account;

(2) the insurer, for the life of the contract, guarantees the principal amount of the purchase payment and interest, and credits a specified rate of interest to net purchase payments and interest credits; and

(3) the insurer guarantees that the rate of any interest paid in excess of the guaranteed minimum will not be modified more than once per year.”²¹³

Even this safe harbor did not enable the SEC to classify what instruments were or were not insurance. Some products so clearly straddle both classifications, such as variable annuities, that they are regulated by both the securities and insurance regulators.

With the federal government having moved away from institutional regulation towards a regime of functional regulation, the old ways of defining insurance based in large part on the status of the entity providing the services or products no longer work. As a result, with many of the definitions for insurance and for security, one almost gets the sense that courts and regulators would like to say about insurance what Supreme Court Justice Stewart Potter said about pornography – they cannot precisely define it but they “know it when they see it.” Part of the problem is that they are attempting to make

²¹¹ *Id.*

²¹² *Id.*

²¹³ *Id.*

fine distinctions between financial services and products when such distinctions do not exist in all situations.

B. Applying the Definitions of Insurance

Obviously, some traditional financial products can be easily categorized as banking products or insurance products or securities. For example, automobile liability insurance clearly would be classified as insurance and not as a banking product or a security. In addition, other financial services products are not fungible with automobile liability insurance, primarily because the vast majority of states mandate that every driver of a car must have automobile liability insurance and most mandate the types of coverage that this insurance must provide.²¹⁴ Most states tend to mandate insurance coverage in the area of property and casualty insurance. As a result, these state regulations have stifled innovation of financial products that might compete with property and casualty insurance products.

In areas where the law has not erected barriers to entry, financial innovation has flourished. These new products provide ample evidence of why it is increasingly difficult to classify products as insurance, banking or securities. In some cases the insurance industry has deliberately marketed its products as alternatives to banking or securities products. The classic examples of this are life insurance and annuities. In other cases, the end users of traditional financial products are using them in place of other financial products. For example, credit cards are being used as health insurance by some individuals. Finally, banking, securities and insurance firms have developed new, hybrid

²¹⁴ Insurance Information Institute, Compulsory Auto/Uninsured Motorists (June 2008) [available at: www.iii.org/media/hottopics/insurance/complutory/] (48 states and the District of Columbia require drivers to have automobile liability insurance).

products that courts and regulators have attempted assign to one of the three major regulatory categories.

1. Life Insurance

Life insurance can be broken down into at least three major categories: term life insurance, whole life insurance and universal life insurance. A term life insurance policy lasts for a fixed time period or until a specific event happens and it requires the policyholder to pay premiums during the period of the policy. If the policyholder dies during this term, then his beneficiaries are paid the amount set forth in the policy. If the policyholder does not die during this term, then he gets nothing back from the insurance company when the term ends. In most cases, term life insurance is not treated as a product that is fungible with other financial products.

Split-dollar life insurance, which is a type of term life insurance, however, is a product that is marketed as insurance, but in many ways acts no differently than a loan.²¹⁵ Many companies have purchased split-dollar life insurance policies for their executives as part of the compensation package for these executives.²¹⁶ The way that a split-dollar life insurance policy works is as follows. The company pays almost all of the premiums on the policy while the executive works for the company.²¹⁷ These premiums grow tax-free within the policy.²¹⁸ When the executive retires, the corporation is repaid the amount that it paid for the premiums, without interest.²¹⁹ After retiring, the executive can

²¹⁵ Tracie Rozhon and Joseph B. Treaster, *Insurance Plans of Top Executives Are in Jeopardy*, N.Y. TIMES (Aug. 29, 2002).

²¹⁶ *Id.*

²¹⁷ *Id.*

²¹⁸ *Id.*

²¹⁹ *Id.*

elect either to have the premiums for the policy repaid out of the cash built up in the policy and the death benefit paid to his estate or to receive regular tax-free withdrawals from the policy while leaving enough cash within the policy to continue to pay the policy's premiums.²²⁰ Albert J. Schiff, president of the Association for Advanced Life Underwriters, has estimated that more than 1,600 companies have taken out split-dollar life insurance.²²¹

The writing of new split-dollar insurance policies came to an abrupt halt following the passage of the Corporate Responsibility Act of 2002²²², better known as the Sarbanes-Oxley Act, because the insurance industry and corporations were concerned that these policies would be considered company loans to executives, which the Act banned.²²³ The insurance industry lobbyists have attempted to get Congress to adopt an amendment to the Sarbanes-Oxley Act granting an exemption for split-dollar insurance policies from the ban on company loans to executives.²²⁴ Senator Charles E. Schumer, a Democratic Senator from New York and the member of Congress who drafted the language banning corporate loans to executives, has stated that he intended to ban these types of policies. Schumer told the New York Times, "There have been abuses of these policies in the past . . . The general view when we passed the law was that this was the type of thing we wanted to eliminate. There was an effort by the life insurance industry to exempt these policies, but we kept them in."²²⁵

²²⁰ *Id.*

²²¹ *Id.*

²²² Pub. L. No. 107-204, 116 Stat. 745 (codified 15 U.S.C.S. §7201 et. seq.)

²²³ Tracie Rozhon and Joseph B. Treaster, Insurance Plans of Top Executives Are in Jeopardy, N.Y. Times (Aug. 29, 2002).

²²⁴ *Id.*

²²⁵ *Id.*

Whole life insurance, unlike term life insurance, covers the policyholder for the entire period of their life. The insurance company invests the premiums paid by the policyholder, which builds up the policyholder's cash value in the policy. The policyholder does not pay tax on the cash value until it is withdrawn. In addition, the policyholder can borrow against the cash value of the policy. As a result, insurance companies frequently market whole life insurance as being both insurance and an investment alternative to investing directly in securities.

Universal life insurance also covers the policyholder for the entire period of their life rather than a fixed term. The policyholder pays premiums and insurance company credits the amount of the premiums above the cost of the insurance to the policy's cash value. The insurance company pays interest on the cash value of the policy. The insurer determines the interest rate, usually based on a predetermined financial index. Thus, universal life insurances acts like insurance and like a savings account with a bank or a money market account with an investment firm.

2. Annuities

Insurance companies also market annuities as investment vehicles. With an annuity, the buyer pays for the right to receive a stream of payments in the future. The terms for annuities can vary based on the nature of the underlying investment, the primary purpose of the annuity, the type of pay-out commitment, and the tax status of the annuity. The annuity can guarantee a fixed rate of return on the underlying investment or a variable rate of return. Annuities with fixed rates of return are called fixed annuities and those with variable rates of return are called variable annuities. In order to achieve

the variable rates of return, variable annuities invest in stocks, bonds, and other investments. The primary purpose of the annuity can be to accumulate wealth or to provide a guaranteed pay out for a certain period of time. The pay-out commitment can be either for a fixed period, a fixed amount, or the lifetime of the owner. Annuity can serve as a tax deferral vehicle, similar to a 401(k) plan or an individual retirement account (IRA), but without the limits on contributions that those investment vehicles entail. Annuities are marketed as investment vehicles, particularly for those concerned about retirement. Annuities are pushed by the insurance industry as an alternative to or a supplement to more traditional investment vehicles, such as mutual funds, IRAs and 401(k) plans.

3. Guaranteed Investment Contract (GIC)

Beginning in the 1970s, life insurance companies began to offer GICs as an alternative to savings accounts or securities.²²⁶ A GIC is a contract that guarantees repayment of principal plus interest at a predetermined time. They are generally marketed to entities with favorable taxable treatment, such as pension plans.

4. Indemnity Agreements

Many businesses offer to repair or replace defective products in order to induce consumers to buy their products in the first place. These indemnity agreements offer a form of insurance from the buyer's perspective against his risk of loss if the product

²²⁶ Melanie Fein, *The Convergence of Financial Products and the Implications for Regulatory Convergence*, Draft Paper Presented at the American Enterprise Institute's Symposium on "Can We Improve Policy-Making in Financial Services?" Appendix 8 (Jan. 24, 2007).

proves defective in the future. Some courts have, in fact, classified such agreements as insurance, even though they were not offered by insurance companies.²²⁷ As a result, some states added specific exemptions from their insurance regulations for these types of agreements.

5. *Debt Cancellation Contracts*

Under a debt cancellation contract, a lender is required to cancel the debt at the death of the borrower. In essence, these contracts can protect the borrower's estate and heirs from future financial difficulties arising from his death and thus, can be analogous to life insurance policies. Some states classify these contracts as insurance.²²⁸ Nevertheless, federal courts have held that they are not insurance and not subject to state regulation when issued by national banks.²²⁹

6. *Other Financial Products Used as Insurance*

Some products seem to fall squarely within one category and in fact are regulated by agencies other than the state insurance commissioner. Nevertheless, many of these products are viewed by the people who use them as a form of insurance.

Derivatives cover a wide range of products. These products essentially involve an agreement, option, or instrument that requires the buyer to take delivery of or assume a specified amount of one or more underlying interests, or that has a price, performance, value, or cashflow based primarily upon the actual or expected price, level, performance,

²²⁷ *State ex. rel. Duffy v. Western Auto Supply Co.*, 134 Ohio St. 163 (Ohio 1938).

²²⁸ *Douglas v. Dynamic Enters., Inc.*, 315 Ark. 575, 869 S.W.2d 14 (1994).

²²⁹ *First Nat'l Bank of Eastern Arkansas v. Taylor*, 907 F.2 775 (8th Cir.), cert. denied, 498 U.S. 972 (1990).

value, or cashflow of one or more underlying interests. Derivatives include options, futures, swaps, warrants, hedges, and securitizations. The sellers use these transactions to reduce their risks due to changes in price, performance, value or cashflow of the underlying interests.

Outlining all of the different ways that derivatives are used as substitutes for insurance is beyond the scope of this paper. For illustrative purposes, weather derivatives will be discussed as one example of a derivative that is fungible for a tradition insurance policy.²³⁰

Weather derivatives are usually based on indexes that are based on the average temperatures and precipitation.²³¹ They are sometimes structured as a swap or an option.²³² A weather option, for example, requires the seller to pay the buyer an agreed upon amount at a set time if certain weather conditions develop, such as the temperature is above normal by 10 degrees during the summer.²³³ Weather derivatives can be used to protect against crop damages due to drought or property damage due to a hurricane. From the buyer's perspective, weather derivatives may sometimes be better than a more traditional insurance policy because weather derivatives do not require that the buyer show that they actually suffered harm before they receive payment. Weather derivatives have become more popular in recent years with over \$16.5 billion worth of weather derivative contracts traded on the Chicago Mercantile Exchange in 2005.²³⁴

Hedges are another type of derivative that act like an insurance policy by reducing the risk of a particular event occurring. For example, another way to insure against the

²³⁰ Financial Services Fact Book 2006 at 84.

²³¹ *Id.*

²³² *Id.*

²³³ *Id.*

²³⁴ *Id.* at 85.

decline in value of one's home is to purchase a hedge against declining real estate markets by buying housing futures and options that are tied to an index like the S&P/Case-Shiller Home Price Indices.²³⁵ Right now the Chicago Mercantile Exchange offers these type of instruments for 10 major real estate markets.²³⁶ If you live in one of those 10 markets and you are concerned that the value of your house will decline, you can short the index. You would then offset some or all of your loss in the value of your home by your gain in the futures market. This strategy is not foolproof as the value of an individual home may not fall as much as the broader real estate market.²³⁷ It also requires an ability to time when the market will fall.²³⁸

As the weather derivatives and housing futures illustrate, derivatives can act like insurance and spread the sellers' risks to others. Derivatives, however, are usually not subject to regulation by state insurance regulators. To the extent that they are regulated, derivatives are regulated by the Securities and Exchange Commission, the Commodities Futures Trading Commission and the banking regulators.

The above examples are not meant to be an exhaustive list of the types of financial products that can be classified as insurance but have the characteristics of banking products or securities or that are banking services or securities that can be used as insurance. They illustrate the problem of putting financial services into neat little baskets in order to regulate in a functional regulatory regime. The next section will look at a few of the available alternatives to using a functional regulatory regime.

²³⁵ Simone Barbibeu, *Four Ways to Hedge Against Falling Home Prices*, THESTREET.COM (Feb. 22, 2008) [available at: www.thestreet.com/print/story/10404177.html].

²³⁶ *Id.*

²³⁷ *Id.*

²³⁸ *Id.*

IV. ALTERNATIVE REGULATORY APPROACHES

The United States needs to move beyond functional regulation for financial services and to a system that regulates products and firms based on the risks that they pose. The first step towards this would be to stop worrying so much about classifying products or firms as insurance, banking or securities and think of them as simply financial services.

Some might argue that this does not get us very far because U.S. law currently does not define financial services products and a definition would need to be created to distinguish financial services firms and products from other businesses and products. One possible definition for financial services is the one that this article has been using. Financial services are defined as any of the activities consider financial in nature pursuant to §103 of the GLBA, which includes banking, securities, merchant banking and insurance products and services. This definition is also circular. Another possible way to define a financial services product is that it is one that “involves an agreement under which a person (the buyer) gives money to another person (the seller) with the understanding that the buyer will get some known or unknown amount of money in some form at an agreed upon date or circumstance in accordance with the agreement.”²³⁹ This definition may be overly broad but it does have the virtue of not being circular.

So if insurance is part of a universe of products and services classified as financial services and it is not unique enough to require its very own regulator, what type of agency should regulate it and how should that agency be structured? If agencies no longer need to be structured around narrowly defined products, as required by functional regulation, the regulators can be more concerned about regulating the risks that these

²³⁹ Fein, *supra* note 226 at 9.

products and firms pose. Federal financial services agencies could be restructured in a number of ways that would be more attentive to the risks posed by the products that they are regulating and less concerned about waging turf wars over whether a particular product or service was functionally closer to a security or an insurance policy. Regulating based on risk also would provide a more flexible regulatory regime than the one currently available under functional regulation.²⁴⁰

What risks do financial regulators attempt to address? Financial regulation attempts to address a wide variety of risks, which align with the two objectives of financial services regulation: financial solvency and consumer protection. To maintain an entity's financial solvency, regulators attempt to manage prudential risks, which can encompass, among others, credit risks, liquidity risks, foreign exchange risks, and balance sheet risks. To protect consumers, regulators may also wish to regulate crime risks, disaster risks, market risks, position risks, and underwriting risks.

The task then becomes how to best divide up responsibility for managing these risks if one is not going to return to functional regulation. This raises issues regarding the breadth of coverage to assign a regulator as well as the depth of its responsibilities. Below are three possible ways of federalizing insurance that would result in better regulations and fewer problems than the current structure or the proposals that have been discussed in Congress to date.

²⁴⁰ Heidi Mandanis Schooner, *Regulating Risk Not Function*, 66 U. CIN. L. R. 441, 481 (Winter, 1998).

A. Create a New Financial Services Commission to Regulate Securities, Commodities, Futures and Insurance

Rather than create a new regulator in the Treasury Department, it would be better if the SEC and the CFTC were consolidated to create a new agency that would also regulate insurance. For purposes of this article, this new consolidated agency will be referred to as the Financial Services Commission (“FSC”). Insurance products frequently overlap with securities and futures products. So including insurance in the FSC would avoid potential turf wars with the SEC and the CFTC over who should regulate a particular hybrid product. In addition, consolidating the regulation of securities, commodities, futures and insurance into one agency would help ensure that the playing field is level among these products. This new agency would handle any insurance companies that operate in more than one state and would leave to state regulators insurance companies operating solely within a single state.

Others have suggested consolidating the SEC and the CFTC before. In 1987, a presidential commission headed by Nicholas Brady (the “Brady Commission”) recommended that the SEC and the CFTC should be merged into the Federal Reserve, which would serve as a single agency to regulate the securities and commodity futures markets.²⁴¹

The FSC should be organized internally around the risks to be regulated rather than maintaining separate departments for securities, commodities, futures, and insurance. The FSC could have a department for prudential regulation, a department for market conduct regulation, and a department for enforcement. The prudential regulation

²⁴¹ REPORT OF THE PRESIDENTIAL TASK FORCE ON MARKET MECHANISMS (June 1988) (hereinafter PRESIDENTIAL TASK FORCE REPORT).

department would deal with managing the financial solvency of the entities being regulated by the agency while the market conduct department would deal with managing the consumer protection issues that will arise. This internal structure allows the agency to prioritize its rulemaking based on risks and not along functional lines.

The FSC would be less prone to agency capture by a narrow segment of the financial services industry because it would cover a broad array of financial services. One of the problems discussed in administrative law is the problem of agency capture under the interest group theory on governmental decision-making. Interest group theory generally assumes the following: (a) small, narrowly focused interest groups, whose members will receive significant benefits from a particular regulatory decision, are better able to overcome collective action problems to mobilize to advance their interests than other groups, which creates a bias for regulation that aids narrow interests; (b) politicians from either the executive or legislative branches try to exchange regulatory benefits for political support from interest groups that are well positioned to provide it; and (c) political control over administrative agencies is sufficient to allow politicians to deliver the type of regulation that the interest groups supporting them seek.²⁴²

Agency capture occurs more frequently in agencies that regulate only one special interest group.²⁴³ In the financial services industry, specialized agencies, like insurance regulators, are more likely to be captured by the businesses that they regulate than

²⁴² Steven P. Croley, *Public Interested Regulation*, 28 FLA. ST. U.L. REV. 7, 15-16 (Fall, 2000). Prof. Croley's article tries to provide some answers as to whether federal administrative agencies can deliver regulation that provides broad based benefits (i.e., those that benefit the general public) rather than regulation that primarily benefits special interests. He first describes and critiques the "interest group," "capture," or "public choice" accounts of regulation. He then discusses an administrative process approach to regulation that focuses on how administrative processes may enable or restrict an agency's ability to formulate regulations without being unduly influenced by special interests. He then uses the administrative process approach to analyze three regulatory initiatives that the interest group theory cannot explain well.

²⁴³ *Id.* at 103.

regulators with a broader scope.²⁴⁴ Thirty-three states have an agency that is only dedicated to regulating insurance.²⁴⁵ Seventeen other states include insurance within a department that regulates more than one financial services area, but these states still maintain a separate division dedicated only to insurance within this department.²⁴⁶ As a result, the insurance division within this department may be subject to capture by the insurance companies.

The report from the California Performance Review, which was published on August 3, 2004, recommended reorganizing and consolidating California's existing departments, agencies and boards.²⁴⁷ The report mentioned that "with small agencies focused only on one business or profession, there is always the risk that the board will be 'captured' by the industry it should be regulating, accepting lax standards instead of protecting consumers."²⁴⁸ As a result, the report recommended consolidating overlapping and duplicative programs to reduce the problem of agency capture. California is one of the states that maintain separate agencies to regulate insurance, banking and securities.²⁴⁹

Regulatory capture can occur more easily in situations in which the agency is only accountable to the executive branch than in situations in which the agency is accountable to a body of competitively elected individuals or is directly accountable to the

²⁴⁴ How much each of these regulators has been captured by their constituents has been debated. David L. Ratner, *Response the SEC at Sixty: A Reply to Professor Macey*, 16 CARDOZO L. REV. 1765, 1776 (1995) ("Unlike the regulators of banks, thrift institutions, and insurance companies, which have acted principally as protectors and advocates for their constituents, the SEC has frequently been at loggerheads with some of the most powerful organizations in the securities industry, particularly the New York Stock Exchange.").

²⁴⁵ Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, XIV U. MIAMI BUS. L.R. 1, 22 (Fall/Winter 2005)

²⁴⁶ *Id.*

²⁴⁷ CALIFORNIA PERFORMANCE REVIEW REPORT, released Aug. 3, 2004, <<http://report.cpr.ca.gov/cprprt/preschg/ebo.htm>> (accessed Dec. 29, 2004); John M. Broder, *Plan Would Consolidate California Agencies*, N.Y. TIMES (Aug. 4, 2004).

²⁴⁸ CALIFORNIA PERFORMANCE REVIEW REPORT, released Aug. 3, 2004, <<http://report.cpr.ca.gov/cprprt/preschg/ebo.htm>> (accessed Dec. 29, 2004).

²⁴⁹ Brown, *supra* note 245 at 22.

electorate.²⁵⁰ Eleven of the states have the general public vote to elect their insurance commissioners.²⁵¹ The insurance commissioners in the remaining states are appointed by the governor.²⁵²

In addition, agency capture will occur less frequently when the head or heads of the regulatory agency have fixed and relatively long terms in office.²⁵³ The terms for the Governors of the Federal Reserve are for 14 years.²⁵⁴ The shorter the term of office, the lower the level of independence a regulatory agency will have. So a term of four years or less may be indicative of a lack of agency independence.²⁵⁵ The insurance commissioners' terms in office vary greatly from state to state because of the different ways that they are selected.²⁵⁶ In the majority of cases, however, they serve at the pleasure of the governor.²⁵⁷

Agency capture, however, will occur more frequently when efforts to advance general interest regulation to the detriment of special interests would threaten an agency's budget or other institutional interests.²⁵⁸ None of the state insurance commissions have complete control over their budgets. The budgetary system employed by the states that comes closest to giving them complete control over their budget is the "dedicated funding system". In the dedicated funding system, the legislature sets an appropriation limit for the state

²⁵⁰ James R. Barth, Gerard Caprio, Jr., and Ross Levine, *RETHINKING BANK REGULATION: TILL ANGELS GOVERN* (Cambridge University Press: 2006) at 97.

²⁵¹ NAIC RESOURCES REPORT 2006, *supra* note 107 at 1-2.

²⁵² *Id.*

²⁵³ Barth, et al, *supra* note 250 at 97-98.

²⁵⁴ *Id.* at 99.

²⁵⁵ *Id.* at 97-98.

²⁵⁶ NAIC RESOURCES REPORT 2006, *supra* note 107 at 1.

²⁵⁷ *Id.*

²⁵⁸ Croley, *supra*. note 241, at 15-16; Steven A. Ramirez, *Depoliticizing Financial Regulation*, 41 WM & MARY L. REV. 503, 518 (Feb. 2000).

insurance commission.²⁵⁹ The insurance commission collects funds from the insurance industry, usually from fees and assessments, fines and penalties, and other incomes generated by it, and puts these funds into a special account.²⁶⁰ The insurance commission then spends the funds in this special account up to the appropriation limit set by the legislature for its budget.²⁶¹ If the revenues going into the special account exceed the insurance commission's expenditures, then the excess is rolled over to the next fiscal year.²⁶² If the revenues going into the special account are less than the insurance commission's anticipated expenditures, then insurance commission must either cut its expenditures to get below the appropriation limit set by the legislature or use the accumulated cash balance from prior years in the special account.²⁶³ Dedicated funding systems, thus, avoid the potential problems of cyclical changes over time.²⁶⁴ Thirty states use dedicated funding systems.²⁶⁵ Eight out of the ten states with the largest annual budgets use a dedicated funding system.²⁶⁶

The other funding systems used by the states include the quasi-dedicated funding system, the general revenue funding system and the combination funding system.²⁶⁷ A quasi-dedicated funding system is similar to the dedicated funding system, except that any remaining unspent funds at the end of the fiscal year are rolled over into the state's general fund.²⁶⁸ As a result, the insurance commission is not insulated from cyclical

²⁵⁹ NAIC RESOURCES REPORT 2006, *supra* note 108 at 27.

²⁶⁰ *Id.*

²⁶¹ *Id.*

²⁶² *Id.*

²⁶³ *Id.*

²⁶⁴ *Id.*

²⁶⁵ *Id.* at 31.

²⁶⁶ *Id.* at 30-31.

²⁶⁷ *Id.* at 27.

²⁶⁸ *Id.*

changes over time.²⁶⁹ In a general revenue funding system, the state creates a budget for the insurance commission as part of its normal budgetary process and funds the insurance commission's budget from the state's general fund.²⁷⁰ All of the revenue collected by the state's insurance commission from the insurance industry is deposited directly into the state's general fund.²⁷¹ Under a general revenue funding system, the state government has considerable control over how the insurance commission spends its money.²⁷² A combination funding system employs elements of other three systems.²⁷³ Five states use quasi-dedicated funding systems, two states use general funding systems and 13 states use combination funding systems.²⁷⁴ If one aggregated how each state stood with regard to each of the variables listed above, one would find that about two thirds of the states show some propensity towards or a substantial propensity towards agency capture.²⁷⁵

The FSC would be less prone to capture than the existing state agencies because it would cover a broader segment of the financial services industry. In addition, the FSC could be further insulated from capture if it was given control over its budget.

This option is probably the most politically feasible of the three options being proposed in this paper. Some support already exists for consolidating the SEC and the

²⁶⁹ *Id.*

²⁷⁰ *Id.*

²⁷¹ *Id.*

²⁷² *Id.*

²⁷³ *Id.*

²⁷⁴ *Id.* at 31.

²⁷⁵ The states' independence was determined by examining five criteria: (1) whether the head or heads of the insurance regulator were appointed by the governor or elected; (2) whether the agency regulating insurance was headed by one or more commissioners; (3) whether the commissioners had fixed terms for four years or less; (4) whether the insurance agency's budget was primarily controlled by the legislature or by the agency; and (5) whether the agency regulating insurance was solely focused on insurance or also regulated other financial services areas. If the state fell within the first category for each question, a value of 1 was assigned. If the state fell within the second category for each question, a value of 0 was assigned. The higher a state's score is, the lower the level of independence of its insurance regulator and the more prone to capture it is. This system was modeled after one used in Barth, et al, *supra* note 250, at 96-102.

CFTC. This proposal would build on that. It avoids the problem of trying to consolidate the banking regulators with the SEC and the other financial regulators. A number of proposals have suggested consolidating the banking regulators with each other and they have successfully resisted those efforts.²⁷⁶ They would likely be even more resistant to being consolidated with a host of other regulatory agencies.

This structure also would be more likely to be adopted if it did not also try to integrate all of the state insurance regulators into the new consolidated federal agency. Not consolidating the banking regulators or the state regulators into this agency would mean that several other agencies within the United States probably would continue to regulate along functional lines. This dichotomy of regulatory styles might create some regulatory clashes when the different approaches came to different conclusions about the

²⁷⁶ In 1949, the Commission on Organization of the Executive Branch of Government (the “Hoover Commission”) recommended transferring all of the federal regulatory authority over banks from the OCC and the FDIC to the Federal Reserve. In 1971, the President’s Commission on Financial Structure and Regulation (the “Hunt Commission”) recommended consolidating banking regulatory responsibilities into three new agencies: (1) the Administrator of National Banks that would assume the supervisory duties of the OCC, (2) the Administrator of State Banks that would assume the supervisory duties of the Federal Reserve and the FDIC but leave in place the state banking regulators, and (3) the Federal Deposit Guarantee Administration that would assume the insurance functions of the FDIC, the FSLIC and the NCUSIF. In 1975, the House Banking Committee completed a study, which recommended the creation of a new federal agency responsible for all federal regulation over state and federally-chartered depository institutions. In December, 1982, the Task Group on Regulation of Financial Services recommended creating a new “Federal Banking Agency” within the Treasury Department that would regulate all national banks and their holding companies while the Federal Reserve would oversee federal regulation of all state-chartered banks and their holding companies, the FDIC’s sole responsibility would be to focus on providing deposit insurance and administering the deposit insurance system, antitrust matters related to banks would be primarily the responsibility of the Justice Department, and securities matters related to banks would be primarily the responsibility of the SEC. In 1994, Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, suggested in a statement before Congress that the OCC and the OTS ought to be merged to form a Federal Banking Commission to supervise all national banks and thrifts, but the Federal Reserve would continue to supervise state banks and bank holding companies. In 1994, the Treasury proposed consolidating the OCC and the OTS into a single agency, which would also have assumed some of the regulatory functions of the Federal Reserve. In 1996, the GAO recommended that the OCC and the OTS be combined into a single agency, which also would have assumed the FDIC’s supervisory responsibilities in the new agency. See U.S. GOVERNMENT ACCOUNTABILITY OFFICE, REPORT TO THE CHAIRMAN, COMM. ON BANKING, HOUSING, AND URBAN AFFAIRS, U.S. SENATE, FINANCIAL REGULATION – INDUSTRY CHANGES PROMPT NEED TO RECONSIDER U.S. REGULATORY STRUCTURE 76 (Oct. 2004); Ramirez, *supra* note 258.

best regulations going forward. It would also leave open the possibility of turf wars among the new agency on one side and the banking regulators and the states on the other regarding products or firms that overlap with the regulatory authority of the banks or the states.

These regulatory clashes could be reduced if the new agency required preempted state regulation of any firms operating in multiple states or whose products and services were sold in multiple states. This level of preemption would severely reduce the regulatory authority of the states in the area of financial services.

Obviously, states would strongly object if this was done because of the loss of funds, power and influence. They would also argue that such a structure would create an unwieldy bureaucracy in Washington, DC that would be less responsive to consumers and investors than the states would be. The consumer protection objections could be overcome in part if the new agency had field offices in all 50 states to assist consumers or investors and to investigate regulatory violations.

B. Adopt a Twin Peaks or Multi-Peaks Model Structured Around Risks

One way to avoid regulatory clashes with other federal agencies and state agencies would be to consolidate all of the financial regulators into two or more federal agencies that regulate certain risks. For example, when two agencies are created, one would deal with prudential risks while the other would deal with market conduct risks. This structure is called the “twin peaks model”. Both agencies would be responsible for the entire range of financial services and firms but each would have a very clear mission about what risks that they are responsible for controlling.

The Treasury in its Blueprint settled on a variant of this structure. As noted above, however, the Treasury's proposal would create five agencies, each responsible for a different regulatory objective. In most cases, these objectives concern regulating particular risks, such as prudential or market conduct risks.

The twin or multi-peak structure would avoid the fatal flaw of the current Congressional proposals because it would not attempt to classify financial services or products based upon function. In addition, this structure would reduce the number of turf wars between agencies because there would be fewer areas of potential overlap between the regulatory responsibilities of each agency. It would not completely eliminate regulatory overlap between the agencies.²⁷⁷ For example, the prudential regulator could require that all breaches of prudential requirements be reported while the market conduct agency might impose a materiality test regarding such breaches.²⁷⁸

In addition, because the agencies' regulatory perspectives are so different, they can potentially give rise to conflicts between the agencies.²⁷⁹ The United States could have the agencies use the President's Working Group on Financial Markets as a forum for resolving these disputes. Another criticism of this structure is that regulatory gaps can still exist between the regulatory spheres of these agencies.²⁸⁰

This model is better able to deal with financial conglomerates than the current system or the proposals to create a new insurance regulator. The twin or multi-peaks model also avoids the problem of creating a super-agency that wields too much regulatory authority,

²⁷⁷ Jeremy Cooper, Deputy Chairman, Australian Securities and Investment Commission, *The Integration of Financial Regulatory Authorities – the Australian Experience*, Presented to the Comissão de Valores Mobiliários 30th Anniversary Conference, *Assessing the Present, Conceiving the Future*, 4 (4-5 Sept. 2006).

²⁷⁸ *Id.* at 13. This problem arose between Australia's prudential regulator and its market conduct regulator.

²⁷⁹ *Id.* at 4.

²⁸⁰ *Id.*

which may happen in the case of a single financial regulator. It decreases the likelihood that the problem of agency capture may occur if the United States created a new federal insurance agency, as was proposed under the NIA and ICPA. Agencies with diverse portfolios of businesses are less likely to be captured than those that regulate a more narrowly defined business segment.²⁸¹

In 1996, the Australian government established the Financial System Inquiry to recommend the best overall framework for the efficient delivery of financial regulation and to recommend ways to improve the regulatory structure.²⁸² This inquiry proposed three models for Australia, the mega regulator, the lead regulator, and the twin peaks regulatory model.²⁸³

Australia's experience with the twin peaks model has not been free of crises. In 2001, the Australian insurance group HIH collapsed.²⁸⁴ HIH was worth \$3.75 billion before it collapsed.²⁸⁵ After an official inquiry, it was determined that Australia's prudential regulator needed to take a more aggressive approach to prudential regulation.²⁸⁶ It is not clear that the twin peaks model was a factor in the agency's failure to catch the fraud that contributed to HIH's collapse.²⁸⁷ Both of Australia's regulatory agencies view keeping up with the rapidly evolving financial markets as one of their biggest challenges.²⁸⁸

Australia has been using the twin peaks model for long, only about 10 years. So it may be too soon to tell how successful this model is in operation, although both appear to

²⁸¹ Brown, *supra* note 245.

²⁸² Cooper, *supra* note 277 at 4.

²⁸³ *Id.*

²⁸⁴ *Id.* at 5.

²⁸⁵ *Id.*

²⁸⁶ *Id.*

²⁸⁷ *Id.*

²⁸⁸ *Id.* at 5 and 8

be working well. The Australian government evaluated the effectiveness of the twin peaks model in January 2006.²⁸⁹ The report did not recommend any changes to the twin peaks model and noted: “Australia’s financial and corporate sectors, and the associated regulatory structures, are highly regarded internationally. Moreover, the broad policy framework has widespread support within business and the wider community in Australia.”²⁹⁰

C. Create a Single Financial Services Agency

A single, federal financial services agency, like the UK FSA, would consolidate the regulatory authority of all of the existing financial services regulators, including the state insurance commissions, into a single agency. A single financial services regulator, like the UK FSA, would regulate firms and products based on the risks that they posed (market conduct, prudential, etc.) rather than trying to shoehorn them into categories that are ill fitting. This model is also used by the Michigan Office of Financial and Insurance Services (“OFIS”). OFIS operates as a single regulator for banking, insurance and securities but regulates these products and services based upon the risks posed. The UK FSA and Michigan’s OFIS each have one department that focuses on prudential regulation and a separate department of the consumer protection. Most states that have banking, securities and insurance combined into one agency still maintain separate offices for each financial service and so retain functional regulation within the combined agency structure.

²⁸⁹ *Id.* at 13.

²⁹⁰ *Id.*

In my article in the University of Miami Business Law Journal, I went into great detail how one example of how such a single federal agency might be structured.²⁹¹ Such an agency would have a department for prudential regulation, one for regulatory processes and risks, one for consumer protection, one for enforcement, one for operations, and one to serve as the financial services guaranty division. As I discussed in detail in that article, a single financial services regulator would provide a number of benefits over the current regulatory regime or one in which a federal financial services regulator for insurance was added to the over 115 state and federal financial services regulators that currently exist. Rather than attempt to recreate the discussion of the pros and cons from that article here, I would just like to note that among the benefits that a single financial regulator may provide, are:

- It would reduce the number of overlapping and duplicative regulations that currently exist.²⁹²
- It would reduce the time and expense of interagency turf wars because integrated or semi-integrated agencies can resolve disputes between divisions more quickly and efficiently than when the conflicts arise between two separate agencies because, in a single agency, the head of the agency can always step in to resolve the dispute rather than requiring the governor, the state legislature or the judiciary to intervene to solve the problem.²⁹³
- It would increase accountability by eliminating regulatory gaps and enabling the public to hold one agency accountable for regulatory failures.²⁹⁴

²⁹¹ Brown, *supra* note 245.

²⁹² *Id.* at 75-76.

²⁹³ *Id.* at 76-77.

²⁹⁴ *Id.* at 75-76.

- It would be less costly.²⁹⁵
- It would provide a single voice for the United States in international negotiations regarding financial services regulations, like Basel II.²⁹⁶
- It would be less prone to capture.²⁹⁷

In addition, it is worth pointing out that a single financial regulator would face some potential problems, including:

- It may be very large and could be unwieldy and costly;²⁹⁸
- It may cause the United States to lose any benefits that it had from the regulatory competition among the plethora of state and federal regulators;²⁹⁹
- It may have difficulty prioritizing issues;³⁰⁰
- It may have difficulty responding to smaller firms and, thus, may undermine the diversity of institutions that currently comprise the U.S. insurance industry;³⁰¹
- It may have difficulty hiring staff with specialized knowledge related to large and small insurance companies;³⁰² and
- It may lack accountability to both consumers and market participants.³⁰³

For a more detailed exposition on each of these points, I would urge you to read the complete article discussing why I believe that, on balance, the benefits of a single financial regulator will outweigh the costs in the long run and that it provides the optimal regulatory structure for the United States.

²⁹⁵ *Id.* at 85-87.

²⁹⁶ *Id.* at 79.

²⁹⁷ *Id.* at 79-80.

²⁹⁸ *Id.* at 87.

²⁹⁹ *Id.* at 88-92.

³⁰⁰ *Id.* at 87.

³⁰¹ *Id.* at 87.

³⁰² *Id.* at 88.

³⁰³ *Id.* at 88.

CONCLUSION

While no regulatory structure is perfect, both the current state insurance regulatory system and the Congressional proposals to federalize insurance suffer from the same fatal flaw. They both fail to recognize that financial services form a continuum of products that cannot be easily categorized and attempting to attach labels to products and firms wastes time, money and other resources. The United States would do better if it moved away from functional regulation and adopted a regulatory structure that concentrated on regulating risks, such as the multi-peaks model as proposed by the Treasury or a single financial regulator along the lines of the UK FSA.

Finally, other areas of financial services are considering consolidating or have consolidated their regulators within the United States. On July 30, 2007, the Financial Industry Regulatory Authority (“FINRA”) began operations after consolidating the National Association of Securities Dealers (“NASD”) and the member regulation operations of the New York Stock Exchange.³⁰⁴ Given that over 115 financial services regulators already exist in the United States, creating a new one for insurance at this time should only be done if there is overwhelming evidence that insurance could not be properly regulated in a consolidated regulator. No such evidence exists. In fact, the blurring of the lines between financial products and firms means that functional regulation that requires a separate regulator for each sector is becoming more of a hindrance than a benefit when it comes to regulating financial services.

This article suggests three alternative structures that would focus on regulating risks and thus, would provide a more flexible regime that would better achieve the goals of

³⁰⁴ James Langton, *Financial Industry Regulatory Authority Begins Operations*, INVESTMENT EXECUTIVE (July 30, 2007).

financial services regulation than the existing structure or the prior proposals for federalizing insurance. Each of these suggestions has its pros and its cons. Some of the proposals would be far more difficult to implement than others because of the resistance of interests vested in the current system to change. Nevertheless, they are each worth considering if the United States wants to design a financial services regulatory structure that will be prepared for the challenges of the future rather than merely attempting to slap patches on the a system that is becoming obsolete.

APPENDIX

COMPARISON OF THE DIFFERENT PROPOSALS FOR FEDERALIZING INSURANCE

	SMART Act	NIA	ICPA	US FSA
No. of State Insurance Regulators	50	50	50	0
Federal Insurance Agency	No, but creates a National-State Insurance Coordination Partnership	Yes, in the Treasury Department	Yes, in the Commerce Department	Yes, as part of a single financial services regulator
Director(s)/ Commissioner(s)	Partnership has 7 Commissioners (3 state, 3 federal & 1 chairman)	1	5	5 with no more than 3 from the same party
Selection of Director(s)/ Commissioner(s)	States select state representatives; reps from Treasury, SEC & Federal Reserve; Chairman nominated by States and appointed by President	Appointed by President with advice & consent of Senate	Appointed by President with advice & consent of Senate	Appointed by President with advice & consent of Senate
Term of Appointment	7 years	5 years	7 years	5 years
Authority of Director(s)/ Commissioner(s)	Has no regulatory authority.	Oversee regulation and supervision of National Insurers, National Agencies, and federally licensed producers, including issuing charters and licenses	Oversee regulation and supervision of National Insurers, National Agencies, and federally licensed producers, including issuing charters and licenses for life insurance, property/casualty, medical malpractice	Oversee regulation and supervision of all financial service providers, including insurance companies, agencies and producers.

	SMART Act	NIA	ICPA	US FSA
Regional Offices	NA	At least 6	None mentioned	At least 50
Funding	States cover the costs of their representatives and federal government covers expenses of others	From fees and assessments to cover expenses and to fund a working capital fund with any excess being refunded to the payers; initial start-up costs will come from a 30 yr. loan from the Treasury Secretary	From normal federal budget appropriations	From fees, assessments and other charges assessed against the financial services industry; sets its own budget; any excess is given to the Treasury
Preemption of State Law	Yes	Preempts state laws on licensing, examination, reporting, regulation, etc. regarding sale or underwriting of insurance but not state laws on unclaimed property, taxes, mandatory assigned risk plan or similar mechanism, compulsory workers' comp. or motor vehicle insurance, exclusive of any rate requirements	Sets minimum national standards but allows States to enforce more stringent requirements on intrastate insurers	Yes
International Negotiations	???	Commissioner may engage in int'l and multilateral agreements; required to consult with President and USTR; may but is not required	USTR will negotiate and consult with Federal Commission and States as appropriate	Responsible for engaging in int'l and multilateral negotiations and agreements; consults with other federal entities as appropriate.

	SMART Act	NIA	ICPA	US FSA
		to consult with states		
Federal Charter/ Licensing	No	Yes	Yes	Yes
Supervision of Federal Insurers	NA	Must examine a National Insurer once every 36 months; may not examine a National Agency unless it receives a complaint or other evidence that the National Agency has violated any law or agreement with Commissioner	Must exam an interstate insurer once every 12 months.	To be determined.
Ability to Set Rates	Ability to set rates ends after 2 years	No and National Insurers, National Agencies and producers are exempt from state rate rules	Yes	Directors must establish standards after conducting a cost-benefit analysis
Consumer Protection	Must adopt NAIC model laws within 3 years or be preempted	Consumer Protection Division	Office of Consumer Protection; ability to set rates; market conduct policies regarding insurance fraud, HIV discrimination, minimum national standards, etc.	Consumer Protection Division; regulations to be revised after cost-benefit analysis
Ombudsman	No	Yes	None mentioned	Yes

	SMART Act	NIA	ICPA	US FSA
Self-Regulating Organizations	NA	Commissioner may license SROs, which will have the authority to carry out the act's purpose and enforce compliance among their members, but may not have rulemaking authority delegated to them by Commissioner	None mentioned	SROs have no regulatory authority
Licensing of Reinsurers	Must adopt NAIC model laws within 3 years or be preempted	Yes	Yes	Yes
Producer Licensing	Must adopt NAIC model laws within 2 years or be preempted	Yes	Yes	Yes
Federal Insurance Guaranty Program	No	Yes	Yes	Yes, as part of a single financial services regulator