



2007-PB-02
March 2007

Uniformity and Efficiency in Insurance Regulation: Consolidation and Outsourcing of Regulatory Activities at the State Level

W. Jean Kwon

Abstract: An intense debate over the choice of regulatory authority, e.g., state vs. federal regulation, continues in the U.S. The debate not only exhibits the diversity of political and economic interests of various groups such as the federal government, state governments and the NAIC, insurance companies and their associations, and policyholders and the general public. It also reflects the need of all parties of interest to align U.S. regulation with the changes in the financial services market and to preserve competitiveness of U.S. insurance companies in the domestic and foreign markets. This study summarizes the general directions of regulatory reforms internationally, reexamines the political history of insurance regulation in the U.S. to identify the motives behind each call for reform, and evaluates the current state-based approaches in comparison to proposed alternatives. The paper concludes that the current state-based system is preferred to any other forms of regulation in the U.S., provided that state regulators unify their activities and improve regulatory efficiency and that the NAIC positions itself as a true association of member regulators and is financially supported primarily by the members.

About the Author: W. Jean Kwon is an associate professor of insurance at the School of Risk Management at the Peter J. Tobin College of Business, St. John's University. He co-authored *Risk Management and Insurance in a Global Economy* (expected April 2007). He serves on editorial boards of several journals, advises multiple insurance institutions, and continues his consulting work in the U.S. He helped establish the Asia-Pacific Risk and Insurance Association in 1997. He is also Chartered Property Casualty Underwriter (CPCU), a professional designation offered by the American Institute for Chartered Property Casualty Underwriter and the Insurance Institute of America (IIA).

Keywords: insurance, regulation, reforms

The views expressed are those of the author and do not necessarily reflect official positions of Networks Financial Institute. Please address questions regarding content to W. Jean Kwon at kwonw@stjohns.edu. Any errors or omissions are the responsibility of the author.

NFI working papers and other publications are available on NFI's website (www.networksfinancialinstitute.org). Click "Research" and then "Publications/Papers."

Uniformity and Efficiency in Insurance Regulation: Consolidation and Outsourcing of Regulatory Activities at the State Level

W. Jean Kwon *

I. Introduction

Insurance is purchased in utmost good faith, and consumers implicitly rely on the integrity of the insurers with who they deal. However, the complex nature of this future-deliverable product affords the easy potential for customer abuse. Hence, governments commonly list “protection of policyholders’ interests” as a key regulatory objective in the insurance act.

The mission of insurance is security and private insurance cannot flourish without public confidence with the market. Thus, government’s duty is to ensure that this confidence is neither misplaced nor undermined, and regulatory intervention is to rectify market failures.¹

Governments seek to ensure that quality, fairly priced products are available from reliable insurers. Accordingly, almost every country has insurance laws and regulations that determine who may sell and underwrite insurance and the circumstances under which they may do so. Minimum reserve, asset quality and quantity, and capital requirements are usually laid down. Special accounting standards are often mandated. In many countries, prices and policy conditions are regulated.

Insurance markets in the U.S. are diverse and complex. We find federal government agencies, state government agencies and over 7,700 private entities supplying various types of insurance products in the country. In a few markets (or lines of insurance business), the government permits no competition (e.g., social security programs by the federal government and workers’ compensation insurance in selected states). In a few other markets, government and private insurers (e.g., competitive state funds and private companies) compete. In all other lines of insurance, only private insurers—domestic and foreign-incorporated alike—compete. The products offered in the markets are diverse, ranging from commodity-like products to capital market-linked, catastrophe risk products. Not surprisingly, the U.S. has been both a market in which foreign companies test their products and a place from which foreign governments learn how insurance regulation would develop.

* I want to thank Ismael Rivera-Sierra, Director of the Davis Library, and Meng Xiong and Zhao Zhou, research assistants, for data collection and book search.

This paper was prepared for “4th Annual Insurance Reform Summit” a conference sponsored by Networks Financial Institute at Indiana State University and held in Washington, D.C. on March 07, 2007.

¹ In many developing countries, an additionally stated (sometimes, implied) goal is promoting the development of the domestic insurance industry so that the industry contributes to overall economic development of the country.

Are we confident that the U.S. sets the standard in insurance regulation? More importantly, are we confident that U.S. insurance regulators have done their best to achieve the two fundamental objectives—protection of policyholders’ interests and provision of insurance by operationally and financially sound companies?² Are regulators offering the supervisory services efficiently and cost effectively? Or, do they have other motives?

Recently, politicians, regulators, market players and consumer representatives have begun a round of debate over the choice of regulatory authority. Of course, it is not the first time they are debating it; similar debates were made in the past (in fact, almost from the beginning of the history of insurance in the U.S., each time with a different motive and under a different market or political environment.

This paper examines what regulation of insurance should be in terms of cost and efficiency and is structured as follows. The next section, Section II, highlights the modus operandi in insurance regulation internationally. Section III investigates the development of insurance regulation in the country with an emphasis on the motive behind each major development. Section IV analyzes recent calls for reform, and is followed by another section dealing with the role as well as cost and operating efficiency of state regulation and the NAIC. The final section offers suggestions for improving regulatory efficiency and conclusions.

II. Modus Operandi in Insurance Regulation Internationally

Regulation varies from "light" to "heavy" worldwide. The U.K., Chile, Hong Kong and the Netherlands, for example, generally rely more on market forces to ensure a viable insurance market, with regulation principally relating to prudential matters. At the other extreme, Japan, Korea, Switzerland and the majority of developing countries practice intensive regulation, focusing not only on insurer prudential matters, but also on product pricing and content and on market stability. Regulatory styles in Canada and the U.S. fall between the two extremes.

Government regulatory policy and administration of the policy typically take place at three levels: legislative, judicial and executive. The legislative body enacts laws to establish the country’s broad legal framework, including the general standards and scope of responsibilities of the insurance regulatory agency. The judiciary resolves disputes between parties of interest in insurance.

The third area of government oversight falls under the state’s executive branch. The International Association of Insurance Supervisors (IAIS) (2006) reports that of the 53 jurisdictions that participated in a survey, only seven jurisdictions (e.g., Czech Republic, Mexico, Spain and Switzerland) have the supervisory authority as part of a ministry (commonly the finance ministry). Thirty one jurisdictions, including the NAIC which

² A 2006 survey by the IAIS shows that the respondent-regulators listed “enhancing market transparency” as another common primary objective in addition to “protection of policyholders’ interests, and ensuring market stability and monitoring insolvency.” Separately, Meier (1988) summarizes the following as other primary objectives in insurance regulation: access that insurance should be available to all individuals who need or are required to have it; social investment by insurance companies; and local protectionism as an attempt to protect local companies from competition by foreign companies.

participates as a representative of the U.S. regulatory authorities, report that the authority is a government agency but not part of a ministry.³ Five jurisdictions (e.g., Canada-Quebec and Malaysia) report that the authority is a quasi-governmental institution. In some countries, such as the Insurance Regulatory Development Authority of India, the body is a quasi-independent authority and is not housed in any ministry.

In most countries, a special department or subordinate institution of the relevant ministry carries out insurance regulatory oversight. In a number of countries, the department is exclusively for insurance regulation (e.g., Argentina, Belgium, Nepal and selected U.S. states).⁴ In some countries, the insurance authority is part of a larger institution that also oversees banking (e.g., Australia, Canada and Peru).⁵ In some other countries, the authority is part of the bigger agency responsible for supervising the entire financial services sector (Denmark, Japan, Korea, Norway, Singapore, Sweden, and U.K.).⁶

The person responsible for insurance supervision commonly holds the title of commissioner, superintendent, supervisor or director. The position is usually appointive. So are the positions in all but 11 U.S. states. The IAIS reports an average of 80 employees (excluding those in administration and secretariat services) per insurance authority. Two-thirds of the respondents outsource certain activities, mainly accounting, and computer support and training matters.

The costs of regulation are covered by the state budget in only eight jurisdictions that responded to the 2006 IAIS survey: in most of those countries, the regulated companies are ultimate bearers of the costs. Fees for services are additional source of funding. Costs of on-site inspection generally are borne directly by the inspected company.

A formal advisory body assists regulatory authorities in most countries. Commonly, this body is composed of representatives of insurance companies, consumer groups, insurance experts and others with an interest in insurance. The number of members varies from 5 to 60, depending on several factors in each of the countries. The body advises the authority on important decisions. In some countries, the regulator must consult the advisory body before taking certain actions. Having an advisory body is not typical in the U.S.

In Canada, regulatory oversight responsibilities are split between the federal and provincial governments, with the latter being charged primarily with policyholder protection matters. An insurer in Canada may elect either a federal or a provincial charter, thus effectively choosing its regulatory locus. National and foreign insurers in Canada typically elect federal chartering. A weaker form of dual regulation is observed in Germany. There are two supervisory authorities in France—the Insurance Companies

³ U.S. states of Kansas and Oklahoma also participated in the survey.

⁴ Specifically, they are *Office de Contrôle des Assurances* of Belgium, *Superintendencia de Seguros de la Nacion* of Argentina and the Insurance Board in Nepal. See Appendix A for state insurance departments in the U.S.

⁵ They are Australian Prudential Regulation Authority, Office of the Superintendent of Financial Institutions of Canada, and *Superintendencia de Banca y Seguros* of Peru.

⁶ They are Danish Financial Supervisory Authority, Financial Services Agency of Japan, Financial Supervisory Services of Korea, Banking, Insurance and Securities Commission of Norway, Monetary Authority of Singapore, Swedish Financial Supervisory Authority, and Financial Services Authority of the U.K.

Committee (CEA, *Comité des entreprises d'assurance*) in charge of accrediting insurers and the Insurance and Mutual Insurance Control Commission (ACAM, *l'Autorité de contrôle des assurances et des mutuelles*), created in 2003, independently overseeing insurers compliance with the laws, regulations and contracts.

An extended form of dual regulation can be said to exist in the E.U. in which the 27 E.U. member countries are bound to E.U. insurance directives governing the implementation of a single license market policy and minimum regulatory standards.⁷ In the U.S., insurance regulation resides primarily at the individual state level. No U.S. federal agency has broad responsibilities for the regulation.

Each country's insurance laws and regulations differ in nature and scope. While no two nations' laws are identical, they are typically designed to address broadly five key concerns. Each of the concerns is briefly described below.⁸

Access to the Market. A baseline issue for the government is determining the role of the public sector vis-à-vis the private sector in the provision of economic security. The trend globally is toward placing greater reliance on competitive insurance markets. The majority of countries today subscribe to the philosophy that government should serve as a supplier of insurance only where some overriding social issue demands it or where the private market has failed to respond adequately to some perceived need and no market-based solution seems feasible.⁹

It is thus necessary to determine who should be allowed to enter the private sector market and on what terms. This decision embodies both market access and national treatment issues.

- *Licensing Requirements.* Licensing is the most important and powerful means of controlling access to the market. It provides the regulator with leverage to compel insurers to comply with the governing laws and regulations. Licensing requirements establish minimum acceptable standards for insurer financial strength. In perhaps all jurisdictions, applicants wishing to establish an insurance company in the jurisdiction must secure a license, thereby becoming an admitted (authorized) insurer.

Without licensing, insurance buyers cannot be protected fully and competition could be distorted. Most countries historically have prohibited their citizens from purchasing insurance from non-admitted insurers.¹⁰ Even liberal regulatory regimes restrict the purchase of compulsory insurances (e.g., automobile liability) to admitted insurers.

⁷ The single market policy of the E.U. also aims at completing a single wholesale (i.e., integrated capital) market, developing open and secure markets for retail financial services, and ensuring financial services market stability with better supervisory systems (Centre for European Policy Studies, 2003).

⁸ The discussion draws heavily from Skipper and Kwon (2007).

⁹ The private insurance market may fail to provide needed insurance when the associated risk is not easily diversifiable or when the private sector avoids business in lines where considerable problems of adverse selection exist.

¹⁰ If buyers nevertheless purchase insurance from an unlicensed insurer, certain tax concessions and regulatory protections, such as guaranty fund cover, may be unavailable.

The trend is toward permitting such consumer-initiated purchases on limited cases. Besides, even where purchase from or sale by non-admitted insurers is prohibited, most countries allow such purchase where needed commercial coverage is unavailable locally. The excess-surplus line of insurance in the U.S. is an example in this regard.

- *National Treatment.* National treatment, toward which most OECD countries are moving, means that foreign entrants into a market are accorded treatment no less favorable than that accorded domestic companies. Thus, licensing (and other) requirements generally are applied nondiscriminatorily as between (1) a state's domestic insurers owned by nationals and those owned by foreigners (i.e., national treatment) and (2) domestic insurers and foreign insurers (i.e., most-favored-nation treatment). This principle is relatively well observed in the U.S.

Balancing Competition against Consumer Protection. After establishing rules determining who will be permitted to compete within their insurance markets, policymakers decide how best to balance the benefits of competition against the need to protect insurance consumers. Generally, this relates to the following four areas: rate and product regulation, financial regulation, intermediary regulation and competition policy regulation.

- *Rate and Product Regulation.* If it exists at all, rate regulation should strive to ensure that rates are not “excessive, unfairly discriminatory or inadequate.” Regulation of policy terms and conditions is intended to reduce the likelihood that insurers take unfair advantage of insureds via the insurance contract itself. Inadequate competition within a market or line of insurance can lead to excessive and sometimes inequitable rates as well as to unfair policy terms and conditions.

Various forms of *ex ante* (prior approval) and *ex post* (subsequent disapproval) rate regulation exist internationally (and within the U.S.). Most commercial lines of insurance and reinsurance are free from rate regulation. In contrast, those lines closely identified with social policy are generally subject to greater rate and policy oversight. Perhaps the line experiencing the most intensive rate regulation—and often unreasonable rate suppression—internationally is automobile liability insurance. Even today, some governments, including those of developed economies, maintain bureau-mandated premium rate schedules for that compulsory line of insurance.

Direct rate regulation in life insurance is the exception worldwide. Through mandated reserve requirements, however, life insurers are subject to a type of indirect rate control. In some jurisdictions, some components of life insurance pricing (e.g., interest rates and expense ratios) are subject to control, thus potentially precluding meaningful price competition.

- *Financial Regulation.* Consumer protection concerns drive governments to insist on certain continuing levels of insurer financial solidity. By experience, we know that in a market where prices and other market elements are strictly regulated, insolvencies are less likely. Conversely, the more competitive a market, the more

likely insurer insolvency is, and the more important financial regulation is - also referred to as prudential regulation, *le contrôle financier* and *Finanzaufsicht*.

One common means of financial regulation is the minimum on-going capital requirement. In the E.U. and many other countries, the requirement is based on solvency margins, such as Solvency II (which is conceptually linked to Basel II in banking). In the U.S., risk-based capital (RBC) models are used, in which minimum acceptable capital for business continuation of an insurer is directly related to the size and riskiness of the firm's underwriting (technical) and investment (non-technical) operations. Several other countries have developed (e.g., Singapore and Taiwan) or are developing (e.g., Korea) their own RBC models. Financial regulation is related to asset limitations and valuation, insurance liability regulation and accounting standards adopted by the regulatory authority.¹¹

- *Intermediary Regulation.* Individuals and businesses rely on the advice as well as risk management and insurance placement services of agents and brokers. As markets become more competitive, a greater variety of products and services evolves, and products and pricing become more complex. These conditions suggest that the services of knowledgeable intermediaries are often more important in highly competitive than in more restrictive markets which allow little differentiation among sellers and their products. For this reason, most governments prohibit the sale of insurance, directly or through an intermediary, by anyone who is not licensed (or registered).

Once an intermediary is licensed, either the insurance regulator or a self-regulatory body exercises ongoing intermediary oversight. As markets become more competitive through less intrusive regulation and through permission of marketing and sales of cross-sector products in the financial services sector, policymakers increasingly realize the need for more carefully crafted, clearer market conduct regulation and greater vigilance in oversight of insurance distribution whether by insurance intermediaries, banks or direct marketing operations.

- *Competition Policy Regulation.* With the increasing globalization of financial services, competition regulation is assuming greater prominence in insurance regulation. Competition policy, also known as antitrust regulation, constitutes a nation's laws and regulations that govern private sector behavior and the market structure within which interactions between insurance suppliers take place. Competition regulation addresses anti-competitive practices of individual firms as well as both horizontal and vertical competition-reducing arrangements between firms. It also includes measures that governments use to assess market competitiveness, including those related to privatization and deregulation of the

¹¹ Several international organizations and the accounting standard-setting bodies have been working since the late 1990s through the International Accounting Standards Board (IASB) to develop a set of international accounting standards. The purpose is to allow stakeholders to have more meaningful comparisons of financial institutions internationally and to ease the burden on multinational financial institutions in the preparation and reporting of their financial results.

market. Sometimes it extends to government actions taken in accordance with regional or international agreements.

Competition laws and provisions are structured around the principle of prohibition or the principle of abuse. Under the “principle of prohibition,” enumerated behavior is deemed anti-competitive and automatically illegal; that is, it is illegal *per se*. Use of this principle is another example of *ex-ante* regulation. Under the “principle of abuse,” an inquiry into the economic effects of the alleged offensive behavior is required. Only with an *ex post* finding of damaging effects can the activity be declared illegal. Switzerland and the U.K. rely on the principle of abuse. U.S. competition regulation is stringent, in part, because it relies on the prohibition principle and, more importantly, because sanctions for violations can involve criminal prosecution. Competition law can be expected to gain in importance as markets liberalize and deregulate. Because of differences in laws and enforcement, national competition policy itself is becoming an important trade issue.

Detecting Insurer Financial Difficulty. Solvency surveillance typically takes place through reporting requirements, on-site financial examination, professional oversight or a combination of any of these means.

- *Reporting Requirements.* Reporting requirements are the core of insurer solvency surveillance, and the great majority of countries require all licensed insurers yearly (or more frequently) to file detailed financial statements. The E.U. requires that all member states prepare their balance sheets and income statements in the same format (although not necessarily using the same valuation standards). Regulators typically conduct financial, statistical and various other analyses to identify insurers that require special regulatory attention.
- *On-site Financial Examinations.* On-site financial examinations (inspections) are relied upon by all OECD member countries and probably most other countries. Regulators judge on-site financial examinations to be one of their most useful surveillance tools. However, the intensity and quality of examinations vary widely.
- *Professional Oversight.* Greater reliance on the professions is an obvious, efficient and effective means of discouraging inappropriate insurer behavior and of revealing it if it occurs. Insurance regulators routinely rely on the accounting and actuarial professions for additional solvency surveillance. With the development of more stringent corporate governance rules lately, insurers increasingly conduct their own internal risk management assessments using audits and examinations, particularly at the prompting of the firm’s board of directors.

Responding to Insurers in Financial Difficulty. An objective of insurance regulation should be establishing proper incentives for efficient and safe insurer operation and instituting safeguards to keep the number of insurer insolvencies to an acceptable minimum. Within a competitive marketplace, some insurer financial difficulties and failures are inevitable.

After identifying an insurer as financially (or operationally) troubled through surveillance mechanisms discussed above, regulators have four options: informal actions, formal actions, rehabilitation and liquidation. In each case, the question that policymakers should address is: what authority should the regulator have compared with the regulated firm. On the one hand, regulatory actions taken precipitously might needlessly harm insurers, assuring their demise because of adverse publicity. On the other, delayed regulatory action can lead to greater consumer (and possibly taxpayer) loss.

Protecting Insureds of an Insolvent Insurer. Policymakers in market economies must decide what protections they should afford insureds of insolvent insurers. One response might be that they should provide no protections—an application of true *laissez-faire* economics. In this way, the marketplace itself eventually would evolve solutions to the problem of how insureds can meaningfully assess insurer solidity. Even if this view were correct, few policymakers seem willing to test the theory fully. Consequently, many countries have some mechanism to guarantee insurance benefits.

Several have insolvency guaranty associations or funds. Some insolvency mechanisms are advanced-funded through assessments of authorized insurers (e.g., U.S. state of New York), while others rely on post-insolvency assessments of authorized insurers (e.g., all other U.S. states). Funds may involve modest (as in the E.U.) or generous (as in the U.S.) indemnity limits. The insured may be fully indemnified to a maximum amount (the U.S.) or some loss-sharing by the insured may be included (the U.K.). The fund may be government run (e.g., some E.U. countries) or operated and financed by the insurance industry (e.g., Canada and Japan).

There is no doubt that the U.S. has played an important role in improving the quality of insurance regulation internationally. Indeed, many foreign regulators, particularly those of developing economies, often benchmark their standards with those of the U.S. to improve the quality of insurance regulation. However, most governments seem not to buy the merit of state regulation in lieu of, say, centralized regulation of insurance. So do many interest groups in the U.S. The next section summarizes the political history of U.S. regulation of insurance to explain why the state system has become the preferred mode of regulation in the country.

III. Political History of U.S. Regulation of Insurance

The First Era (Colonial Insurance to 1867). The history of insurance regulation in the U.S. can be divided into five eras starting from the first era of no or minimal regulation. The first known form of insurance regulation was the incorporation requirement for an organization to offer insurance coverage. We can draw two observations. As insurance companies then commonly had their business territories limited to a single state, such incorporation was at the state level. Further, insurance corporations had to be established by special legislation because states did not have general incorporation acts.

Patterson (1927) points out that insurers would benefit from the incorporation requirement as such regulation could limit the number of suppliers and place insureds at a

bargaining disadvantage. He also points out that "...the corporation not only made insurance possible, but also created the demand for regulation."

States also gained from the requirement. For example, the legislation creating INA Insurance Company included a provision that the insurer's capital be invested in specific government bonds (Meier, 1988). This argument is supported by Kimball's (1960) finding that states attempted to restrict insurer ownership of real estate for income or speculative purposes by the incorporation legislation. Hence, the earliest form of regulation was a win-win solution mainly for the state and the supplier.

Regulation (restriction) of entry, especially of foreign insurers (domiciled in another state) and alien entities (incorporated in another country), was observed in several states, such as Pennsylvania, Maryland, New York and Virginia, by the 1800s. Meier (1988) argues that state governments made serious efforts to protect local insurers—a key source of state revenues—from foreign and alien companies.¹² Cowee (1948) adds that the "primary" objective of insurance regulation [in the very early period]...seemed to be directed toward tax revenues." For example, a taxation policy earmarked tax revenue from the Massachusetts Hospital Life Insurance Corporations to support a local hospital (Patterson, 1927). General premium taxation began with New York in 1824.

Solvency regulation was adopted by Massachusetts in 1799 and New York in 1814. However, it was more for making financial statements available for public viewing than for any meaningful financial analysis, and states had few options against insolvent insurers (Patterson, 1927). Put differently, there was no administrative body within any state government in charge of insurance regulation until New Hampshire and Massachusetts established an insurance board in 1851 and 1855, respectively. Regulation of policy forms and ratemaking followed. States also attempted to regulate agency licensing and, particularly in life insurance, reserve setting.

Several developments in the fire insurance markets during the era warrant close attention. Fire insurance premiums were originally determined by competition among insurers, but the competition was for their independent agents rather than for policyholders.¹³ Further, the failure to create a database for loss projection and risk classification resulted in a rate structure and possible insurer insolvency in the event of a major inner-city fire (Wandel, 1935). Insurance companies did not welcome the increasing pressure and scope of regulation, and their antipathy resulted in a legal challenge—*Paul vs. Virginia*—or the beginning of the second era.

The Second Era (1868~1944). In the case of *Paul vs. Virginia* (1868), an insurance agent and insurance companies led by the National Board of Fire Underwriters, argued that insurance was "interstate commerce" and only the federal government could regulate the industry. Kimball and Boyce (1958) find that they then preferred federal regulation based

¹² Discriminatory insurance taxes were a source of revenue for states until the decision of the Supreme Court over the case of *Metropolitan Life Insurance Company vs. Ward* in 1985. The court concluded that such a taxation practice was not the purpose of state regulation and also a violation of the Equal Protection Clause of the Constitution.

¹³ During the late 19th century, insurance companies reached an agreement to set premium and agency commission rates. This attempt failed in part because some insurers did not adhere to the rate schedules and in part because several states introduced anti-compact laws.

on their perception that the federal government would be a weaker body than many of the more aggressive states when it came to insurance regulation. The Supreme Court rejected the argument by Samuel Paul and insurance companies; that is, the business of insurance was not commerce.¹⁴ Hanson (1977) states that this particular *judicial accident*—the initial misinterpretation of the Constitution’s interstate commerce clause—promoted the development of state regulation of insurance.

The court decision gave state governments a basis to fortify their regulatory foundations. Insurance regulators formed the National Insurance Convention in 1871, the predecessor of the National Association of Insurance Commissioners (NAIC), and began to systematically organize their regulatory approaches (e.g., standardization of fire insurance coverage).

Kolko (1963) contends the reform of the so-called “progressive era” in insurance regulation (1900~1918) supported “the organization of the economy and the larger political and social spheres.” He furthers that the state maintained “overly” apparent neutrality by letting the regulatory agency maintain a market condition which guaranteed industrial growth and reasonable profits; in other words, the interests of the public were sacrificed in the interests of the private corporate sector. As time passed by, the legitimacy of state regulation of insurance was widely questioned by the media, consumers and reformers.

Regulators in several states were also concerned about the problems of rate inadequacy and introduced state-supervised rate-making programs. Those programs failed. Price fixing was wide spread, and some ill-minded private rating bureaus thought they were insulated from federal regulation as insurance was “not” commerce. The failure led to a series of investigations, such as the life insurance investigation in 1905~1906 by the Armstrong Committee and the fire premium rate investigation in 1910~1911 by the Merritt Committee. Constitutional amendments to introduce federal regulation of insurance were put forward several times—for example, in 1914, 1915 and 1933—but none survived (Cowee, 1948).

The Third Era (1945~1980). This era began with the McCarran-Ferguson Act, an interesting outcome of the case of *U.S. vs. South-Eastern Underwriters Association* (1944). The case brought another challenge to state regulation of insurance. Brought by the U.S. Department of Justice, the case was in part to punish the 134 fire insurance companies—all stock companies—for fixing prices and contributing to a bribery fund for a Missouri insurance commissioner and in part to penalize many other insurance companies—starting with the 198 insurance companies and their trade organization, the South-Eastern Underwriters Association—for criminal violations of federal antitrust laws (Huddle, 1945).

The Supreme Court found that a fire insurance company conducting a substantial portion of its business across states was engaging in “interstate” commerce and fixing

¹⁴ This decision was reaffirmed in several cases including *New York Life Insurance Company vs. Deer Lodge County* (1913).

noncompetitive premium rates would be a violation of antitrust law.¹⁵ Many fire insurance companies feared the threat of criminal prosecution, and state governments were at risk of losing a *good tax revenue* source (Kimball and Boyce, 1958). In fact, insurance companies and state regulators, through the NAIC, had been preparing for this adverse decision potential and already introduced a bill to block the federal government's attempt to regulate insurance business.

Their efforts culminated with the passage of the McCarran-Ferguson Act in 1945 which is based on Public Law 15, a bill submitted to Congress by the NAIC. The Act, among others, declared that continuance of state regulation of insurance business and collection of taxes was in the public interest and exempted insurance from federal antitrust laws—the Sherman Act, the Clayton Act and the Federal Trade Commission Act—“to the extent that such business is not regulated by state law.”

The response by state governments, particularly regarding rate regulation, also resulted in consolidation of regional rating bureaus eventually to the Insurance Services Office (ISO) as well as the development of multi-line insurance business. (States began to adopt less stringent rating policies from the mid-1960s and the ISO no longer functions as a rating bureau.)

The adoption of the McCarran-Ferguson Act has greatly influenced how states regulate insurance markets and how the regulated companies operate in those markets. With the Act, Congress formally granted states the power over the regulation of insurance in the private sector.¹⁶ States (and the NAIC) understood clearly again that Congress had the power to deprive them of regulatory power on finding the incompetence of state governments.

The NAIC once again became the focal point for the states' pursuit of uniformity of rules and means of regulation and their efforts to coordinate their supervisory activities. States began to adopt new legislation based mainly on All Industry Committee (AIC) model bills of the NAIC. Later, states joined their efforts together to develop model acts dealing with various issues such as rate regulation and unfair trade practices.

Still, the regulatory system was far from being perfect. Opponents to state regulation pointed out that there was an unnecessary overlapping of regulation (e.g., duplication of filings and financial statements) and unnecessary costs of regulation (e.g., licensing fees by state as well as state assessments of other fees). Conflict of state laws prevented efficient and effective regulation for consumers. In contrast, supporters of state regulation continued to emphasize, among others, the importance of regulation by state agencies that were flexible to meet differing needs of the citizens and familiar to the local market and

¹⁵ There was no rate collusion in life and health insurance markets, and these lines avoided rate regulation. Marine insurance already had a specific exemption from the antitrust laws since World War II (Meier, 1988). Even today (and as discussed earlier in this paper), life insurers and group health insurers individually establish their own premium rates, provided that the pure cost of insurance reflects the minimum reserve requirements by state regulators. (Individual health insurance and Blue Cross/Blue Shield business are subject to varying degrees of rate regulation.)

¹⁶ The Supreme Court's view in favor of McCarran-Ferguson Act was reaffirmed in several cases, such as *Prudential Insurance Company vs. Benjamin* (1946) and *Dexter vs. Equitable Life Assurance Society of America* (1975).

economic conditions. Cowee (1948) added that the concern that local risks were insured by companies operating in multi-states could be overcome through cooperation between states, between the companies and the states, and between the companies themselves.”

The Fourth Era (1981~1998). During this era, the NAIC increased its role as a forum for the development of uniform policy and introduced a number of new model acts. It enhanced rules regarding insolvency regulation, developed risk-based capital models, and introduced the state accreditation program as an attempt to raise the quality of state regulators in the aggregate.

In 1990, a subcommittee (led by John Dingell) of the U.S. House of Representative reported that the state system had failed to deliver its promise and proposed the Federal Insurance Solvency Act of 1992 to “employ good officers of the federal government to make sure that insurance promises...will be kept.” The bill proposed dual regulation, where federally chartered companies would belong to a National Insurance Protection Corporation and be fully responsible financially for member insolvency. The bill did not become law.

The Fifth Era (1999 to Present). This era began with the introduction of the Gramm-Leach-Bliley Act in 1999 which, among others, permits competition between state-regulated insurers (especially those in life business) and federally chartered entities in banking and investment. In the financial services market, sectoral regulators retain their own authority and the Federal Reserve Board serves as an umbrella regulator. The issue of merging state regulators into one naturally has emerged. The introduction of the Terrorism Risk and Insurance Act also triggered the debate for federal regulation as the federal government, functioning as the reinsurer of the terrorism risk, needed to deal with state governments for rate and form approval matters related to terrorism coverage.

The near finalization of a single insurance market policy of the E.U. has reemerged as an issue. The E.U. as well as many other countries continues to express concern about the state-based licensing system even for a nationwide operation in the U.S. and being subject to laws and regulations of multiple jurisdictions. At the same time, large U.S. insurers continue to expand business geographically—many of them entering the E.U., China, India, Russia and other developing and developed markets—commonly with a single license for the class of business in each regional or local market.

Insurance regulators in the U.S. assert that the financial stability of the market and the protection of policyholders’ interests are the primal goals of regulation. However, the history of insurance regulation evidences that, like other parties of interest, regulators have political and economic motives, especially a revenue generation motive—revenues from both *premium* and corporate income taxation.

IV. Calls for Reform

States have made numerous changes to improve the quality of regulation. Some changes were made voluntarily. Some other changes reflect states’ (and the NAIC’s) response to Congressional pressure.

One recurring basis for the pressure is that state regulation is not efficient, the state-based system is costly, and regulatory measures are not standardized. As alternatives to state regulation, numerous interest groups—including Congress—have proposed pure federal regulation, dual regulation with optional federal chartering of insurance companies, creation of an advisory board, and the introduction of minimum regulatory standards, among others.

Federal Regulation. Congress has attempted to transfer the regulatory authority to the federal government. As recently as last year, the U.S. Department of the Treasury expressed the need to consolidate the door to the U.S. insurance market via a federal regulatory system (Quarles, 2006). None of the attempts have been successful.

States' resistance to federal regulation of insurance has been strong. As early as in the early 1910s, states argued that they should retain "some of the constitutional powers, rights and privileges as to their own companies" (Taylor, 1915).

Several others, including Richard Steward, a former insurance commissioner of New York, addressed the advantages of a state system to those of federal regulation. They can be summarized in four points. First, when a system already exists, it is better to improve the system—especially when the system has not failed—than to discard it and install a new system. Further, how long will it take to install a new system? What is the cost of doing so to the regulated, consumers and tax payers?

Second, the state is closer to the citizenry of the state and may better reflect the needs of the citizens in the policymaking process than the federal government (although there still is a danger of the politicians being captured by the regulated). Decaminada (1988) adds that the federal government is more likely than the state government to make social policy through administrative agencies. Even with a federal system, much of the practical matters still need to be done at the regional or state level to take account of local peculiarities (Kimbell, 1981).

Third, there is the benefit of being able to quarantine incompetent practices of a state to that state. Conversely, the diversity of regulation by multiple agencies offers opportunities for experimentation with regulatory structures and content, thus the possibility for further improvement of the overall regulatory system (Randall, 1999). Efficiency should not be viewed in terms too narrow (e.g., elimination of the presence of multiple agencies), especially when each "duplicative regulatory mechanism can serve to constrain the other" (Kimball, 1981).

Finally, state governments are subject to review and investigation by Congress and others in the federal government, and thus the state system helps preserve a check-and-balance system in insurance regulation. As found from the history of insurance regulation in the U.S., Congress and several federal government agencies have in fact exercised their investigative power in several occasions.

White (2003) also makes an argument against federal regulation based on the fact that tort systems differ from state to state and the U.S. Supreme Court has held that "tort law does not constitute the regulation of insurance, [and] it is not clear that federal regulation could offer uniformity." Indeed, the terms of insurance coverage in property-liability

lines (particularly in automobile liability and workers' compensation) are closely linked to substantive law of the state.

Given the century long resistance to pure federal regulation by state governments, lack of consensus among the regulated companies and their trade associations, and strong opposition of selected consumer groups to centralization of government power, the calls for reform are now focused more on other alternatives, particularly optional federal chartering. These alternatives are briefly discussed below.

Dual Regulation (Optional Federal Chartering). The first proposal for optional federal chartering in the modern history seems to be the 1976 bill (revised and reintroduced in 1977) of the Federal Insurance Act. The bill proposed that any qualified insurer could be federally chartered, thus being exempted from state regulation in most areas, required to participate in a federal guaranty fund, subject to federal solvency and investment standards, and also subject fully to federal antitrust laws. States would retain control of policy contracts and marketing techniques and impose taxes on all companies doing business within the jurisdiction.

Around the period of liability crisis, several bills were submitted to Congress (Manders, 1990). Two bills during the 1985~1986 session proposed a total repeal of McCarran-Ferguson Act or a repeal of certain parts of the act that precludes use of the federal antitrust laws. Six bills in the 1987~1988 session included proposals for a repeal of the act while permitting states to conduct ratemaking activities to generate pure premium rates in the property-liability lines. During the 1988~1989 session, three bills were submitted including the Insurance Competition Improvements Act of 1990 and the Insurance Competitive Pricing Act of 1990. These two acts were in effect proposals for dual regulation by competitive activity.

The State Modernization and Regulatory Transparency (SMART) Act of 2006 was a proposal to reform the state system without creating a federal agency or optional federal charter. It would require states to comply with uniform standards, improve product regulation process and move toward a market-based rating system. The bill also proposed creation of a seven-member panel consisting of representatives of state governments and federal agencies (including the SEC).

The National Insurance Act of 2006 proposed a dual regulation system for insurers and intermediaries. For the regulation of nationally chartered insurance companies and intermediaries, the Office of National Insurance would be created within the Department of the Treasury. Unlike under the previous proposals for dual regulation, national insurance companies under this bill would participate in the guaranty funds in the states of operation and, as and when necessary, also in the National Insurance Guaranty Corporation. National insurers also would be subject to state tax laws, assigned risk plans and other mandatory residual market mechanisms. Insurers would be free to convert their charters. New bills are being proposed during the current Congressional session.

Of course, all state governments want to maintain the status quo with an opportunity to improve their regulatory approaches. (See below for a further discussion.) However, the regulated are not harmonized as each cohort of the regulated wishes to maximize their own benefits. Large property-casualty insurance companies in commercial insurance as

well as their main trade association, the American Insurance Association, support optional federal chartering. The American Council of Life Insurers (ACLI), a trade association for large life insurance companies, is in support of a “uniform, national regulatory structure” (ACLI, 2006). It views that with the optional chartering system, large life insurance and annuity companies would compete more effectively with banks offering similar products. The American Bankers Insurance Association and the Council of Insurance Agents and Brokers also support federal chartering.

State regulation is supported by the National Association of Mutual Insurance Companies, the National Association of Professional Insurance Agents, Independent Insurance Agents & Brokers of America and the National Alliance of Life Insurers (representing mainly small and mid-sized life insurers). Given the split views, would the optional federal chartering system be the choice?

Optional federal chartering is not without a flaw. For instance, Grace and Klein (2000) point out that the creation of a federal agency would end up as a big cost to consumers and tax payers if a large number of companies choose to keep their status and if states remove rate and form regulation. They also find that regulatory compliance costs can be reduced significantly if states unify their regulatory process and if they do so through a “central clearing house.”

Harrington (2006), who initially supported optional federal chartering, now offers two alternatives to the chartering approach. He supports the State Modernization and Regulatory Transparency Act of 2004, which would force federal preemption of state regulations that fail to meet minimum standards in various areas of regulation. As an another proposal, he suggests a “primary state” regulation system which would allow insurers to choose a primary state for the purpose of rate, form and other types of regulation and permit the insurers to operate in all other “secondary” states where they are licensed without having to meet the corresponding requirements in those states.

V. Examination of State Regulation: Costs and Benefits

From re-examining the history, we find that the quality of state regulation has indeed improved. State governments have removed prior approval regulation of rates and policy forms in commercial insurance while retaining their power to control rates and forms in more or less public policy-related areas (e.g., personal line business and workers’ compensation). The NAIC reports that many states have also adopted laws to meet Gramm-Leach-Bliley Act provisions regarding reciprocity for non-domestic intermediary licensing.

The NAIC has also adopted a number of measures to unify regulatory measures practices by states. They include, but are not limited to, the following:

- The Uniform Certificate of Authority Application allows foreign insurers to file copies of the same application for admission in multiple states. All 50 U.S. states and the District of Columbia participate in the program as of September 2006.

- The Examination Tracking System stores insurer examination information that state regulators can share. Most states participate in the program.
- The Financial Database Repository is a database of annual and quarterly financial statements filed by more than 5,000 U.S. domiciled insurance companies. All states but Rhode Island, Virginia and Washington participate in the program.
- The Producer Database is a communication network that links state insurance regulators with the entities they regulate. It is part of the National Insurance Producer Registry, an outsourcing arm of the NAIC, and designed to facilitate the electronic exchange of producer information. All states but Virginia participate in the program.
- The System for Electronic Rate and Form Filing is a web-based application designed to provide an efficient process for rate and form filing. All states participate in the program.
- The Complaints Database System is a nationwide database used for referencing and analyzing complaints that consumers file with state regulators. Most states participate in the program.
- StateBasedSystems.com, launched in October 2006, is designed to expedite services for insurance regulators and insurance entities. The system allows electronic filing of complaints, license application and verification of license status.

Strong participation of states in these systems indicates that state governments increasingly move in tandem, thus making a stronger argument against federal regulation or optional federal chartering. Despite the efforts, they are still criticized for lack of efficiency.

A GAO study (2002) finds the need for improvement in three areas of state regulation: licensing uniformity and reciprocity, rate and product approval, and national treatment of companies. Another GAO study (2003) finds no generally accepted standards for market conduct regulation in the states, thus leaving gaps for potential abuse of consumers by insurance suppliers.

Harrington and Miller (2002) contend that the progress in property-liability insurance regulation has been slow. With particular respect to rate regulation, they find that there is expanded recognition of regulators' inability to make coverage more affordable and that competitive rating generally works. Sonnichesen (2004) also finds from a 2002 "speed-to-market" survey that it took an average of 81 days for companies to secure approval of minor changes to existing life and annuity products and that the average period for approval of major changes to existing products was 109 days.

Besides, two critical questions still remain unanswered. One is related to the ultimate goals of regulation. The other is regarding the identity of the NAIC, the role it should play and how it should be funded. These concerns are further elaborated in the remaining part of this section.

Is State Regulation Practice Based Purely on Public Interest Theory? Several theories have been developed to explain the rationale for regulation. For example, *public theory of regulation* suggests that regulation is designed for the benefit of the general public or the consumer in the regulated industry; that is, the purpose of regulation is to correct market failures, externalities and information asymmetry.

Stigler (1971) offers another view—*the theory of economic regulation*—that regulation is acquired by the regulated and designed primarily for the benefit of, say, the insurance industry. In return, regulators gain political (and financial) support to stay in office. Posner (1974) modifies Stigler’s theory and proposes *equilibrium-based theory of regulation* that regulation is “the product of coalitions between the regulated industry and the organized consumer group, the former obtaining some monopoly profits from regulation [and] the latter obtaining lower prices (or better services than they would in an unregulated market—all at the expense of unorganized, mostly consumer, groups.”

Meier (1988) criticizes Stigler’s theory as based on an assumption of mutual benefit exchange between the regulator and the regulated, whereas, in reality, not all industries demand regulation and several authorities (e.g., the Food and Drug Administration, the Federal Aviation Administration and the Environmental Protection Agency), he claims, do not reflect the interest of the regulated. For the insurance industry, Meier concludes that “capture” does not occur because the industry is too segmented to reach common policy goals, that there are a wide variety of ways that states regulate the industry, and that the federal government (or Congress) could take over the regulatory authority if states fail to perform their duties. In other words, Meier suggests that we would find evidence supporting *political theory of regulation* such that each of the four groups—the industry, consumer groups, regulatory bureaucrats and political elites—has specific goals in the regulatory process and the influence of each group depends on the resources it can mobilize. None of the theories seem to explain fully the phenomena in the U.S. insurance industry.

Nonetheless, from the early era of insurance regulation, state governments have been questioned as to whether they regulate the industry for the pure sake of policyholder protection and market stability. States have also been repeatedly questioned—more during the early eras than today—as to how strong the tax (revenue-raising) motive is in insurance regulation.

The three general purposes of tax systems are to promote social goals, to promote economic goals and to raise revenue.¹⁷ It needs little explanation that governments intend taxation to raise revenue.

¹⁷ In general, social goals relate either to discouraging or to encouraging certain behavior. Governments often design tax systems also to promote economic goals. They attempt to stimulate overall national economic activity through tax decreases and, at other times, attempt to retard excessive growth through tax increases (Skipper and Kwon, 2007).

Table 1: National Average Trending of the Cost of Insurance Regulation

	2000	2001	2002	2003	2004
Budget as a Percentage of Revenues	8.52%	7.99%	7.56%	7.20%	6.81%
Budget as a Percentage of Premiums	0.09%	0.09%	0.08%	0.08%	0.08%
Revenues as Percentage of Premiums	1.08%	1.15%	1.07%	1.14%	1.21%

Source: NAIC (2005).

Governments require revenues to provide the services demanded of them by their citizens. Taxation is the most important and a universal means of obtaining this needed revenue.

State governments find three major sources of revenue in the insurance market. One is the fees and assessments on insurance companies. The second is the corporate income tax, which is based primarily on the profitability of insurance business in the state of operation.

The third is premium taxes levied on policyholders. Most countries provide tax relief to policyholders for premiums paid for qualifying life insurance policies. In contrast, it appears that most governments are less reluctant to impose premium taxation in property-liability insurance. As such, premium tax rates with property-liability insurance are generally higher than with life insurance.

Of those countries that levy property-liability premium taxes, rates range from less than 1 percent (Japan) to a high of 50 percent (automobile liability insurance in Denmark). Most countries apply uniform tax rates to all property-liability lines. In selected countries, the rates vary by line of insurance business (e.g., 1~4 percent in the U.S.). Some governments levy other premium-based taxes that can greatly increase the effective tax in property-liability insurance. Premium-based taxation is to be paid irrespective of insurer profitability. The effective taxes on insurers and ultimately on policyholders can, therefore, be astoundingly high. These taxes, when included in the premiums charged, raise insurance prices and thus depress insurance demand. To the extent that competing non-insurance techniques of dealing with risk escape such taxation, the competitive environment is biased against insurance. Hence, if the government insists on taxation on insurance premiums, it should be obliged to use a somewhat meaningful share of the revenue for the benefit of the taxpayers, i.e., policyholders.

Barrett (2006) finds that U.S. states in the aggregate raised \$15.3 billion of revenues from the insurance industry in 2004. The specific sources of the revenues were premium and income taxes (86.6%), fees and assessments (11.65%), fines and penalties (0.34%) and other (1.39%). During the same year, they budgeted, again in the aggregate of all states, only \$1.04 billion or 6.81% of the revenues generated for insurance regulation.¹⁸ The budget was as low as \$2 million or so in South Dakota and Wyoming. As further illustrated in Table 1, the insurance industry is indeed an important revenue generating source for state governments.

¹⁸ By state, it was as high as 146.22% in Michigan and 12.83% in Connecticut and as low as 2.5% in Tennessee and 2.55% in Massachusetts.

Appendix A shows that a total of 9,968 full time equivalent staff—6.1% of them being executives—were involved in insurance regulation in the U.S. in 2004. The number of staff was as large as 1,310 in California and as few as 25 in Wyoming (excluding U.S. territories and jurisdictions). During the same year, there were 7,738 domestic insurance companies (e.g., 617 in New York and 5 in Wyoming), 68,910 licenses for insurance business, 370,651 intermediaries incorporated as business entities, 4.3 million domestic, individual producers and 474,946 consumer complaints registered.

Gettlin (1997) compares the costs of regulation in the financial services sector using 1995 data and to find that the insurance industry, size of which was about a half of the banking industry in terms of assets (\$2.89 trillion and \$5.76 trillion, respectively, in 1995), paid more than the banking industry in taxes and fees to states (\$9.29 billion and, \$4.62, respectively).¹⁹ More specifically, insurance companies paid \$990.5 million in fees and assessments to state regulators, while banks paid a total of \$722.1 million to both state and federal regulators. At the same time, state insurance regulators spent about one-fourth what banking regulators did on industry oversight.

These findings evidence the presence of a strong tax motive in insurance regulation in the U.S. State regulators state on and off that the shortage of manpower is a hindrance to achieving regulatory efficiency. To make that statement valid, they need to ask themselves a series of questions. Are state governments planning to reduce their dependence on the insurance industry for revenue generation? Are state regulators expecting a higher percentage of state income from the industry for insurance regulation?

Appendix A also shows the relative position of the insurance commissioner within the state government structure in each of the U.S. jurisdictions. In 16 states and the District of Columbia, the commissioner (director) has a direct communication channel with the head of the state (mayor in the case of D.C.). In many other states, the insurance department (division) belongs to a larger department (commonly dealing with finance, commerce, revenue & taxation or consumer matters). The variations in the relative positions of commissioners and insurance departments may affect how effectively state regulators can achieve their stated goals of regulation without or with little influence of other departments of the state or the state itself.

What is the Identity of the NAIC? Since the establishment of its predecessor in 1871, the NAIC has played an important role in insurance regulation. However, the identity of the NAIC within the regulatory structure is not clear. It has been setting regulatory standards that it cannot enforce. It has never had any real authority and merely identifies itself as a “voluntary organization of the chief insurance regulatory officials” in the U.S. At the same time, it represents the U.S. at the International Association of Insurance Supervisors.

It seems that even some of its state members do not merely support NAIC activities. For example, the state of Vermont, as a means of expressing its discomfort with the NAIC, now requires that the organization file an annual report with the state legislature and justify its actions for the previous year. Kimball (1981) finds that, despite the rise in the

¹⁹ Put differently, these figures do not include income taxes paid to the federal government.

scope of interstate cooperation, there still was a considerable bureaucracy within the NAIC that slowed the implementation of that cooperation.

For tax filing purposes, the NAIC identifies itself as a non-profit trade association (Barrett, 2006). As shown in Table 2B, however, it generates 61.47% of its revenues for 2007 from database fees and sales of publications and data. Its budget dependency on state assessments is merely 3.18% in 2007. A comparison of its budget with those of state insurance departments using 2006 data shows that NAIC's expenses for the year (\$58.9 million) were surpassed only by California's (\$193.8 million) and New York's (\$179.8 million).²⁰ There also is a question regarding the NAIC's continuous build-up of its surplus, which is expected to reach \$62.7 million by end of 2007. Why does it need such a build-up when it recognizes itself as a non-profit association?

Table 2A: NAIC Revenues and Expenses (Simplified and Selected Years) (1999-2007)

	1999	2001	2003	2005	2006	2007
Revenues (\$)	44,028,315	46,298,216	58,234,435	59,231,565	59,339,189	63,380,432
State assessments	1,544,528	1,656,994	1,815,610	1,910,113	1,968,635	2,015,609
Database fees	19,967,504	20,358,959	24,366,126	25,609,165	24,239,191	24,470,912
Publications/data sales	12,806,543	12,538,079	13,460,855	14,244,226	14,484,775	14,488,796
Service Income	4,643,330	7,038,676	8,576,114	9,285,127	9,604,552	10,734,358
Meetings	1,858,252	1,357,315	1,869,100	1,984,000	2,094,901	2,780,791
Interest	1,331,534	298,193	3,474,937	792,717	1,019,950	1,397,162
Education	1,394,710	974,921	798,451	773,750	916,270	1,013,990
Other	861,064	2,075,079	3,873,242	4,632,467	5,010,915	6,478,814
Expenses (\$)	42,091,930	43,806,331	54,104,909	56,315,622	58,995,281	62,674,841
Surplus (\$ million)	13.60	35.50	36.98	50.18	54.35	55.49

Source: Barrett (2006).

Table 2A: NAIC Revenues and Expenses (1999-2007) (Distribution of Revenue Sources)

	1999	2001	2003	2005	2006	2007
Revenues	100%	100%	100%	100%	100%	100%
State assessments	3.51%	3.58%	3.12%	3.22%	3.32%	3.18%
Database fees	45.35%	43.97%	41.84%	43.24%	40.85%	38.61%
Publications/data sales	29.09%	27.08%	23.11%	24.05%	24.41%	22.86%
Service Income	10.55%	15.20%	14.73%	15.68%	16.19%	16.94%
Meetings	4.22%	2.93%	3.21%	3.35%	3.53%	4.39%
Interest	3.02%	0.64%	5.97%	1.34%	1.72%	2.20%
Education	3.17%	2.11%	1.37%	1.31%	1.54%	1.60%
Other	1.96%	4.48%	6.65%	7.82%	8.44%	10.22%

Source: Barrett (2006).

Thus, a concern arises as to whether the regulated industry, ultimately insurance consumers, ends up financing a quasi-regulatory agency where in fact the NAIC does not possess such authority. In other words, the NAIC and state regulators need to re-examine seriously what the NAIC is when it comes to identifying its "real" identity and what is the appropriate means to support its activities financially.

²⁰ The average budget of all U.S. insurance departments was \$22 million for the year.

VI. Conclusions

This paper examines various aspects of insurance regulation. In particular, it examines the common goals of insurance regulation and the typical activities of regulatory authorities internationally; U.S. state insurance departments share those goals. It analyzes the development of insurance regulation from a political point of view, and finds evidence supporting the economic theory of regulation during the early era(s) and a continuing role of the revenue generation motive of state governments in the aggregate. It also finds that inefficiency in state regulation had been the main cause to the calls of reform, but no alternatives guarantee efficiency improvement—whether operational or financial.

Given that the state system exists and it reflects local needs in policymaking, the author suggests maintenance of the current system, i.e., state regulation, while all parties of interest continue to work together to improve the system. This requires, among others, simplification, if not unification, of several regulatory measures.

Upgrading the quality of regulation, particularly prudential regulation of insurance companies and market conduct regulation of both the companies and insurance intermediaries, is one. State regulators additionally encourage self regulation of the companies and intermediaries at the trade association level and corporate governance (i.e., internal risk management) at the corporate level. Restructuring the regulatory agencies to better achieve the written goals of regulation—consumer protection and market stability—with political independence of the regulated and a minimum intervention by the state government in its budgeting and human resources matters—need to be considered. As financial services markets continue to converge in the U.S. and abroad, state insurance regulators need to consider how to better strategically align their measures with regulators of other sectors in the home country and in foreign soils.²¹

State regulators need to help the NAIC identify its role and position itself among state regulators, but never as a quasi-regulatory agency. The author believes the NAIC should remain purely an association of state insurance regulators, and perform the role of clearing house of the administrative activities outsourced by the members (i.e., state governments), and financially supported mainly by the members. The NAIC may continue to provide database access fees, offer training services, sell publications and offer other administrative services delegated by state governments but *at cost*. It recommended that it consider creating an advisory board comprising both internal and external members in charge of overseeing the association's activity. Like those in the corporate world, regulators across the states and around the world need to practice *self regulation* and *integrated risk management* for themselves.

Adoption of a single, national licensure system is another. This should not be a difficult task, as all U.S. regulators currently participate in the Uniform Certificate of Authority

²¹ Joint Forum (2006) finds that “cross-sectoral convergence in [financial services] market practice and in regulatory approaches is occurring naturally.... As a result, “all sectors will more closely align requirements with measures of risk that are calibrated using economic capital models.”

Application administrated by the NAIC. For example, the system can treat all applications as for nationwide operation unless an applicant opts out for a single or multiple-state operation. Every applicant selects the state of domicile and may freely move to another state. Under this system, the states exhibiting regulatory efficiency—thus, less likely being captured by neither the regulated industry nor the state government itself—can attract more insurance companies. With an increasing emphasis on prudential and market conduct regulation, they can better protect the interests of policyholders. In return, they will enjoy long-term benefits of good management of the local insurance industry.

All the efforts for the reform at the state level require participation by and efforts of all parties of interest—the regulator, the regulated and the consumer. The author closes this paper with two quotations:

That state regulation *can* be more effective than federal regulation is not sufficient—federal regulation can only be prevented when the states and the industry combine to assure that state regulation *is* more effective. Such effectiveness is best measured by the degree of mutual benefit to both the consumer and the industry. Therefore...state regulation...is no anachronism but rather maintains the advantage of being able to tailor pertinent rules and laws to the specific needs of both the industry and a more local consuming public (Belkin, 1979).

The social responsibility of insurance regulation is “to recognize that changes in and out of insurance are constantly altering the social responsibility of insurance regulation; that its goals should change accordingly; that it sometimes falls to government to lead the industry toward change, and that it always falls to government to make the conscious effort to order its own house by current intelligence and not by habit (Steward, 1971).

References

- American Council of Life Insurers (2006). "Modernizing Insurance Regulation Remains Top Priority for Broad-based Financial Services Coalition Members," *ACLI News Release* (December 1) at www.acli.com (accessed on February 15, 2007).
- Barrett, Eleanor (2006). "Familiar Refrain," *Best's Review* 107 (November): 56-60.
- Belkin, Janet (1979). "State Regulation: Anachronism or Advantage," *Federation of Insurance Counsel Quarterly*, 29 (winter): 209-225.
- Center for European Policy Studies (2003). "*The Future of Insurance Regulation and Supervision in the E.U.* (unpublished).
- Cowee, John (1948). "Federal Regulation of Insurance," *Wisconsin Commerce Reports*, 2 (September): 1-89.
- Decaminada, Joseph (1988). "Insurance Regulation: State or Federal?" *CPCU Journal*, 41 (March): 9-11.
- Gettlin, Robert (1997). "The Price of Regulation," *Best's Review* (Life/Health edition), 98 (October): 49-53.
- Government Accountability Office (2002). *State Insurance Regulation: Efforts to Streamline Key Licensing and Approval Processes Face Challenges*. Washington, D.C.: Government Printing Office.
- Government Accountability Office (2003). *Insurance Regulation: Common Standards and Improved Coordination Needed to Strengthen Market Regulation*. Washington, D.C.: Government Printing Office.
- Grace, Martin and Robert Klein (2000). "Efficiency Implications of Alternative Regulatory Structures for Insurance," a chapter in Peter Wallison ed. *Optional Federal Chartering and Regulation of Insurance Companies*. Washington, D.C.: the American Enterprise Institute Press.
- Hanson, Robert (1977). "An Overview—State Insurance Regulation," *CLU Journal*, 31 (April): 20-31.
- Harrington, Scott (2006). *Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation*, The 3rd Annual Insurance Reform Summit, Networks Financial Institute, Washington, D.C. (March 1).
- Harrington, Scott and Tom Miller (2002). "Insurance Regulation and Government Insurance," *CATO Handbook for Congress: Policy recommendations for the 108th Congress*. Washington, D.C.: CATO Institute.
- Huddle, Frank (1945). "Regulation of Insurance" in *Pictorial Research Reports*, 1 (January): 44-60.
- International Association of Insurance Supervisors (2006). *Report on Insurance Laws, Regulations and Practices in IAIS Member Jurisdictions*. Basel: IAIS.
- Joint Forum (2006). *Regulatory and Market Differences: Issues and Observations*. Basel: the Joint Forum.
- Kimball, Spencer (1981). "The Federal Role in Insurance Regulation," a chapter in *Issues in Insurance*. Malvern: American Institute for Property and Liability Underwriters: 141-198.

- Kimball, Spencer (1960). *Insurance and Public Policy*. Madison: University of Wisconsin Press.
- Kimball, Spencer and Ronald Boyce (1958). "The Adequacy of State Insurance Rate Regulation," *Michigan Law Review* 56: 545-578.
- Kolbo, Gabriel (1963). *The Triumph of Conservatism*, Princeton: Princeton University.
- MacAvoy, Paul (1977). *Federal-State Regulation of the Pricing and Marketing of Insurance*. Washington, D.C.: American Enterprise Institute for Public Policy Research.
- Manders, John (1990). "Proposed Congressional Amendments to the McCarran-Ferguson Act: Their Impact on State Regulation," *Journal of Insurance Regulation*, 9 (September): 107-135.
- Meier, Kenneth (1988). *The Political Economy of Regulation: The Case of Insurance*. Albany: State University of New York.
- National Association of Insurance Commissioners (NAIC) (2005). *2004 Insurance Department Resources Report*. Kansas City: NAIC.
- Patterson, Edwin (1927). *The Insurance Commissioner in the United States*. Cambridge, MA: Harvard University Press.
- Posner, Richard (1974). "Theories of Economic Regulation," *Bell Journal of Economics and Management Science*, 5 (autumn): 337-352.
- Quarles, Randal (2006). Testimony before the Senate Banking, Housing, and Urban Affairs Committee (July 18). Washington, D.C.
- Randall, Susan (1999). "Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners," *Florida State University Law Review* 26: 625-699.
- Skipper, Harold and W. Jean Kwon (2007). *Risk Management and Insurance: Perspectives in a Global Economy*. Boston: Blackwell Publishing.
- Stigler, George (1971). "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, 2 (spring): 3-21.
- Stewart, Richard (1971). *Reason & Regulation*. Chicago: CNA Financial Corporation.
- Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, U.S. House of Representatives (1990), *Failed Promises: Insurance Company Insolvencies*. Washington, D.C.: U.S. Government Printing Office.
- Taylor, John (1915). *The Federal Regulation of Insurance*. Hartford: Connecticut Mutual Life Insurance Company.
- Wandel, William (1935). *The Control of Competition in Fire Insurance*, Lancaster, PA: Art Printing Company.
- White, Wayne (2003). "Federalizing Insurance Regulation: A Treacherous Road to Reform," *Legal Backgrounder*, 18 (April 4): 1-4.

Appendix A: Structure of Insurance Regulation and the Number of Insurance Companies by State (2005)

State	Head of Agency	Regulatory Agency	Parent Agency	Full-time Equivalent Staff ^a	Domestic Insurers ^a	Non-domestic Insurers ^a
Alabama	Commissioner	Department of Insurance	Office of the Governor	134.6	52	1,348
Alaska	Director	Division of Insurance	Dept. of Commerce, Community & Economic Development	57	9	753
Arizona	Director	Department of Insurance	Office of the Governor	140	355	1,519
Arkansas	Commissioner	Department of Insurance	-	180	70	1,457
California	Commissioner	Department of Insurance	-	1,310.8	190	1,367
Colorado	Commissioner	Division of Insurance	Department of Regulatory Agencies	78	66	1,405
Connecticut	Commissioner	Department of Insurance	-	136	111	1,130
Delaware	Commissioner	Department of Insurance	-	79	135	1,321
D.C.	Commissioner	Dept. of Insurance, Securities and Banking	Office of the Mayor	87	61	1,349
Florida	Commissioner	Office of Insurance Regulation	Florida Financial Services Commission	305	587	1,610
Georgia	Commissioner	Office of Insurance and Safety Fire Commissioner	-	146	111	1,486
Hawaii	Commissioner	Insurance Division	Dept. of Commerce and Consumer Affairs	76	172	971
Idaho	Director	Department of Insurance	Office of the Governor	74	22	1,400
Illinois	Director	Division of Insurance	Dept. of Financial and Professional Regulation	311	389	1,468
Indiana	Commissioner	Department of Insurance	-	94	175	1,640
Iowa	Commissioner	Insurance Division	Department of Commerce	96	207	1,401
Kansas	Commissioner	Insurance Department	-	146.5	52	1,597
Kentucky	Executive Director	Office of Insurance	Department of Public Protection	177	55	1,500
Louisiana	Commissioner	Department of Insurance	-	273	135	1,452
Maine	Superintendent	Bureau of Insurance	Dept. of Financial and Professional Regulation	78	31	1,038
Maryland	Commissioner	Insurance Administration	Office of the Governor	283	79	1,410
Massachusetts	Commissioner	Division of Insurance	Office of Consumer Affairs	138.83	91	1,102
Michigan	Commissioner	Office of Financial and Insurance Services	Department of Labor and Economic Growth	126	142	1,407
Minnesota	Commissioner	Department of Insurance	Office of the Governor	81.3	179	1,313
Mississippi	Director	Insurance Department	-	80	52	1,442
Missouri	Director	Department of Insurance	Office of the Governor	218.5	225	1,395
Montana	Commissioner of Insurance and Securities	Insurance Department	State Auditor's Office	48.5	35	1,380
Nebraska	Director	Department of Insurance	-	94	109	1,459
Nevada	Commissioner	Division of Insurance	Department of Business and Industry	72	80	1,725

State	Head of Agency	Regulatory Agency	Parent Agency	Full-time Equivalent Staff ^a	Domestic Insurers ^a	Non-domestic Insurers ^a
New Hampshire	Commissioner	Insurance Department	Office of the Governor	80.5	40	932
New Jersey	Commissioner	Division of Insurance	Department of Banking and Insurance	352	109	1,195
New Mexico	Superintendent	Insurance Division	Public Regulation Commission	79	18	1,418
New York	Superintendent	Insurance Department	-	902	617	963
North Carolina	Commissioner	Department of Insurance	-	398	88	1,286
North Dakota	Commissioner	Insurance Department	-	45.5	41	1,400
Ohio	Director	Department of Insurance	Office of the Governor	278	266	1,519
Oklahoma	Commissioner	Insurance Department	-	128	99	1,591
Oregon	Insurance Administrator	Insurance Division	Dept. of Consumer and Business Services	91	143	1,571
Pennsylvania	Commissioner	Insurance Department	Office of the Governor	408	304	1,483
Rhode Island	Superintendent	Insurance Division	Dept. of Commerce and Insurance	43	33	1,159
South Carolina	Director	Department of Insurance	Office of the Governor	94	276	1,488
South Dakota	Director	Division of Insurance	Department of Revenue and Regulation	28	46	1,380
Tennessee	Commissioner	Insurance Division	Dept. of Commerce and Insurance	146.6	74	1,475
Texas	Commissioner	Department of Insurance	-	986.6	475	1,546
Utah	Commissioner	Department of Insurance	Office of the Governor	82	41	1,431
Vermont	Commissioner of Banking, Insurance, Securities & Health Care Administration	Division of Insurance	Dept. of Banking, Insurance, Securities and Health Care Administration	52.25	546	903
Virginia	Commissioner	Bureau of Insurance	State Corporation Commission	210	75	1,443
Washington	Commissioner	Office of Insurance Commissioner	Office of the Governor	200	58	1,373
West Virginia	Commissioner	Office of Insurance Commissioner	Department of Revenue	85	23	1,367
Wisconsin	Commissioner	Office of the Commissioner	Office of the Governor	132	374	1,552
Wyoming	Commissioner	Insurance Department	Office of the Governor	25	5	1,392
American Samoa	Commissioner	Office of the Commissioner	Office of the Governor	-	0	12
Guam	Director of Revenue and Taxation	Office of the Insurance & Banking Commissioner	Department of Revenue and Taxation	8	5	102
Puerto Rico	Commissioner	Office of the Commissioner of Insurance	-	127	53	295
U.S. Virgin Islands	Commissioner	Division of Banking and Insurance	Office of the Lieutenant Governor	-	3	137

^a Based on 2004 data.

Source: NAIC (2005)