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Small Companies & Federal vs. State Regulation

by Norman E. Hill

Long-established state regulation for insurance companies started to come under fire in the early '90s. Primary causes were insolvencies of several large life insurers. Congressman Dingell wrote a very critical report about inadequacies of the state structure. In response, the National Association of Insurance Commissioners worked to establish an accreditation system. In general, there was increased concern about passing more model bills faster and pushing for more uniform adoption of models across the 50 states.

In 1994, when Republicans gained control of Congress, agitation for federal preemption lost momentum. New Congressional leaders seemed to support continued state regulation, although for some legislation such as the Health Insurance Portability and Accountability Act (HIPAA), they did not hesitate to establish federal mandates for states to adopt.

Recently, several small life insurers have been victimized in a scam. Whether through ownership or reinsurance ceded, their invested assets were removed to a common location and then transferred overseas. Although the total amount for guaranty associations to make up is small compared to previous bankruptcies, the question of the adequacy of state regulation has again arisen. One article in *Business Week* called for complete preemption by a federal authority.

Also, a liquidity crisis suffered by one large company has affected its ability to pay cash values on certain large GIC/type policies. Even though its solvency does not appear threatened, this incident may lead to similar attacks on state regulation.

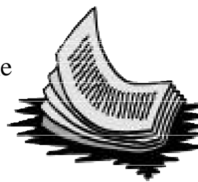
Democrats believe they have a chance in 2000 to regain control of at least the House of Representatives. If so, Congressman Dingell would again be in charge of a key committee looking into insurance matters.

Both of the above developments have once again made state versus federal regulation a hot topic for insurers. Property-casualty associations have been mixed in their sentiments. So far, life and health trade associations have rallied behind the existing state framework. This is especially true for the association representing small life companies.

Areas of Concern about State Regulation

KEY ASPECTS OF the existing regulatory framework are often attacked as inadequate, inconsistent, or onerous. In a few cases, I have provided some counter arguments.

Products



TO MANY, THIS area is the most troublesome aspect of state regulation. There is a distinct lack of uniformity in state regulations governing policy forms, rates and advertising material. The problem is worse for large companies or even small companies that market across a substantial number of states. This problem is even more acute with health insurance than life insurance.

Some critics go even further and claim that, besides lack of uniformity, there is lack of objectivity. Individual insurance departments are inconsistent in treatment of one company versus another. Often, this depends on what analyst reviews submissions. Moreover, departments may be inconsistent in treating an individual company across time. Some claim that individual department analysts are often arbitrary and capricious in reviewing submissions. Since regulations are often generally worded, analysts' own whims govern. In such case, the insurer has no option but to amend its filing for that state or demand a hearing.

This lack of uniformity makes it virtually impossible for uniform national products and marketing campaigns. The cost of doing business is increased as a result, both in home office attempts at gaining approval and in lost sales due to regulatory delays.

One answer could be uniform policy provisions for standard benefits. Such change, of course, would not help with innovative new products. Nevertheless, the approval process could often be speeded up.

Perhaps, a new designation such as "Certified Policy Analyst" could be devised. With centralized training, state insurance department employees could become more knowledgeable of products. Adoption of model laws is not enough; more uniform interpretation of complex concepts is needed to improve the process.

One proposal in a particular state would have allowed automatic policy approvals for any form previously approved in a large number of states. However, the governor vetoed the bill on the grounds that it would interfere with existing insurance department authority.

Currently, rate filings with new health products must certify uniformity with minimum loss ratios. Recently, there has been a movement to do away with these. Instead, rates would have to be actuarially certified as "sufficient," but still not "excessive." If this change were adopted, there would be no objective standards for approving rates at all.

Even more recently, regulators have expressed concern over rate increases on existing long term care products. Once again, minimum loss ratios have been proposed as a precondition for granting such rate increases.

For health medical policies, states routinely adopt bills that require additional mandated benefits. In some cases, these may be considered as clarifications of existing policy provisions. In other cases, they definitely provide additional benefits. These bills apply not only to new sales but also to policies already inforce under previously approved forms. Policyholders must often be notified in writing of such mandated benefits.

Accounting and Auditing

UNIFORM REQUIREMENTS FOR annual CPA audits and opinions based on statutory accounting are in place. Originally, the expectation was that this change would free up department personnel for market conduct and similar exams. However, states routinely duplicate and sometimes contradict outside auditor conclusions on all aspects of financial statements.

Statutory CPA audits are in addition to SEC GAAP audit opinions required by most insurers. They add a significant cost

for companies. Lack of reliance in them by insurance departments adds further to costs under state regulation.

Recently, statutory accounting was codified after a study that took several years. However, at the last minute, the scope of the new statutory accounting was watered down. Now each state can set its own accounting principles. General conformity with codification will eventually be required for accreditation. However, codification has set no uniform standards for investments or minimum reserves beyond the existing Standard Valuation Law. One state has been adamant about retaining investments standards more liberal than most other states.

Receivership

IN INSURER BANKRUPTCIES, receivers are appointed to run the companies temporarily. Receivers are usually insurance department employees. In some cases, there have been complaints about extensive delays in resolving company problems, selling off blocks of policies or assets, and ending the receivership. It is uncertain whether commercial bankruptcies have similar problems with court-appointed receivers and whether such bankruptcies are resolved more efficiently.

Market Conduct

SOME INSURERS HAVE complained about a generally hostile attitude on the part of market conduct examiners. Instead of concentrating on identifying and correcting problems, their emphasis is on maximizing company fines, i.e., on raising revenues for the department. Instead of defining one general type of violation, fines have sometime been levied for each individual instance of a violation.

Arguably, this attitude is similar to federal inspectors from the Environmental Protection Agency and the Equal Employment Opportunity Commission. There is no reason to believe the situation would be improved under federal regulation.

Health Insurance Portability and Availability Act (HIPAA)

RECENT FEDERAL LEGISLATION on health insurance instructed the Treasury and the Health Care Financing Administration to prepare various interpretive regulations. These were to cover areas such as long-term care, renewability and definition of certain health products. After over two years, none have been prepared. Someone argued that if this is an example of the effectiveness of federal regulation, it makes the current state structure look good.

Reserves

SOME INSURERS MAY support federal preemption, because they believe that current reserving standards under the state system are overly conservative. Their hope may be that a unified federal system would lead to more liberal statutory standards.

This opinion is questionable. There is no evidence that federal authority would call for radical changes in accounting and reserving standards, such as under GAAP accounting. Also for solvency purposes, intangible assets such as deferred acquisition cost and goodwill might not be admissible. Many products today require full account values for GAAP, which might even surpass statutory requirements.

Agent Licensing and Company State Admissions

THERE HAVE BEEN general complaints about extensive delays in obtaining these types of licenses.

General Considerations

SOME HAVE ARGUED that, for state regulation of insurance to survive and ward off federal preemption, greater state uniformity is needed. In other words, laws and regulations cannot continue in the current patchwork structure. For this change to occur, education is needed to convince sensitive state regulators and the National Conference of Insurance Legislators (NCOIL) Currently, several legislators have stated publicly that they “won’t allow the NAIC to tell them what to do.” In New York, one legislator has deliberately bottled up one small, technical piece of legislation that has prevented New York (the most prominent regulatory state) from keeping its NAIC accreditation.

These groups will have to be convinced of the following:

1. Significant problems do exist in the current state structure.
2. The only alternative is greater uniformity among states or complete loss of their power to federal preemption.

Use of state compacts is one possibility for achieving uniform legislation. To curb problems with narrow majorities, significant regulations, models and amendments might require super majorities of states, such as 60% or higher. Such requirement might solve the very touchy question of states’ rights.

In the industry, there may be increasing sentiment for federal regulation. This seems more prevalent among larger companies. Today, many of these are subject to the New York Insurance Department, considered the toughest state.

The concept of dealing with only one regulatory body on a national basis has a certain appeal. However, it should be remembered that once a switch to federal regulation is in place, there is no appeal from that regulatory body (except to the extent that decisions of the SEC or the IRS can be challenged in court). With onerous regulation in certain states, companies have the option of redomesticating or of setting up new subs. No such alternative would be available under federal regulation.

Possible Options

SEVERAL OPTIONS ARE available for companies to promote, including:

1. State charters continued on an improved national standards basis; these standards could come from state compacts or federal mandates to states.
2. Federal charters, preempting all state powers.
3. Retain the status quo and struggle with existing problems, while pushing for uniform adoption of existing models.

Conclusions

So far, the NAIC has vigorously supported state regulation of insurance, both in public and in testimony before Congress. Key segments of industry have supported them. Nonetheless, key changes in the current system may be necessary to retain a state regulatory structure.

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