

The Insurance Industry: Past, Present, and Future

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Insurance is a dynamic industry that changes in response to state, national, and international events. Throughout the history of the United States, two main issues in insurance have existed and have been examined multiple times through Congressional legislation and Supreme Court rulings. These two issues are that of state versus federal regulation and the appropriate scope of insurance companies: whether companies should be strictly limited to engaging in only insurance matters or if it is appropriate for a company to engage in a combination of insurance, investment banking, and commercial banking activities. Both of these issues have been addressed many times throughout history and it is unlikely that they are in their perfect, concrete form today. As times change, so do the views on these issues. Recently, the Dodd-Frank Act was passed by Congress and signed into affect by the President. This current piece of legislation addresses many things, including federal regulation of the insurance industry. Examining past legislation and understanding current legislation can help one to comprehend the insurance industry.

An issue that has had the attention of the insurance industry since 1869 is the issue of state versus federal regulation. Specifically, this debate raises the issue as to whether insurance is interstate commerce and therefore can be subjected to federal regulation. The year 1869 first documents this debate, with the case of Paul versus Virginia. In 1866 the state of Virginia passed a law that required all out-of-state insurance companies doing business in the state of Virginia to obtain a license to engage in such actions. Samuel Paul, acting as an agent of several New York insurance companies, failed to obtain a license prior to engaging in insurance business in Virginia and therefore was fined by the state. Paul appealed to the Supreme Court, where it was ruled that interstate insurance transactions are not interstate commerce and therefore cannot be regulated by the federal government. Paul was therefore forced to pay Virginia's state fine.

The Paul versus Virginia ruling held for over seventy years until the case of the United States versus the Southeastern Underwriters Association in 1945. The Southeastern Underwriters Association (SEUA) was composed of about 200 private stock insurance companies specializing in fire insurance located over the span of six southern states: Alabama, Florida, Georgia, North Carolina, South Carolina, and Virginia. The SEUA controlled about ninety percent of the fire insurance located in those six states and used boycotts and coercion to force non-SEUA companies into premium-fixing. The SEUA and its members were charged with two items: fixing interstate commerce by maintaining noncompetitive premium rates on fire insurance and monopolizing trade of fire insurance in the previously stated six states. The case was brought forward to the Court system because of the clear inconsistencies between the behaviors of the SEUA and the rules set forth in the Sherman Anti-Trust Act. Ultimately, it was ruled that insurance across state lines was considered interstate commerce and therefore subject to federal regulation. As Justice Black stated in his opinion to the court, “No commercial enterprise of any kind which conducts its activities across state lines has been held to be wholly beyond the regulatory power of Congress... We cannot make an exception of the business of insurance.” This opinion issued by the Supreme Court made it clear that they no longer wanted insurance companies to be able to engage in interstate transactions without having to abide by the same laws and regulations as other companies engaging in business across state lines.

Congress and the Supreme Court do not always see eye-to-eye. Although the SEUA ruling gave the federal government power, with power comes responsibility. Congress saw the potential cost of the federal government having that amount of responsibility and, one year after the previous ruling, passed the McCarran-Ferguson Act in 1945. This act exempts insurance engagements from most federal regulation, unless federal law specifically states otherwise. Insurance

companies are subject to anti-trust and anti-monopoly laws only to the extent that the state does not regulate such issues. Often, the McCarran-Ferguson Act is seen as a piece of legislation that overturns the US v. SEUA Supreme Court opinion. However, it does not overrule the opinion in the sense of reverting the insurance industry back to where it was before the SEUA case, which would be back to the rules of Paul v. VA. Rather, this piece of legislation should be seen as a modification of the US v. SEUA opinion. It does not state that insurance is not subject to federal regulation, as was the case under Paul v. VA, but instead leaves the broad power of regulation with the states while leaving the door open for possible federal regulation in the future.

Paul versus Virginia, the United States versus the Southeastern Underwriters Association, and the McCarran Ferguson Act are the three main events that have impacted the issue of state regulation versus federal regulation of the insurance industry. The United States began with states being solely in charge of regulation, then that broad power was given to the federal government, and lastly the broad power was given back to the states with opportunities for the federal government to intervene when seen fit.

The second major issue that affects the insurance industry is deciding the correct scope of insurance companies. The first piece of legislation affecting this issue was the Glass Steagall Act in 1933. This act separated commercial banking, investment banking, and insurance. This meant that a commercial bank could not own an insurance company, something that had previously been relatively common. As can be determined by examining the year of this act, the Glass Steagall Act was passed soon after the Depression as part of Roosevelt's "New Deal". The purpose was to restore confidence in the banking system, which was arguably accomplished. It is debated by historians as to whether or not the actions taken in this act actually did anything to improve the economy in and of themselves, or if it was little more than a placebo effect that

caused confidence to be returned to the banking industry. Either way, it seems that the Glass Steagall Act served its purpose in restoring confidence to banking after an unfortunate economic time, but the separation of the three areas of financial services was eventually terminated.

In 1999, Gramm-Leach-Bliley (GLB) Act eliminated the distinction between the three main areas of the financial services sector. It once again became possible for the financial services industry—the combination of commercial banking, investment banking, and insurance—to operate in full force. The GLB Act did many other things in addition to overturning part of the Glass Steagall Act. It also required subsidiary insured depository institutions to be well capitalized in order for the holding company to engage in broader financial activities, allowed banks with assets of less than \$1 billion to conduct financial services through subsidiaries and required banks with assets exceeding \$1 billion to conduct financial services subsidiaries, among many other things.

While the previous acts happened many years ago and have been studied and analyzed in detail, an act that is new to the insurance industry is the Dodd-Frank Act. The exact implications of this act have yet to be seen, as it is possible that certain areas will be revised or not enforced, but there are several major areas of change that can be seen by looking at key areas within the legislation.

The first major change to the insurance industry due to the Dodd-Frank Wall Street Reform Act is found in Title I with the establishment of the Financial Stability Oversight Council (FSOC).

As per the US Department of Treasury's website, the FSOC "is charged with identifying threats to the financial stability of the United States, promoting market discipline, and responding to emerging risks to the stability of the United States financial system". To help the FSOC perform its intended functions, the Dodd-Frank Act creates an Office of Financial Research, which

collects information for the FSOC. Using this information, the FSOC can recommend that primary financial regulatory agencies apply heightened or new standards for financial activities. These recommendations, or those that are similar, must be applied. If the financial agency feels as though the recommendations are not beneficial or are not needed, then they may explain so in writing to the FSOC.

In determining how this power of the FSOC may affect insurance agencies, it is necessary to examine the definition of a “primary financial regulatory agency”. According to the Frank-Dodd Act itself, the definition is vast and consists of about three pages of organizations that all fit the definition. Section “D” of the definition states insurance companies and activities that are incidental to insurance activities are included in the definition of “primary financial agencies”. Therefore, the FSOC has the authority to make recommendations to state insurance regulators and thus the FSOC is able to affect state regulation of the insurance industry.

Another function of the FSOC is its authority to determine if the Federal Reserve should supervise a “Nonbank Financial Company” whose financial distress would threaten the financial stability of the United States. Once again, examining the definition of “Nonbank Financial Company” is necessary in order to determine the impact of this authority on insurance companies. The definition of a “Nonbank Financial Company” includes foreign or US entities that derive 85% or more of their gross revenues from activities that are “financial in nature”. “Financial in nature” includes activities related to insurance. Therefore, if an insurance company was in questionable financial health and would hurt the financial state of the United States if they failed, the FSOC would have the authority to determine that the Federal Reserve should supervise them. Supervision by the Federal Reserve would, as indicated in Title I, result in

stringent standards regarding risk-based capital requirements, liquidity requirements, and enhanced public disclosures, among many other things.

In summary, the two main ways that the development of the Financial Stability Oversight Council affects the insurance industry is by allowing the FSOC to recommend and virtually require insurance companies to enforce acts that they recommend and potentially subjecting insurance companies to supervision by the Federal Reserve. At first glance, these powers may seem extreme. They allow for the Federal government to have the power to regulate insurance companies. However, the FSOC does not in itself take power away from insurance companies. If insurance companies are operating efficiently and legally, there is no reason for the FSOC to have to enforce either of these two powers. In that regard, the FSOC acts more as a check-and-balance system than as an authoritative figure.

The Financial Stability and Oversight Council is not the only newly established regulatory entity created by the Dodd-Frank Act that affects the insurance industry. The insurance industry is more directly affected by Title V, which established the Federal Insurance Office (FIO).

Referring to Sec. 313 (c) of the Dodd-Frank Act, the main functions of the FIO are to monitor the insurance industry, monitor the extent to which traditionally underserved communities and people have access to affordable insurance, recommend to the FSOC that an insurer be supervised by the Federal Reserve, and to consult with states regarding insurance matters of national importance. Unlike the FSOC, the FIO does not have the authority to make recommendations for new laws and heightened standards. While they can advise that a company be supervised by the Federal Reserve, they have no power to enforce that recommendation. In this sense, the FIO does not have as much power over insurance companies as does the FSOC. It

should also be noted that the functions of the FIO do not apply to health insurance, long-term care insurance, or crop insurance.

Another aspect of the FIO are the reports that it is required to make to Congress. The three sets of reports are “Annual Report to Congress”, “Reports on US and Global Reinsurance Market”, and “Study and Report on the Regulation of Insurance”. The first set of reports, “Annual Report to Congress”, will report on how data collected has been used “to monitor the markets for the protection of investors and the integrity of the markets”. It will be first issued in September of 2011 and will be issued annually thereafter. The second set of reports, “Reports on US and Global Reinsurance Market”, contains two types of reports. The first is a report describing the scope of the reinsurance market and the role it plays in supporting the insurance industry in the United States. The second is a report on the impact of the reinsurance reforms contained in the Dodd-Frank Act that will be discussed shortly. The first report will be issued by September 30, 2012 and the second report will be issued by January 1, 2013. The last set of reports, “Study and Report on the Regulation of Insurance”, requires the Director of the FIO to study the insurance industry and suggest ways to “modernize and improve the system of insurance regulation in the United States.” The Dodd-Frank Act lays out many standards for the director to follow when writing this last report and also recommends that he or she make legislative, administrative, or regulatory recommendations and consults with State insurance regulators and various other insurance experts. This last set of reports will be issued by January of 2012.

In general, it can be seen that the three sets of required reports are designed to analyze the insurance industry’s current position in both the global market and national market and also, through the annual report, make sure the insurance industry stays knowledgeable about their position. Through the yearly report, if the financial position of the insurance industry starts to

fall, it will not go unnoticed and therefore will be able to be dealt with appropriately rather than ignored.

Included in the Dodd-Frank Act is an Act that was passed by the House of Representative several times, but never passed the Senate until included in Dodd-Frank. That act is the Nonadmitted and Reinsurance Reform Act of 2010. This act contains two main sections: the first dealing with surplus lines insurance and the second dealing with reinsurance.

Part I of this Act, titled “Nonadmitted Insurance” mainly focuses on providing a uniform approach to regulating the commercial surplus lines market. One way in which this is accomplished is by making it so only the insured’s home state may require payment of premium taxes for surplus lines insurance. The insured must only meet the requirements of their home state. States can also no longer prohibit placing insurance with a non-US surplus lines insurer, as long as that insurer is listed on the NAIC’s Quartly Listing of Alien Insurers. Lastly, it is no longer required for exempt commercial insurers to search with due diligence for an admitted insurer before turning to surplus lines insurance as long as the insured is made aware that an admitted market may exist.

Ways in which these requirements and loosening of requirements will affect the surplus lines and reinsurance market is yet to be seen, as these actions will not take affect until July 21, 2011. The goal is to make capital more accessible by getting rid of the burden to comply with multiple states’ regulatory requirements. The second part of the Nonadmitted and Reinsurance Reform Act of 2010 is titled “Reinsurance” and focuses on addressing solvency regulation of US reinsurers. As in conformity with the first section, this act makes the insurer’s home state the sole regulator of the reinsurer’s financial solvency as long as the state is a NAIC-accredited state.

Examining past and current regulatory acts and trends affecting the insurance industry can provide insight into where the insurance industry may possibly head in the future. In the past, legislation has focused on whether insurance companies should be regulated by the state or by the federal governments and whether insurance companies should also be allowed to engage in commercial and investment banking. Currently, the Dodd-Frank Wall Street Reform Act is addressing, among other things, the issue of state versus federal regulation. While it is possible to read this new piece of legislation, it is still not possible to observe how exactly it will be enacted. Observing how the federal government handles or ignores its newly given power over the insurance industry will set a tone regarding this issue for many years in the future.

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