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Recommended Citation

Ralph S. Tyler, & Karen S. Hornig, *Reflections on State Regulation: A Lesson of the Economic Turmoil of 2007-2009*, 4 J. Bus. & Tech. L. 349 (2009)

Available at: <http://digitalcommons.law.umaryland.edu/jbtl/vol4/iss2/6>

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Reflections on State Regulation: A Lesson of the Economic Turmoil of 2007–2009

THE COLLAPSE OF THE HOUSING, CREDIT, AND FINANCIAL MARKETS in the United States in 2007–2009 will produce, as it should, a re-examination of the nation's regulatory structure.¹ The question “how did this happen?” naturally leads to the question “how can we avoid a repeat?” The scope of the collapse—starting with the decline of overpriced and over-mortgaged homes, and extending through investment banks, savings and loans, and insurance companies—certainly indicates that there was no single cause and thus, there is no single cure.² Our nation experienced a massive systemic failure (the greatest economic crisis since the Great Depression as we have so often been told); it will take extensive systemic, regulatory corrective actions to reduce the likelihood of repetition.³

Developing a comprehensive list of all the logically necessary corrective actions is beyond the scope of this article and well beyond the competence of the authors. The relevant limited area in which we claim experience is state regulation of insurance. We propose, therefore, to look at recent economic events through that prism. In doing so, perhaps some useful lessons of broader applicability will be learned.

* Insurance Commissioner, Maryland Insurance Administration.

** Associate Deputy Commissioner, Maryland Insurance Administration. The opinions, beliefs and viewpoints expressed by the authors are not official policies of the Maryland Insurance Administration and do not necessarily reflect the opinions, beliefs, and viewpoints of the Administration of the State of Maryland.

1. See generally Thomas Lee Hazen, *Filling a Regulatory Gap: It is Time to Regulate Over-The-Counter Derivatives*, 13 N.C. BANKING INST. (forthcoming 2009), available at <http://ssrn.com/abstract=1338339> (last modified Feb. 5, 2009) (stating that credit default swaps “magnified and contributed to [the] market failure that began in the latter half of 2008[,]” before “examin[ing] the regulation of instruments similar to credit default swaps and conclud[ing] that credit default swaps should be regulated as well”); John Patrick Hunt, *Credit Rating Agencies and the “Worldwide Credit Crisis”: The Limits of Reputation, the Insufficiency of Reform, and a Proposal for Improvement*, 2009 COLUM. BUS. L. REV. (forthcoming 2009), available at <http://ssrn.com/abstract=1267625> (last modified Jan. 25, 2009) (criticizing a number of reform efforts aimed at credit rating agencies and advocating a solution to the credit rating incentive problem that would require credit rating agencies to give up profits earned by a rating that is proved by the product's performance over time to have been a low-quality rating).

2. See David Anderson, *The Credit Crisis*, 72 TEX. B.J. 24, 24–25 (2009).

3. See Stephen Labaton, *S.E.C. Concedes Oversight Flaws Fueled Collapse*, N.Y. TIMES, Sept. 27, 2008, at A1.

Our nation's current system of economic regulation is a complex hodge-podge of federal and state agencies.⁴ Consistent with the American aversion to central planning of the economy, the system is intentionally diffuse.⁵ There is no single regulator of the United States economy.⁶ With respect to regulation of the domestic insurance industry, the states (plus the District of Columbia, Puerto Rico, Guam, and the Virgin Islands) are the dominant regulators.⁷ An important qualification to this description involves health care, where the federal government plays an important regulatory role, through Medicare and by preempting state regulation of large employers' self-funded plans.⁸

We wish to make clear our perspective, if not bias. We are state insurance regulators. We see each day the strengths of the state regulatory system and its benefits to Maryland consumers. We work to improve and strengthen the weaknesses of our state's insurance regulatory system. Our overall view is that the state system of insurance regulation has served the country well in the past and did so again in the turmoil of 2007–2009.⁹

We would caution against learning the wrong lessons from the present turmoil. While better and more thoughtful regulation is needed, that conclusion should not be equated automatically with exclusive or primary *federal* regulation.¹⁰ The federal regulatory system, with its responsibilities for securities and banking, for example, has not distinguished itself in the current crisis.¹¹ State regulation of insurance during this same period looks quite good by comparison.¹² We caution strongly against discarding that which worked because so much else failed.

The goal of insurance regulation is to promote the welfare of the public by ensuring fair contracts at fair prices from financially strong companies.¹³ Regulation is intended to prevent market failures, including financial insolvency of insurance companies and unfair treatment of insurance consumers.¹⁴ These dual goals of as-

4. U.S. DEP'T OF THE TREASURY, BLUEPRINT FOR A MODERNIZED FINANCIAL REGULATORY STRUCTURE 32, 44 (2008) [hereinafter TREASURY REPORT], available at <http://www.treas.gov/press/releases/reports/Blueprint.pdf>.

5. See *id.* at 2.

6. *Id.* at 4.

7. *Id.* at 61.

8. Peter J. Hammer, *Competition and Quality as Dynamic Processes in the Balkans of American Health Care*, 31 J. HEALTH POL. POL'Y & L. 473, 477 (2006).

9. See *infra* Part III.

10. For an argument proposing primary federal regulation, see TREASURY REPORT, *supra* note 4, at 10.

11. John C. Coffee, *SEC's New Rules Fail to Address Key Rating Issues*, N.Y. L.J., Jan. 15, 2009, at 5.

12. Jim Connolly, *Blame Feds, Not States for AIG Mess, Regulators Contend*, NAT'L UNDERWRITER PROP. & CASUALTY—RISK & BENEFITS MGMT., Sept. 29, 2008, at 7, 7, 32.

13. Karen Pollitz et al., *New Directions in Health Insurance Design: Implications for Public Policy and Practice*, J.L. MED. & ETHICS (SPECIAL SUPP.), Winter 2003, at 60, 61.

14. TREASURY REPORT, *supra* note 4, at 63–64.

suring insurer solvency and fair treatment of consumers include availability and affordability of insurance.¹⁵

The discussion that follows is in three parts. We first provide some brief background and legal history of how it came to pass that states have been, and are, the dominant, albeit not the sole, regulators of the insurance industry.¹⁶ The second section discusses how we have seen the economic problems of 2007–2009 impact the insurance industry.¹⁷ The third and final section argues that the strengths of the state regulatory system are substantial and well worth preserving, recognizing a need for continued improvement.¹⁸

I. BACKGROUND AND LEGAL HISTORY OF THE INSURANCE INDUSTRY

The business of insurance is a significant economic driver in the economy on a global, national, and local level.¹⁹ By the end of calendar year 2006, insurance companies in the United States held assets of \$6 trillion.²⁰

A. *History of the Insurance Industry*

The concept of insurance has deep roots. There is strong evidence of early forms of bonds and benevolent societies in China, India, Egypt, Greece, and Rome.²¹ During the Middle Ages, the concept of commercial insurance grew throughout Europe with maritime insurance contracts becoming common place in Italy.²² The first set of insurance regulations, known as the “law merchant,” developed to expedite international commerce.²³

Insurance as we know it in the West today traces its roots back to 16th and 17th century England.²⁴ With the growth of exploration, international trade, and the boom of urban centers, the need for marine and fire insurance grew.²⁵ Edward Lloyd opened a coffee house in London in the late 1680s that was frequented by ship owners, businessmen, and sailors.²⁶ It became a meeting place for those seeking to have their ships and inventories insured.²⁷ “This early marine insurance was

15. Robert W. Minto, *Captives and RRG's in the Reinsurance Environment*, in REINSURANCE LAW & PRACTICE 2006: NEW LEGAL & BUSINESS DEVELOPMENTS IN A CHANGING GLOBAL ENVIRONMENT 837, 939 (Practising L. Inst., 2006).

16. See *infra* Part I.

17. See *infra* Part II.

18. See *infra* Part III.

19. See TREASURY REPORT, *supra* note 4, at 126 (commenting on the role of insurance in safeguarding the assets of consumers and businesses in the overall economy).

20. *Id.*

21. WILLIAM R. VANCE, HANDBOOK ON THE LAW OF INSURANCE 8 (Buist M. Anderson ed., 3d ed. 1951).

22. *Id.* at 10.

23. *Id.* at 11.

24. *Id.* at 14–15.

25. See *id.* at 17.

26. *Id.*

27. *Id.*

issued by individuals . . . [and t]hose who agreed to accept a portion of the risk wrote their names under the description of the risk and terms of agreement.²⁸ This practice gave rise to the common insurance term, “underwriting.”²⁹ The devastating Great Fire of London of 1666 was the impetus for the growth in the fire insurance business in England.³⁰

In the United States, fire insurance was initially the most popular form of insurance.³¹ Some sources give Benjamin Franklin credit for starting America’s first insurance company when he founded Philadelphia Contributionship for the Insurance of Houses from Loss by Fire in 1752.³² America’s first true fire insurance company was the Friendly Society of Charleston founded on February 3, 1736 in Charleston, South Carolina.³³ This effort was short-lived, however. Four years later, in 1740, a destructive fire caused widespread property damage in Charleston and led to the collapse of the Friendly Society.³⁴

B. Regulation of Insurance in America

As America grew, so did the demand for commercial and personal insurance, and by the mid-19th century the insurance industry had expanded to include casualty insurance, accident and health insurance, and life insurance.³⁵ The industry boomed and so did the demand for its regulation.³⁶ “As early as 1866 the insurance trade, though still in its infancy, was subject to widespread abuses.”³⁷

States began to pass laws regulating the sale of insurance and forming state insurance commissions.³⁸ The Maryland Insurance Administration (MIA) was created in 1872.³⁹ As early as 1871, state insurance regulators recognized the need to work in concert with one another to coordinate regulation and thus created the

28. ARTHUR ANDERSEN, *THE INSURANCE INDUSTRY: AN INTRODUCTION* 1 (1991).

29. *Id.*; VANCE, *supra* note 21, at 17–18.

30. VANCE, *supra* note 21, at 19.

31. *Id.* at 23.

32. *Id.*; Insurance Information Institute, Insurance 101, <http://www.iii.org/media/research/insurance101> (last visited Feb. 12, 2009).

33. See Charleston SC History: A Timeline of South Carolina Settlement, Economy, Revolutionary War, and Civil War, <http://www.charlestonscarestate.us/charlestonhistory.html> (last visited Feb. 12, 2009); e-ReferenceDesk, South Carolina History Timeline: Important Dates, Events, and Milestones, <http://www.e-referencedesk.com/resources/state-history-timeline/south-carolina.html> (last visited Feb. 12, 2009).

34. Mutual Assurance Society of Virginia, Mutual Assurance—Its Beginning in America, <http://www.mutual-assurance.com/newInsInAmerica.asp> (last visited Feb. 12, 2009).

35. See VANCE, *supra* note 21, at 23–35 (explaining the historical progression of these types of insurance in the United States).

36. See *id.* at 37 (explaining the early history of state regulation of the insurance business).

37. *United States v. Se. Underwriters Ass’n*, 322 U.S. 533, 544 (1944), *superseded by statute*, McCarran-Ferguson Act, ch. 20, 59 Stat. 22 (1945) (codified as amended at 15 U.S.C. § 1011 (2006)), *as recognized in U.S. Dep’t of the Treasury v. Fabe*, 508 U.S. 491, 500 (1993).

38. See VANCE, *supra* note 21, at 36.

39. Maryland Insurance Administration, Historical Information, <http://www.mdinsurance.state.md.us/sa/jsp/aboutMia/HistoricalInfo.jsp> (last visited Feb. 13, 2009).

National Association of Insurance Commissioners (NAIC).⁴⁰ A first major NAIC initiative “was the development of uniform financial reporting by insurance companies.”⁴¹ Today, the NAIC is made up of the insurance regulators from all fifty states, the District of Columbia, and the United States territories.⁴²

The legal history of insurance regulation in the United States turns on the definition of interstate commerce as it relates to insurance.⁴³ In 1868, the Supreme Court shaped the state-based nature of insurance regulation when it ruled in *Paul v. Virginia* that the sale of insurance is *not* commerce for the purpose of the United States Constitution’s Commerce Clause.⁴⁴

The Commonwealth of Virginia passed a law in 1866 that “provided that no insurance company, not incorporated under the laws of the State, should carry on its business within the State without previously obtaining a license for that purpose”⁴⁵ To obtain a license, the law also required an insurance company to deposit a bond with Virginia’s treasurer.⁴⁶ Samuel Paul, a citizen of Virginia, was hired by several New York insurance companies to work as their agent selling insurance in Virginia.⁴⁷ Though he applied for a Virginia license, the companies did not deposit a bond with Virginia’s treasurer.⁴⁸ Paul was denied a license and the insurance companies challenged Virginia’s action as in violation of the Privileges and Immunities and Commerce Clauses of the United States Constitution.⁴⁹

The *Paul* Court found first that a corporation was not a citizen for the purposes of the Privileges and Immunities Clause.⁵⁰ But the part of the ruling that had the greatest impact on the development of state insurance regulation was the finding, which stood for nearly eighty years that, “[i]ssuing a policy of insurance is not a transaction of commerce.”⁵¹ The Court found that insurance policies are personal contracts between the insurance company and the insured, and that even when they are purchased by a resident of one state from a company domiciled in another state, the contracts are local in nature.⁵² The Court made it clear that regulation of

40. National Association of Insurance Commissioners, About the NAIC: The NAIC’s History and Background, http://www.naic.org/index_about.htm (last visited Feb. 13, 2009).

41. *Id.*

42. *Id.*

43. See *Paul v. Virginia*, 75 U.S. 168 (1868) (determining whether the sale of insurance is interstate commerce as protected by the U.S. Constitution’s Commerce Clause), *abrogated by* *United States v. Se. Underwriters Ass’n*, 322 U.S. 533 (1944), *superseded by statute*, McCarran-Ferguson Act, ch. 20, 59 Stat. 22 (1945) (codified as amended at 15 U.S.C. § 1011 (2006)).

44. *Id.* at 183.

45. *Id.* at 168.

46. *Id.*

47. *Id.* at 169.

48. *Id.*

49. *Id.* at 169–70.

50. *Id.* at 177.

51. *Id.* at 183.

52. *Id.*

insurance was within a state's purview.⁵³ "Now, the Federal government can no more regulate the commerce of a State than a State can regulate the commerce of the Federal government; and domestic bills or promissory notes are as necessary to the commerce of a State as foreign bills to the commerce of the Union."⁵⁴

This reading of the Commerce Clause with respect to insurance was reiterated by the Supreme Court until it was reversed in 1944 in *United States v. South-Eastern Underwriters Ass'n*.⁵⁵ The South-Eastern Underwriters Association (SEUA) was indicted under the Sherman Act⁵⁶ for price fixing and anti-competitive practices in Alabama, Florida, Georgia, North Carolina, South Carolina, and Virginia.⁵⁷ The SEUA argued that it was not subject to the Sherman Act because insurance is not commerce for the purpose of the United States Constitution.⁵⁸

In a deeply researched opinion by Justice Black, the Court reversed *Paul v. Virginia* and found that its broad holding that insurance is not commerce was inconsistent with the Court's application of the Commerce Clause to other businesses.⁵⁹ Furthermore, the Court rejected the *Paul* Court's notion that regulation of commerce was either exclusively state or exclusively federal, stating,

*[i]t is settled that, for Constitutional purposes, certain activities of a business may be intrastate and therefore subject to state control, while other activities of the same business may be interstate and therefore subject to federal regulation. And there is a wide range of business and other activities which, though subject to federal regulation, are so intimately related to local welfare that, in the absence of Congressional action, they may be regulated or taxed by the states.*⁶⁰

The Court concluded that "no commercial enterprise of any kind which conducts its activities across state lines has been held to be wholly beyond the regulatory

53. *Id.*

54. *Id.* at 184.

55. 322 U.S. 533 (1944). Consistent with its assertion in *Paul v. Virginia*, the Supreme Court has regularly recognized that insurance transactions are not to be considered commerce. See *N.Y. Life Ins. Co. v. Deer Lodge County*, 231 U.S. 495, 503 (1913) ("These [insurance] contracts are not articles of commerce in any proper meaning of the word."); *Hooper v. California*, 155 U.S. 648, 654 (1895) ("Issuing a policy of insurance is not a transaction of commerce."). The Supreme Court changed its stance in *South-Eastern Underwriters*, when it reasoned that "it would indeed be difficult now to hold that no activities of any insurance company can ever constitute interstate commerce so as to make it subject to such regulation" 322 U.S. at 550.

56. Sherman Anti-Trust Act, ch. 647, 26 Stat. 209 (1890) (codified as amended at 15 U.S.C. §§ 1-2 (2006)).

57. *South-Eastern Underwriters*, 322 U.S. at 534-35.

58. *Id.* at 536.

59. *Id.* at 548 (noting that despite the assertion made in *Paul*, the Supreme Court has consistently recognized that "certain activities of a business may be intrastate and therefore subject to state control, while other activities of the same business may be interstate and therefore subject to federal regulation") (internal citations omitted).

60. *Id.*

power of Congress under the Commerce Clause. We cannot make an exception of the business of insurance.⁶¹

In response to the *South-Eastern* decision, Congress in 1945 passed the McCarran-Ferguson Act that acknowledged the federal government's right to regulate insurance as interstate commerce, but agreed that the federal government would not exercise this right as long as the industry was regulated adequately by the states.⁶²

The debate about state versus federal regulation of insurance has continued over the last several decades as the political winds shifted in favor of industry and against regulation, with the culmination, in 1999, of the passage of the Gramm-Leach-Bliley Act (GLB Act).⁶³ The purpose of the GLB Act was to facilitate affiliation among banks, securities firms, and insurance companies.⁶⁴ While preserving much of state insurance regulation, the GLB Act was designed to "eliminate[] many Federal and State law barriers to affiliations among banks and securities firms, insurance companies, and other financial service providers . . . [and] provide[] financial organizations with flexibility in structuring these new financial affiliations through a holding company structure, or a financial subsidiary"⁶⁵ The Act set the stage for corporate structures that blended traditional insurance business with other, higher risk financial services.⁶⁶

In recent years, Congress has been urged by large insurers to enact legislation authorizing an Optional Federal Charter (OFC) for insurers.⁶⁷ Similar to the system that exists in banking, an OFC would permit insurers to choose between state and

61. *Id.* at 553.

62. McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011–1015 (2006)).

63. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 15 U.S.C.); see also Matthew J. Restrepo, *The Convergence of Commercial and Investment Banking Under the Gramm-Leach-Bliley Act: Revisiting Old Risks and Facing New Problems*, 11 L. & Bus. Rev. AM. 269, 270–72 (2005). The Glass-Steagall Act was passed in 1933 and it "acted to prevent commercial banks from underwriting most types of securities and from affiliating with investment banking firms." *Id.* at 271. "In 1987, the [Federal Reserve Board,] FRB[,] approved securities activities in non-bank subsidiaries of Bank Holding Companies" with some limitations, an obvious departure from the Glass-Steagall Act's separation of commercial and investment banking. *Id.* The FRB stipulated that as long as a certain percentage of the revenue earned by a firm engaging in underwriting was not derived from bank-ineligible activities, a commercial bank was free to affiliate with them. *Id.* The FRB originally set the revenue limitation at 5%, however this cap rose dramatically to 25% by 1989. *Id.* at 272. "This trend of the softening of certain Glass-Steagall restrictions, by federal regulators, came to a dramatic climax in 1999 when Congress passed the [Gramm-Leach-Bliley] Act" *Id.*

64. H.R. REP. NO. 106-434, at 127 (1999) (Conf. Rep.).

65. *Id.*

66. See generally Restrepo, *supra* note 63, at 273 (noting that the Gramm-Leach-Bliley Act eliminated the protections that the Glass-Steagall Act had in place to restrict commercial banks from getting involved with risky services such as underwriting and anti-competitive activities).

67. See *Senators Introduce Optional Federal Charter Legislation*, INS. J., Apr. 5, 2006, available at <http://www.insurancejournal.com/news/national/2006/04/05/67081.htm> (noting that "[t]he Council of Insurance Agents & Brokers, which represents large commercial property/casualty domestic and international commercial insurance brokers, supports the optional federal charter system").

federal regulation.⁶⁸ While recognizing the need for greater uniformity among states, generally smaller companies and insurance agents have supported continuing state-based regulation.⁶⁹

II. THE IMPACT OF THE ECONOMIC DOWNTURN OF 2007–2009 ON THE INSURANCE INDUSTRY

A. National and International Impact

In September 2008, the economic crisis erupted in earnest on Wall Street and the Federal Reserve stepped in to prop up the American International Group (AIG), “the world’s largest insurance company.”⁷⁰ AIG’s financial investment subsidiaries were heavily involved in issuing high-risk derivatives contracts.⁷¹ The goal of the Federal Reserve was to step in and oversee what it thought would be a quick and orderly sale of AIG’s insurance subsidiaries, all of which were considered (and are still considered) financially strong stand-alone companies.⁷² By mid-October 2008, the taxpayers were exposed to \$1.047 trillion in debt as a result of the financial crisis and that figure is rising as a result of the federal government’s attempt to stimulate the economy and reverse its decline.⁷³ As of this writing in early 2009, the prospect of sales of AIG’s insurance subsidiaries is still an unrealized hope.⁷⁴

As the economic crisis spread throughout the economy, the insurance industry has been impacted by the contraction of available credit and the general decline of

68. Wolcott B. Dunham, Jr. et al., *U.S. Insurance Regulation Reform S.2509: National Insurance Act of 2006*, BANKING & FIN. SERVICES POL’Y REP., Oct. 2006, at 10, 12–13 (“An insurer could remain in the state system and not be subject to federal regulation or an insurer could opt into the federal system and not be subject to state regulation.”).

69. See Peter J. Wallison, *Competitive Equity: An Optional Federal Charter for Insurance Companies*, FIN. SERVICES OUTLOOK (Am. Enter. Inst. for Pub. Policy Research, Wash., D.C.), Mar. 2006, at 1, 2, 4, available at http://www.aei.org/docLib/200603091_fso_g.pdf. The National Association of Insurance Commissioners (NAIC) advocates the interests of small insurers in all fifty states and opposes an optional federal charter because it believes it can create sufficient uniformity at the state level. *Id.*

70. See Andrew Clark, *US Government Steps in to Rescue Insurance Giant AIG*, THE GUARDIAN, Sept. 17, 2008, available at <http://www.guardian.co.uk/business/2008/sep/17/marketturmoil.creditcrunch>.

71. See Jesse Eisinger, *The \$58 Trillion Elephant in the Room*, PORTFOLIO.COM, Oct. 15, 2008, <http://www.portfolio.com/views/columns/wall-street/2008/10/15/Credit-Derivatives-Role-in-Crash> (noting that AIG was heavily involved in dealing with risky credit-default swaps, a type of derivative contract).

72. See CSAC Excess Insurance Authority, *AIG Update—10/20/2008*, http://www.csac-eia.org/pdfs/AIG_Update_102008.pdf (noting that AIG Commercial Insurance and its subsidiaries remain highly rated as they hold assets exceeding \$70 billion and have a statutory surplus of \$26.7 billion).

73. Robert P. Hartwig, *Conference Presentation at the Southeastern Regulators Association Conference: Financial Crisis: Private & Public Sector Impacts Challenges Amid Economic and Regulatory Uncertainty* (Oct. 20, 2008) (transcript available at http://server.iii.org/yy_obj_data/binary/800559_1_0/SERA.pdf).

74. See David S. Hilzenrath, *AIG Moving Slowly on Asset Sales to Pay Debt*, WASH. POST, Jan. 14, 2009, at D1, available at <http://www.washingtonpost.com/wp-dyn/content/article/2009/01/13/AR2009011302701.html> (noting that market conditions for the sale of AIG’s insurance subsidiaries is bleak because the suitable buyers are also financial services companies that have seen their buying power reduced by dropping stock values).

investment value.⁷⁵ Nonetheless, the lesson is that insurance companies that continued to behave more-or-less like traditional insurance companies—insuring risks that they understood, meaning the insurer had sound underwriting guidelines and rational pricing—are, at present, financially sound.⁷⁶ AIG is strong evidence for this general proposition.⁷⁷ The AIG operating insurance companies are financially sound.⁷⁸ This is a testament to effective state regulation of the business of insurance. The problems at AIG that resulted in the initial \$85 billion federal bailout (with more billions thereafter) were at the holding company level where it was involved in exotic and not well understood transactions.⁷⁹

B. *Impact at the Maryland State Level*

Maryland saw firsthand the impact that high risk investments have on insurance businesses, on a smaller scale, with financial guaranty insurers.⁸⁰ These “monoline” firms (often because they provide service to only one industry—financial services) traditionally insured the timely payment of interest and repayment of principal on municipal bonds.⁸¹ This was a successful and profitable business.⁸²

Starting in about 2001, monoline insurers began insuring structured finance products and this transformed into the business of insuring credit default swaps (CDS) of mortgage-backed and other asset-backed securities.⁸³ The buyer of a CDS receives credit protection and the seller of the swap guarantees the credit worth-

75. See generally David Roche, *The Credit Crunch Will Go On*, WALL ST. J., Sept. 18, 2008, at A25, available at <http://s.wsj.net/article/SB122169266450449841.html> (explaining that insurers such as AIG have suffered significant losses amidst the current economic downturn and widespread contraction of credit).

76. See *S&P Rates Phila. Indemnity, Phila. Insurance; 'AA-'; Outlook Stable*, INS. J., Feb. 5, 2009, <http://www.insurancejournal.com/news/national/2009/02/05/97638.htm> (explaining that Philadelphia Indemnity Insurance Company and its sister company Philadelphia Insurance Company received an AA- financial strength rating because of their strong competitive position and their valuable “underwriting discipline”); see also *Fitch Affirms Travelers' Ratings; Outlook Stable*, BUS. WIRE, Feb. 13, 2009, http://www.businesswire.com/portal/site/home/permalink/?ndmViewId=news_view&newsId=20090213005704&newsLang=en (noting that Fitch Ratings has rated the insurance subsidiaries of The Travelers Companies, Inc., at AA because it views the companies’ “investment portfolio as a high-quality and liquid portfolio with comparatively little exposure to problem asset classes such as mortgage backed securities with sub-prime or Alt-A collateral”).

77. See *supra* note 72 and accompanying text.

78. See *id.*

79. See Laura Bruce, *Have an AIG Policy? Officials Say Don't Worry*, BANKRATE.COM, Sept. 17, 2008, http://www.bankrate.com/brm/news/insurance/insurance_news-AIG-policies-a1.asp (stating that AIG involved itself with derivatives and swaps and in the process guaranteed pools of mortgages without understanding the risks involved).

80. See Press Release, Md. Ins. Admin., Insurance Commissioner Approves ACA Financial Guaranty Corporation Settlement and Restructuring Plan (Aug. 8, 2008), available at <http://www.mdinsurance.state.md.us/sa/documents/ACArelease-final-08-08.pdf> (explaining that ACA Financial Guaranty Corporation, a financial insurance guarantor incorporated in Maryland, has suffered greatly due to the meltdown of the sub-prime mortgage market).

81. Richard C. Bosse, Jr., Note, *Financial Guaranty Insurance: Is It “the Business of Insurance” Under the McCarran Act?*, 1988 COLUM. BUS. L. REV. 855, 856 n.7.

82. *Id.* at 855–57.

83. Bruce E. Stern, *Synthetic Securitization: A Comment on Bell & Dawson*, 12 DUKE J. COMP. & INT'L L. 567, 567 (2002).

ness of the product.⁸⁴ Thus, this swap transaction transfers the risk of default from the holder of the underlying security to the seller of the swap.⁸⁵ These swap transactions were not themselves regulated as insurance even though they can be used to hedge (i.e. insure) against a default.⁸⁶ The insured CDS allowed otherwise lower-rated securities to be more highly rated and, therefore, more valuable in the marketplace.⁸⁷

We now know at least three things about these transactions: (1) the underlying assets (mortgages on homes and ultimately the homes themselves) had far less value and were far riskier than projected; (2) these transactions were complex and not well understood; and (3) these transactions were unregulated.⁸⁸

Often, these transactions were structured in such a way as to have a devastating impact on the company's bottom line if things turned sour, as they have.⁸⁹ Insurers' contracts provided that if the insurer was downgraded (as happened), its counterparties had the right to require it to post additional collateral.⁹⁰ In December 2007, in anticipation of being downgraded by the rating agencies, a Maryland domiciled bond insurer entered into a consent order with the MIA providing that, in the event of the then anticipated downgrade, thereby triggering an obligation to post about \$1.7 billion in additional collateral, and in the absence of forbearance agreements with all of the insurer's counterparties, the MIA could institute, without objection from the insurer, conservatorship, rehabilitation, or liquidation proceedings.⁹¹

In fact, the insurer obtained forbearance agreements, which were extended several times so no proceedings were commenced.⁹² Ultimately, after months of negotiations, *but no litigation*, all parties agreed that the insurer would be placed in runoff.⁹³ The expectation is that the runoff company would be able to satisfy all

84. Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 *FORDHAM L. REV.* 2039, 2063 (2007).

85. Paul M. Goldschmid, Note, *More Phoenix than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 *COLUM. BUS. L. REV.* 191, 222.

86. See Robert F. Schwartz, *Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation*, 12 *FORDHAM J. CORP. & FIN. L.* 167, 173 (2007) (noting that although financial regulators have regulatory authority over CDS's, many market observers believe that they "should qualify as capital markets products that escape regulation under state law").

87. See Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 *U. CIN. L. REV.* 1019, 1027-28 (2007) (explaining the role of CDO and CDS in increasing the value of lower-rated securities).

88. Aaron Unterman, *Exploring Risk: Global Implications of the Securitization of U.S. Housing Debt*, 4 *HASTINGS BUS. L.J.* 77, 89 (2008).

89. See Steven Golick, *Canadian Ruling Favors Third-Party Releases*, *AM. BANK. INST. J.*, July/Aug. 2008, at 40, 40.

90. *Id.*

91. Reuters, *Extension for Troubled Bond Insurer*, *N.Y. TIMES*, Jan. 22, 2008, available at http://www.nytimes.com/2008/01/22/business/22bond.html?_r=1&pagewanted=print.

92. See *id.*

93. Vikas Bajas, *Bond Insurers' Distress Rattles Wall Street*, *N.Y. TIMES*, Jan. 19, 2008, available at <http://www.nytimes.com/2008/01/19/business/19ambac.html>.

policyholder claims.⁹⁴ MIA's principal interest was protection of policyholders and, hopefully, this objective was achieved.⁹⁵

III. THE STRENGTH OF STATE REGULATION

There is an active debate underway in the insurance industry, in Congress, in the media, and among state legislators and regulators regarding the pros and cons of the current state-dominated system of insurance regulation as compared to the asserted benefits of a more federally driven system.⁹⁶ There are those who insist that the current state-based system, despite the acknowledged inefficiencies of a system of fifty plus separate regulatory regimes, has served well the country, its consumers, and the insurance industry, and, therefore, change in the regulatory structure is not warranted.⁹⁷ There are those who take the polar opposite position and insist that the current system is, at best, a highly inefficient anachronism ill suited to a global insurance market, and the solution is to federalize insurance regulation, much as securities regulation was federalized in the 1930s.⁹⁸ Not surprisingly, there are many whose views fall somewhere between these two extremes.⁹⁹

To fairly weigh these various views, one must consider what parts of the present structure make sense, meaning they provide protection to consumers without creating unreasonable inefficiencies, and how the present system could be made more efficient, through federal intervention or otherwise, without sacrificing protections for consumers.¹⁰⁰ This framework does not tilt the conclusion in favor of perpetuating the present regulatory structure merely because it exists, while recognizing that some of the most strident attacks on state regulation are motivated by little more than a self-interested desire to diminish regulation.¹⁰¹

94. See, e.g., *id.*

95. See *id.* (stating that a bailout may be a possible solution).

96. Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 626 (1999).

97. Meghan M. McAllister, *A Quick Fix, But No Real Solution: Why ERISA Preemption Should Not Be Expanded to Health Plans*, 10 DEPAUL J. HEALTH CARE L. 359, 382–83 (2007).

98. David A. Skeel, Jr., *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 TEX. L. REV. 471, 541 (1994).

99. See Danielle F. Waterfield, *Insurers Jump on Train for Federal Insurance Regulation: Is It Really What They Want or Need?*, 9 CONN. INS. L.J. 283, 285 (2002).

100. See David G. Stebing, *Insurance Regulation in Alaska: Healthy Exercise of a State Prerogative*, 10 ALASKA L. REV. 279, 296 (1993) (noting the dangers of state insurance regulation and emphasizing that Congress must take an active role in protecting consumers).

101. See Peter C. Carstensen, *Evaluating "Deregulation" of Commercial Air Travel: False Dichotomization, Untenable Theories, and Unimplemented Premises*, 46 WASH. & LEE L. REV. 109, 109 n.2 (1989) ("Industry self-interest, as well as self-serving demands by other interest groups, can greatly affect regulation and any reform in regulation. Regulatory decisions are, after all, political ones which specific economic interests may vigorously try to influence because of the impact on their economic well being.").

A. *The Importance of Economic Regulation*

The relentless attack on state regulation because it is regulation cannot be underestimated. The insurance industry, not unlike other powerful economic interests, opposes regulation almost as a matter of religion, except, of course, for those regulations that are protective of its special interests.¹⁰² Industries which receive special tax treatment do not oppose that type of governmental intervention in their business.¹⁰³ The anti-regulation argument is that regulation causes delay and increases cost, delay hurts consumers (as well as the industry), and the increased costs hurt consumers as they are passed on to the consumer.¹⁰⁴ There is truth in this argument, but it is far from the whole truth.

The costs of regulation must be compared to the harms that flow from any weakening of regulation.¹⁰⁵ The most significant—and the most likely—harm if regulation is weak is abuse of consumers.¹⁰⁶ Those who attack regulation, focusing on its costs, suggest, at least implicitly, that industry would behave more fairly and responsibly if there were less regulation.¹⁰⁷ The evidence does not support this view.¹⁰⁸ Notwithstanding regulation, business practices, the pressures of profit maximization, and obligations to shareholders often lead insurance companies to act against the interest of their policyholders.¹⁰⁹ Any weakening of regulatory oversight would skew the balance further to the detriment of consumers.¹¹⁰

102. See generally Raymond A. Guenter, *Rediscovering the McCarran-Ferguson Act's Commerce Clause Limitation*, 6 CONN. INS. L.J. 253, 260 n.24 (2000) (stating that industry support for regulation depends on how stringent the law may be).

103. *Id.*

104. See McAllister, *supra* note 97, at 382.

105. Kenneth E. Spahn, *Service Warranty Associations: Regulating Service Contracts as "Insurance" Under Florida's Chapter 634*, 25 STERSON L. REV. 597, 618 (1996).

106. McAllister, *supra* note 97, at 382.

107. See generally Eliot M. Blake, Comment, *Rumors of Crisis: Considering the Insurance Crisis and Tort Reform in an Information Vacuum*, 37 EMORY L.J. 401, 429 (1988) (noting that many states have responded to regulatory inefficiencies, inequities in rates and competition, as well as other market restrictions by implementing deregulation as a more efficient means of insurance governance).

108. See *id.* ("Implementation of deregulation, however, has not necessarily led to enhancement of regulatory goals and actually appears to have encouraged rate hikes."); see also Hellen A. Garten, *Subtle Hazards, Financial Risks, and Diversified Banks: An Essay on the Perils of Regulatory Reform*, 49 MD. L. REV. 314, 314-15 (1990) (noting that "refurbishing" regulatory controls is a better alternative to the unpredictable and often ineffective strategy of blanket deregulation in the banking industry).

109. See *State Farm Mut. Auto Ins. Co. v. Campbell*, 538 U.S. 408, 419 (2003) (describing how the insurance company altered company records to make their client appear less culpable, "disregarded the overwhelming likelihood of liability" in its decision to contest liability, and, after losing at trial, instructed their clients "to put a for-sale sign on their house"); Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholders' Objectively Reasonable Expectations of Insurance Coverage*, 5 CONN. INS. L.J. 335, 398 (1998) ("Insurance companies may violate a policyholder's reasonable expectations of coverage for purely financial reasons. This is because insurance companies profit by prolonging a coverage dispute rather than paying a claim—even when they know the claim is valid.")

110. As it is, the bargaining power of the consumer—the policyholder—is nearly non-existent as compared to the insurer's leverage. Egan v. Mut. of Omaha Ins. Co., 620 P.2d 141, 146 (Cal. 1979) ("[T]he relationship of insurer and insured is inherently unbalanced; the adhesive nature of insurance contracts places the insurer in a superior bargaining position."); *Hayseeds Inc. v. State Farm Fire & Cas.*, 352 S.E.2d 73, 77 (W. Va. 1986)

Some have argued that the concept of insurance regulation should be abandoned in favor of holistic regulation of the financial services industry because the financial services system has made insurance products increasingly fungible with one another.¹¹¹ Yet, regulators must address head-on whether this trend in the financial services industry has provided any real benefit to consumers (rather than to companies) and whether the current crisis is not a call to get the system back to basics and away from the glorification of unique, complex, and arcane products.¹¹²

One clear lesson in dealing with the consumer fall-out from the AIG bailout is that even sophisticated, well-informed consumers of annuity products were uncertain about the fundamental nature of the product they had purchased.¹¹³ Investment in insurance and investment in securities are two distinct and fundamentally different things.¹¹⁴ The choices and risks involved with each must be plain to purchasers.¹¹⁵ Both the insurance industry and the banking and financial services industry must get back to basics and the federal government should carefully and honestly examine the role that the passage of the GLB Act¹¹⁶ has had on putting consumers at risk.¹¹⁷ The GLB Act eliminated many of the depression era barriers

("[T]he bargaining power of an insurance carrier *vis-a-vis* the bargaining power of the policyholder is disparate in the extreme.")

111. Elizabeth F. Brown, *The Fatal Flaw of Proposals to Federalize Insurance 2* (Univ. of St. Thomas Sch. of Law Legal Studies Research Paper Series, Paper No. 07-25, 2007), available at <http://papers.ssrn.com/abstract=1008993>.

112. See Colbert I. King, *Back to Basics in Banking*, WASH. POST, Sept. 20, 2008, at A19 ("[L]awmakers and regulators should consider restoring the wall between commercial banks and investment banks that was pulled down in 1999 by a Congress and White House that were sold a bill of goods by Wall Street. . . . [M]ake commercial banks go back to doing what they do best: providing a safe place for people to deposit their money.").

113. NAELA Annuity Task Force, *Annuity Policy: Consumer Protection Issues and Public Policy Recommendations*, 3 NAELA J. 77, 81 (2007) ("Because of the explosion in the use of annuities and the sophistication of the annuity products which are sold . . . there is often a great deal of confusion about what exactly is an annuity. . . . Even many of the annuity salespeople . . . struggle to understand the products they sell.").

114. See SEC v. Variable Annuity Life Ins. Co. of Am., 359 U.S. 65, 71–73 (1959) (distinguishing insurance from securities investment based on the "one earmark of insurance," which is the underwriting of risk in insurance; thus "'insurance' involves a guarantee that at least some fraction of the benefits will be payable in fixed amounts"). But see Thomas Lee Hazen, *Disparate Regulatory Schemes for Parallel Activities: Securities Regulation, Derivatives Regulation, Gambling, and Insurance*, 24 ANN. REV. BANKING & FIN. L. 375, 434 (2005) ("[W]e must ask whether this regulatory disparity can be explained other than as an accident of the different history and public choice input—whether insurance is so different from the gambling, securities investments, and derivatives investments as to warrant such different regulatory treatment.").

115. See Dorit Samuel, *The Subprime Mortgage Crisis: Will New Regulations Help Avoid Future Financial Debacles?*, 2 ALB. GOV'T L. REV. 217, 229 (2009) ("It is intuitively obvious that any method of evaluating return on an investment must deal with the perceived amount of risk attached to that investment.").

116. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 15 U.S.C.).

117. See Ass'n of Banks in Ins. v. Duryee, 270 F.3d 397, 401 (6th Cir. 2001) (intervenor-defendant insurance trade organizations arguing that federal law preemption of state law regulations allows banks to offer insurance products without requiring them to comply with state consumer protection regulations imposed on the insurance industry); Adam Nguyen & Matt Watkins, Recent Legislation, *Financial Services Reform*, 37 HARV. J. ON LEGIS. 579, 591–92 (2000) (commenting that the GLB Act's "possible consequences include unilat-

between financial services entities.¹¹⁸ Within a relatively short period following the passage of the GLB Act, the nation has experienced an economic crisis on a dramatic scale.¹¹⁹ There is a cautionary tale there.

B. *The Weakness of Federal Regulation*

Those who seek structural change in the system of insurance regulation, expanding the role of the federal government by necessarily contracting the role of the states, must concede that the recent record of the federal government as a financial regulator has been dismal.¹²⁰ The most notable and highly publicized regulatory failures in our lifetimes have been in the housing mortgage industry with follow-on adverse impacts on banks and other financial institutions.¹²¹ At least in theory, these industries were (and are) federally regulated.¹²² Nothing remotely comparable has occurred in the state regulated insurance industry.¹²³ This history indicates that consumer protection at a massive retail level is not something that the federal government has shown the capacity to do well.¹²⁴ The federal government is simply too large and too far removed from the daily lives of average citizens to perform this

eral effects that lead to elevated prices and reduced output, and high market concentration, particularly at the local market level, with adverse effects on individual consumers and small businesses”).

118. See *supra* note 117.

119. In response to the Great Depression, Congress passed the Glass-Steagall Act one hundred days into the New Deal. Harvey L. Pitt, *Bringing Financial Services Regulation into the Twenty-First Century*, 25 YALE J. ON REG. 315, 317 (2008). The Gramm-Leach-Bliley Act repealed the Glass-Steagall Act. *Id.* at 318. The GLB Act, also known as the Federal Financial Modernization Act, was signed into law in November, 1999. N.Y. State Bar Ass'n v. FTC, 276 F. Supp. 2d 110, 111 (D.D.C. 2003) (“The purpose underlying the GLBA is ‘to enhance competition in the financial services industry by providing a prudential framework for the affiliation of banks, securities firms, insurance companies, and other financial service providers . . .’” (quoting H.R. REP. NO. 106-434, at 245 (1999) (Conf. Rep.))). Beginning in 2006, “hundreds of thousands of homeowners, many forced by foreclosure, have moved out of single-family homes into rental housing, creating an excess of approximately 600,000 vacant, largely investor-owned single-family units for sale.” Alan Greenspan, *We Will Never Have a Perfect Model of Risk*, FIN. TIMES, Mar. 16, 2008, http://www.ft.com/cms/s/0/edbdbc6f-f360-11dc-b6bc-0000779fd2ac.html?ncklick_check=1 (“The current financial crisis in the US is likely to be judged in retrospect as the most wrenching since the end of the second world war.”).

120. See Charles Keenan, *A New Balance of Power*, BANK DIRECTOR, July 2008, at 30, available at http://www.bankdirector.com/issues/articles.pl?article_id=1195 (calling the Blueprint for a Modernized Financial Regulatory Structure “an attempt to address the shortcomings of the Gramm-Leach-Bliley” Act—shortcomings that led to “mortgage lenders loosen[ing] underwriting standards, [which set] the stage for the subprime crisis,” and rejecting the Blueprint for its plan to increase further federal regulation).

121. See Elizabeth F. Brown, *The Tyranny of the Multitude is a Multiplied Tyranny: Is the United States Financial Regulatory Structure Undermining U.S. Competitiveness?*, 2 BROOK. J. CORP. FIN. & COM. L. 369, 386–87 (2008) (discussing regulatory agencies’ failure to better regulate the housing mortgage industry resulting in the current financial crisis).

122. Stuart M. Rigot, *Non-Traditional Mortgage Products: Does Guidance Effectively Inform Borrowers of Risk?*, 11 N.C. BANKING INST. 131, 154 (2007) (“Mortgage brokers . . . are far from unregulated and without oversight—[t]he [mortgage broker] industry is regulated by seventeen federal laws and numerous state and federal regulations.” (alterations in original) (quoting National Association of Mortgage Brokers Frequently Asked Questions, <http://www.namb.org/namb/FAQs1.asp?SnID=1854943273>)).

123. See generally George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521 (1987) (discussing the liability insurance crisis of the late 1980s).

124. See *supra* notes 120–23 and accompanying text.

function effectively.¹²⁵ The states, by contrast, while certainly not performing these functions perfectly, do a much better job precisely because they are so much closer to citizens and their concerns.¹²⁶

Because consumer protection is the legitimate goal of insurance regulation, it is useful to define what this term encompasses.¹²⁷ Consumer protection in insurance regulation seeks to assure that purchasers of insurance products receive the benefit of the bargain of their purchase of coverage.¹²⁸ The most basic consumer protection is financial solvency of insurers.¹²⁹ If an insurer is not in business and solvent when a policyholder makes a claim, the consumer gets no protection.¹³⁰ To continue to provide solvency protection, states must protect zealously their right to review the financial records of insurers to monitor insurers' solvency.¹³¹ States should similarly protect their right to take all appropriate actions to avoid insolvencies.¹³²

Some yet to be created federal agency could become the new monitor of insurers' financial solvency.¹³³ Over time, a federal agency could be established, equipped, and staffed to perform this function.¹³⁴ The question is the wisdom or need of establishing this function at the federal level when it is a function that states have

125. See Randall, *supra* note 96, at 664–65 (“Favorable reasons for . . . state regulation of the insurance industry include . . . the classic federalist arguments: . . . [such as] proximity to the citizenry and to the relevant issues and increased responsiveness as compared to a distant central administrator . . .”).

126. See *id.* at 686 (“[T]he existing regulatory structures could be dismantled and replaced with federal regulation, [the] state regulatory failures . . . do not, in themselves, suggest a need for federal regulation”).

127. Sean B. Hecht, *Climate Change and the Transformation of Risk: Insurance Matters*, 55 UCLA L. REV. 1559, 1606–07 (2008) (“The goals of insurance regulators are generally consumer oriented, balancing protections for current and future policyholders against the need for insurers to earn a reasonable profit in order to keep the industry robust.”).

128. *Id.* at 1607 (“The general objectives of regulators are ensuring that insurance is available and offered at a fair price, protecting insurance company solvency (which protects insurers as well as policyholders from the possibility of failing to make good on their insurance contracts), and preventing unfair practices by insurance companies.”).

129. *Id.*

130. *Id.*

131. Emeric Fischer, *Banking and Insurance—Should Ever the Twain Meet?*, 71 NEB. L. REV. 726, 754 (1992) (“If the fox could be appointed to guard the chicken coop, then insurers could be relied upon to maintain adequate reserves without external supervision.”). See, e.g., Randall, *supra* note 96, at 642 (noting that reliance on annual financial statements filed by insurers was inadequate to ensure solvency and thus in the late 1980s, several large property and casualty insurers became insolvent).

132. See Karl L. Rubinstein, *The Legal Standing of an Insurance Insolvency Receiver: When the Shoe Doesn't Fit*, 10 CONN. INS. L.J. 309, 315 (2004) (“[T]he law considers insurance to be a public asset. The solvency of insurers is, accordingly, a matter of vital public concern both in regard to preventing insurer insolvencies and in regard to handling them when they do occur.” (footnotes omitted)).

133. See, e.g., Waterfield, *supra* note 99, at 300 (discussing the Federal Insurance Solvency Act, proposed by Representative Dingell, which would have established a federal agency, the Federal Insurance Solvency Commission, to unify the solvency standards and regulate insurer solvency). See also Federal Insurance Solvency Act of 1993, H.R. 1290, 103rd Cong. §§ 101–113 (1993) (discussing the establishment of the Federal Insurance Solvency Commission).

134. See *supra* note 133 and accompanying text.

performed for a long time, and with considerable success, as evidenced by the small number of insurance company insolvencies.¹³⁵

States should be equally zealous in resisting federal preemption in connection with a state's authority to seek to resolve a claim or dispute between an insurance carrier and an individual consumer or business. As state regulators, we see the ineffectiveness of the current system of self-funded health insurance where, thanks to federal preemption, consumer complaints are beyond the reach of state regulation.¹³⁶ Experience confirms that there is no readily available forum for consumers relegated to the no-man's land created by the Employee Retirement Income Security Act (ERISA).¹³⁷

One argument in favor of federal regulation is that the industry would be regulated by more competent regulators.¹³⁸ This argument seems to be greatly undermined by the extraordinary regulatory failures highlighted by the nation's current economic crisis.¹³⁹ The federal government's failure to adequately regulate the financial and banking sectors could not be in more stark contrast to the state-based regulation of insurance companies.¹⁴⁰ For the past twenty or so years, the dominant mode of thinking at the federal level has been unapologetically anti-regulatory.¹⁴¹ The markets-regulate-themselves view has been discredited deeply by recent events.¹⁴² Importantly, this stance did not impact the insurance industry, as it did

135. Randall, *supra* note 96, at 664–65, 686.

136. Laura D. Hermer, *Private Health Insurance in the United States: A Proposal for a More Functional System*, 6 HOUS. J. HEALTH L. & POL'Y 1, 30–31 (2007) (noting that “ERISA provides that self-insured plans . . . are subject only to ERISA, rather than to state law” and that ERISA “largely removes most regulation states could propose regarding health insurance plans . . . without offering any substantial federal remedies to replace them”).

137. Employee Retirement Income Security Act, 29 U.S.C. §§ 1001–1461 (2006) (regulating both employee pension and benefits plans, including health care). Prior to ERISA's enactment, state law regulated the health insurance industry. Donald T. Bogan, *Protecting Patient Rights Despite ERISA: Will the Supreme Court Allow States to Regulate Managed Care?*, 74 TUL. L. REV. 951, 951 (2000). ERISA contains a broad preemption clause, interpreted by the courts to preempt “virtually all state regulation of health care benefit plans, not just pension plans.” *Id.*

138. See TREASURY REPORT, *supra* note 4, at 131 (noting that the Treasury's recommends an Office of National Insurance to federally regulate insurance because it will provide “true national regulatory expertise and guidance” on the insurance industry).

139. Editorial, *Hard Truths About the Bailout*, N.Y. TIMES, Sept. 20, 2008, at A18 (noting the current economic crisis is a result of a failure of the government to regulate market players and the Bush administration's belief that “the market, with its invisible hand, works best when it is left alone to self regulate and self correct”); Bernard Yeung, *Failures on Many Fronts*, THE STRAITS TIMES (Singapore), Oct. 1, 2008, <http://www.sghousing.com/2008/10/01/failures-on-many-fronts/>.

140. See Franklin W. Nutter, *The Insurance Wars: The Battle Over McCarran-Ferguson*, THE BRIEF, Winter 1989, at 10, 14–15 (while state regulation results in “tailored responses to local insurance problems,” federal regulation of banking and securities industries has failed to deter bank failures and insider trading, respectively).

141. TREASURY REPORT, *supra* note 4, at 62–63 (in 1945 Congress passed the McCarran-Ferguson Act giving states regulatory jurisdiction over “the business of insurance,” while exempting insurance from federal antitrust law, and in 1999 passed the Gramm-Leach-Bliley Act reaffirming state insurance regulation).

142. See *Hard Truths About the Bailout*, *supra* note 139.

finance and banking, because insurance has been regulated at the state level.¹⁴³ This is not to say that political pressure is not brought to bear upon regulation at the state level, but because of the great diversity among and between states, states resisted weakening of regulation.¹⁴⁴

Many point to the lack of uniformity among state regulations as an inherent evil that “can lead to inefficiencies and undue regulatory burden, and can directly limit insurers’ ability to compete across state boundaries and international borders.”¹⁴⁵ Given the dramatic growth in the insurance industry in the last fifty years, there seems to be little evidence of insurers’ inability to compete.¹⁴⁶ Viewed more broadly, one can see advantages to the deliberate state regulatory approach especially when viewed through the experience of the current economic crisis.¹⁴⁷ One cost of speed to market can be protection of the consumer.¹⁴⁸ A major contributing factor to the current economic crisis was that companies began to engage in complex and high-risk business practices such as credit default swaps, which few questioned and fewer understood. Inquiry tended to begin and end with the short-term positive impact that a particular business practice had upon profits.¹⁴⁹ The trade-off is that the investor/consumer is more exposed in our current situation, with devastating consequences to individuals, governments, non-profit organizations, and businesses, large and small.¹⁵⁰ Notably, insurance companies were not in the eye of this storm.¹⁵¹ State regulation—with all of its complexity—results in insurance

143. See Press Release, Nat’l Ass’n of Prof’l Ins. Agents, Insurance Industry Remains Stable During Financial Crisis, Thanks to State Regulation (Oct. 3, 2008), available at <http://pianet.com/NewsCenter/PressReleases/10-3-08.htm> (stating that state regulation of insurance is a success in the current economic crisis because “‘state insurance regulators got it right at the same time that federal regulators’ experiments with ‘self-regulation’ failed to properly supervise the most fundamental activities of banks and securities firms”).

144. See Nutter, *supra* note 140, at 14 (noting that “political favoritism” affects state insurance commissioners, but that a lack of uniformity in regulation among the states is a strength).

145. See TREASURY REPORT, *supra* note 4, at 126.

146. See *id.* (noting that states have primarily regulated insurance for over 135 years and the insurance industry constitutes a large part of the U.S. financial sector with U.S. insurers holding assets totaling \$6 trillion in 2006).

147. See Press Release, Nat’l Ass’n of Prof’l Ins. Agents, *supra* note 143 (noting the strength of insurance industry during the economic crisis stems from conservative and prudent state regulation).

148. See TREASURY REPORT, *supra* note 4, at 68–69 (recognizing that state insurance regulators sometimes take several years to ensure consumer protection before approving new products, as opposed to a couple of months for federally regulated securities products, so the NAIC attempted to use uniform national standards to institute more “speed to market” with insurance policy form approval).

149. See Gretchen Morgenson, *Behind Biggest Insurer’s Crisis, A Blind Eye to a Web of Risk*, N.Y. TIMES, Sept. 28, 2008, at A1 (showing that credit default swaps, intended to diminish risk and spread prosperity, were often beyond the understanding of executives selling them).

150. See *id.* (suggesting that failure to adequately understand the credit derivatives for the purpose of making quick money resulted in the falling of Bear Stearns, Lehman Brothers, and is threatening the entire economy).

151. While AIG is the world’s largest insurance company, it was in fact its financial services arm and not any of its wholly-owned insurance companies that undermined the solvency of the company. Mary Williams Walsh, *With Fed’s \$85 Billion Loan, A.I.G. Starts to Calculate a Measured Sell-Off*, N.Y. TIMES, Sept. 18, 2008, at C11.

companies behaving in a more conservative and deliberate manner.¹⁵² What state regulation lacks in speed to market, it makes up for in the long-term protection of customers and the companies themselves.¹⁵³

C. *Where Uniformity is Needed*

While the state-based insurance regulatory system has a proven track record and has the advantage of proximity to citizens, the current system is not defensible when it imposes protectionist barriers to market entry without generating compensating benefits in the form of consumer protections.¹⁵⁴ The state-by-state licensing of insurance producers fits this description.¹⁵⁵ States have made commendable progress toward uniformity and reciprocity in the area of producer licensing through the NAIC.¹⁵⁶ Absent federal intervention, however, there is no reasonable likelihood that states will achieve, in the foreseeable future, a seamless nationwide producer licensing system.¹⁵⁷ Tellingly, there are few who would argue that the costs and inefficiencies of the present non-unitary system are equaled, let alone outweighed, by any identifiable advantages.¹⁵⁸

Uniform federal standards (which the NAIC has been moving toward, arguably at too slow a pace) could and should be enforced by the already existing state regulatory structure.¹⁵⁹ The problem with the dual regulatory structure that would result from the OFC—i.e., some insurance companies would be regulated by the states and some by the federal government—is the risk that consumer protection

152. See Press Release, Nat'l Ass'n of Prof'l Ins. Agents, *supra* note 143 ("America's insurance consumers have been well protected and insurance companies remain stable and sound in the current financial turmoil thanks to fiscally prudent regulatory oversight by state insurance regulators . . .").

153. See *id.* (asserting that although some argue that federal regulation of the insurance industry would make it more efficient, prudent state regulation has ensured the industry's soundness and stability).

154. See Brown, *supra* note 111, at 6 (noting that the significant time and money expenditures in getting licensed as an insurance provider create barriers in entering the insurance industry, thus protecting current providers from competition and driving up costs for consumers).

155. "Insurance producer" is a person who, "for compensation, sells, solicits, or negotiates insurance contracts . . ." MD. CODE ANN., INS. § 1-101(u)(1) (West 2009). Licensing and post-licensing requirements vary between states. Brown, *supra* note 111, at 5.

156. TREASURY REPORT, *supra* note 4, at 68.

157. See *id.*; Brown, *supra* note 111, at 5–6 (recognizing that each state has different definitions of "insurance," as well as different licensing and post-licensing requirements, which proposed federal regulation strives to make uniform).

158. See Brown, *supra* note 111, at 3 & n.3 (showing that some insurance associations support federal regulation of insurance because the current state-regulated system is costly and cumbersome).

159. Waterfield, *supra* note 99, at 307 (suggesting that smaller insurance agents believe that states have and will continue to implement reform "when given a little incentive by the federal government through the use of national insurance standards").

would get lost.¹⁶⁰ The focus on service to and protection of the consumer is the foundation of state regulation.¹⁶¹

Furthermore, the OFC does not solve the problem of uniformity of regulation.¹⁶² Depending upon how the political winds blow, federally chartered insurance companies could get a wink and a nod while state regulated insurers would be subject to more stringent regulation putting smaller, more localized companies at a competitive disadvantage.¹⁶³ It is not in the best interest of consumers or of the marketplace in general to disadvantage smaller companies.¹⁶⁴ In fact, the opposite should be true.¹⁶⁵ While we are in a global marketplace, the recent economic crisis highlights the risks inherent when companies become “too big to fail” and are too far removed from their customers.¹⁶⁶ We have learned, for example, that mortgage finance companies were unconcerned about the level of risk being assumed by a buyer because that company did not hold that paper for long and, therefore, did not bear that risk.¹⁶⁷ These arrangements increased dramatically the likelihood of risky and, frankly, unfair business practices.¹⁶⁸ The small insurance producer that is committed to a particular community or state and understands the consequences of failing to serve its customers’ needs serves an important role in the marketplace.¹⁶⁹

Those who wish to preserve the core of state insurance regulation should be the leading advocates for federal reform of those parts of the system where an absence of uniformity creates inefficiencies without providing tangible benefits to consum-

160. See Press Release, Nat’l Ass’n of Prof’l Ins. Agents, *supra* note 143 (noting lawmakers considering federal regulation of the insurance industry should consider that state regulation has ensured protection for consumers despite contradictory language in the insurance policies themselves).

161. See Hazen, *supra* note 114, at 432 (stating that “the consumer-protection impetus is underscored by state insurance regulation,” which construes policies in favor of the consumer and requires most insurance policies, especially those marketed to consumers, to be approved by state regulators).

162. See TREASURY REPORT, *supra* note 4, at 128 (stating that the suggested Optional Federal Charter gives insurance companies the option of choosing between federal and state regulation, rather than a unitary system).

163. See Nutter, *supra* note 140, at 14–15 (proposing that federal regulation could result in the consolidation of smaller, domestic insurers that are unable to compete with large competitors, which can more easily deal with a federal regulatory agency).

164. See Daniel D. Barnhizer, *Inequality of Bargaining Power*, 76 U. COLO. L. REV. 139, 151–52 (2005) (describing the unequal bargaining power possessed by small businesses).

165. *Id.*

166. See, e.g., Robert O’Harrow, Jr. & Brady Dennis, *The Beautiful Machine*, WASH. POST, Dec. 29, 2008, at A1 (discussing the creation of AIG Financial Products and the events leading up to its collapse); Brady Dennis & Robert O’Harrow, Jr., *A Crack in the System*, WASH. POST, Dec. 30, 2008, at A1 (describing AIG Financial Products’ involvement in credit-default swaps, the risks involved in the financial products, and mistakes made by the company that led to its collapse); Peter S. Goodman & Gretchen Morgenson, *Saying Yes to Anyone, WaMu Built Empire on Shaky Loans*, N.Y. TIMES, Dec. 28, 2008, at A1 (describing the current economic meltdown).

167. See *supra* note 166 and accompanying text.

168. *Id.*

169. See Hecht, *supra* note 127, at 1606–07 (stating that a goal of insurance regulation is to balance the needs of the consumer with the viability of the insurer).

ers.¹⁷⁰ Federal legislation to achieve uniformity in producer licensing, without an adverse financial impact on states and without diminishing a state's non-discriminatory use of its disciplinary authority over licensees, should be welcomed.¹⁷¹ Similar support should be voiced for proposals such as the one to establish an Office of Insurance Information within the United States Department of the Treasury.¹⁷² State insurance regulation is not undermined by the federal government's increasing its understanding of the national and global insurance market.¹⁷³

Some of the opposition to any expansion of federal activity in the field of insurance is prompted by the fear that once the federal nose gets under the tent the entire camel will follow.¹⁷⁴ There are a number of flaws in this line of argument. First, and perhaps most obviously, this argument incorrectly posits a total absence of federal activity in insurance at present.¹⁷⁵ While state regulation is, in fact, the dominant mode of insurance regulation, it is not the exclusive mode.¹⁷⁶ Medicare, our national health insurance system for persons over sixty-five, is ample proof that the federal government is already a major player in the area of health insurance.¹⁷⁷

Moreover, the absolutist position also incorrectly suggests that states have some unconditional "right" to be the principal regulators of insurance and that the federal government would be acting improperly by infringing upon the states' "rights" in this area.¹⁷⁸ As discussed above, the Supreme Court settled this issue long ago in favor of federal authority.¹⁷⁹ The fact that Congress has, to a great extent, allowed states to be the principal regulators of insurance should not be equated with the states having some "right" to do so.¹⁸⁰ In the end, the case for state regulation must

170. See Nutter, *supra* note 140, at 14–15.

171. See *id.* at 10, 14; Robert Rusbult, *Insurance Regulatory System in 'Desperate' Need of Repair*, THE HILL, Sept. 20, 2006, <http://thehill.com/op-eds/insurance-regulatory-system-in-desperate-need-of-repair-2006-09-20.html> (stating the shortcomings of the current insurance regime and requesting a new policy).

172. Insurance Information Act of 2008, H.R. 5840, 110th Cong. (2008).

173. See TREASURY REPORT, *supra* note 4, at 126–30 (discussing the state's involvement in insurance regulations and how federal regulations would increase uniformity and efficiency).

174. Patrick Basham, Op-Ed., *Political Perils of Overregulation: Big Government and the Financial Crisis*, WASH. TIMES, Sept. 22, 2008, at A23 (describing how overregulation leads to more regulation).

175. See Press Release, Nat'l Ass'n of Prof'l Ins. Agents, *supra* note 143 (stating that there is currently little existing federal insurance regulatory authority).

176. See Nutter, *supra* note 140, at 10, 14–15.

177. Robert D. Atkinson & Daniel D. Castro, *A National Technology Agenda for the New Administration*, 11 YALE J.L. & TECH. 190, 206 (2009) ("The federal government is the single largest health care payer in the United States spending over \$600 billion annually on eighty million Americans through programs such as Medicare . . .").

178. See Robert L. Redding, Jr., *Insurance Regulation: State vs. Federal Debate Continues*, AUTOINC., Dec. 13, 2003, <http://www.asashop.org/autoinc/dec2003/legis.htm> (quoting Sen. John McCain who articulated that the state and federal systems need to work together in regulating insurance).

179. *United States v. Se. Underwriters Ass'n*, 322 U.S. 533, 592–93 (1944) ("Congress . . . [may] take insurance regulation into the federal system, may formulate and announce the whole scope and effect of its action in advance, fix a future effective date, and avoid all the confusion, surprise, and injustice which will be caused by the action of the Court.").

180. *Id.*; see also 15 U.S.C. § 1011 (2006).

be based on a demonstration that state regulation adds value, not unnecessary barriers, and cannot legitimately be based on some claimed “right.”¹⁸¹

Macro global economic forces are driving—and, indeed, should drive—insurance industry representatives and thoughtful policymakers to examine our current system to identify inefficiencies and to look for solutions to protect, if not enhance, the competitive position of the United States.¹⁸² These macro forces coupled with the current crisis will produce, in the not distant future, changes in the present system.¹⁸³ The question for states is not if change is coming, but how dramatic that change will be and whether states will participate in the design of the new system.

The fiscal elephant in the room of any discussion about altering states’ regulatory authority is the enormous amount of insurance premium tax that states collect.¹⁸⁴ Even in flush economic times, which these are not, no state is going to be supportive of a change that reduces a significant source of state revenue. States should acknowledge that preserving their opportunity to impose and collect premium tax is of overriding importance.¹⁸⁵

The relative effectiveness of the absolutist “just say no” tactic as a response to the call for greater federal involvement as compared to the tactic of constructive engagement in the reform debate is not knowable.¹⁸⁶ This is a question of political judgment on which reasonable people can disagree. The rejectionist position is premised on the theory that the best offense is an unyielding defense.¹⁸⁷ The alternative constructive engagement approach starts from the perspective that change is inevitable, and even desirable, and the goal is to preserve the core of state regulatory authority.¹⁸⁸

IV. CONCLUSION

In the end, our view is that change in the field of insurance regulation is both inevitable and desirable, and states will be left behind and insurance consumers will be disadvantaged if state insurance regulators oppose all efforts to broaden the

181. See Nutter, *supra* note 140, at 14 (describing the benefits of state insurance regulation).

182. See TREASURY REPORT, *supra* note 4, at 126–27 (“The lack of regulatory uniformity in the United States in a time of increasing convergence and globalization has caused many insurers to question the effectiveness and efficacy of state insurance regulation. This has led some to express concerns . . . [regarding] insurers’ competitive innovations . . .”).

183. *Id.*

184. See, e.g., Sidney D. Watson et al., *The Road from Massachusetts to Missouri: What Will it Take for Other States to Replicate Massachusetts Health Reform?* 55 U. KAN. L. REV. 1331, 1361 (2007) (stating that Missouri collects a 2% tax on all insurance premiums, with the exception of health insurance).

185. See, e.g., *id.* (“Missouri could also raise \$155 million in revenue by imposing a 2% tax on health insurance policies sold in the state”).

186. See Nutter, *supra* note 140, at 33–34 (stating that “[p]roponents of change have not made their case,” and thus, the insurance industry should continue to be regulated by the states).

187. See, e.g., TREASURY REPORT, *supra* note 4, at 126–31 (proposing federal regulation of the insurance industry to create greater efficiency and uniformity among the states).

188. Linda B. Tigges, Note, *Functional Regulation of Bank Insurance Activities: The Time Has Come*, 2 N.C. BANKING INST. 455, 486–87 (1998) (“[F]uture legislative change is inevitable.”).

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role of the federal government in insurance regulation. States should defend that which is important and defensible while bending on issues where a practice does not yield tangible benefits to consumers and, instead, serves principally to protect parochial interests.

The change in the world of insurance regulation that is coming will carry with it elements of pain and discomfort and, ultimately, a new set of problems. The pain and the problems will be diminished, and the benefits of greater uniformity through federal standards in certain areas will be maximized if those who believe that consumer protection is the reason for state insurance regulation are clear about what they are seeking to preserve and why it is worth preserving.

Finally, it is worth remembering that economic incentives, the need to innovate, and the drive for higher profits will always mean that market forces will be more nimble and move more quickly than regulatory forces. The regulatory system will always be a step or three behind the market. But we need to attempt to keep pace.