

**US and Canada
Special Report****Optional Federal Charter****Will Treasury Support Promote Passage?****Analysts**

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- [Review and Outlook 2007–2008: US Property/Casualty Insurance, Special Report, Dec. 3, 2007.](#)
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Overview

Debate surrounding Optional Federal Charter (OFC) regulation for insurance companies has begun in earnest again. While congressional legislation has been introduced multiple times, its prospects for passage had always been slim. Recently the US Department of Treasury (Treasury) brought the issue to the forefront through its broad plan to modernize the regulatory structure of the US financial services industry in response to the current capital markets crisis. The Treasury supports an OFC and set forth general guidelines regarding the basic elements it believes any legislation should contain.

As an unbiased observer of credit and insurance markets, Fitch is neutral as to the ultimate passage of OFC regulation. The purpose of this report is to highlight for readers any possible ratings implications that could ultimately result from the passage of OFC regulation, and to summarize key issues and market perspectives.

While controversial, the OFC has gained increasing industry support over the years, primarily from larger US and non-US life and property-casualty insurers and reinsurers who operate nationally and globally. Their goal is to work with a single federal regulator and eliminate what they view as redundancies and inefficiencies of state regulations regarding licensing, policy forms, rate filings, solvency regulation and market conduct exams. In this regard, Fitch recognizes potential efficiencies of the OFC proposal, particularly in the life insurance and annuity market in which insurers have considerable disadvantages relative to other financial product providers in terms of quickly and efficiently launching new products.

However, there is considerable uncertainty as to the form of any final regulation, and movement to an OFC may cause insurers to be faced with overlapping and confusing state and federal regulatory requirements. There are also questions whether federal regulators will have greater effectiveness in insurer solvency regulation and in preventing market conduct issues that are harmful to policyholders and that have periodically affected the industry. Thus, while offering potential theoretical benefits in some market participants' minds, the ability of federal regulators to execute as envisioned remains an uncertainty.

Also while insurers generally agree that the elimination of what they view as market-distorting pricing restrictions would be helpful, more active federal participation in the regulatory process may also bring additional legislation that the industry ultimately views as less beneficial. For instance, legislators frustrated with the industry's response to Hurricane Katrina introduced bills (The Insurance Industry Competition Act of 2007) that would have stripped the industry of its limited antitrust exemption provided under the 1945 McCarran-Ferguson Act, which would have effectively eliminated the sharing of industry loss-cost data through rating bureaus.

Fitch believes increased federal regulation of the insurance industry is inevitable in the long term. Still, Fitch does not expect passage of any OFC legislation in the near term due to continued strong opposition from several influential constituencies, election-year uncertainties and continued divisiveness in Washington.

Overview of the Treasury Proposal

The Treasury issued a report in March 2008 entitled “Blueprint for a Modernized Financial Regulatory Structure” to address capital market participants’ and policymakers’ concerns that the current regulatory structure for the entire financial services industry has not kept pace with the globalization of capital markets and has failed to adapt to the complexity of sophisticated new products. Additionally, there has been tremendous convergence in financial services providers and products over the past decade, rendering the current “silo” approach less relevant.

With respect to the insurance industry, the Treasury has recommended an OFC providing a federal system of chartering, licensing, regulation and supervision for insurers, reinsurers and insurance producers (agents and brokers). The current state-based regulation of insurance would continue for those companies that elect not to be regulated at the national level.

The Treasury also recommends the establishment of the Office of National Insurance (ONI) within its department to regulate those insurance companies operating under an OFC. The ONI would be self-funded by assessments imposed on federally chartered insurers, led by a federal commissioner and subject to congressional oversight. Since the legislative process is lengthy and difficult, the Treasury wants Congress to immediately establish an Office of Insurance Oversight within the Treasury to establish a federal presence in insurance for international and regulatory issues.

Additionally, the Treasury reiterated its view opposing the creation of a national catastrophe fund. It believes the existence of price controls is the reason why some insurance companies’ support the idea of a federal backstop for natural catastrophe losses. The Treasury believes arguments in favor of rate regulation are “unpersuasive” and said those states without onerous rate controls generally have more competing insurers who are financially sound, overall lower rates and smaller residual markets. To ensure consumers are protected, the Treasury recommends establishing a separate Division of Consumer Affairs and Division of Insurance Fraud.

History of State-Based Insurance Regulation

The current US system of insurance regulation by the individual states can be traced back to 1851 when New Hampshire appointed the first insurance commissioner. At that time, the industry was dominated by small mutual companies operating in a single state, or at most a small region.

The National Association of Insurance Commissioners (NAIC) was created in 1871 to address the need to coordinate regulation of multistate insurers. The NAIC is composed of insurance regulators from the 50 states, the District of Columbia and five US territories.

Until 1944 insurance was not considered interstate commerce and therefore not subject to federal regulation. But in the case of the United States v. South-Eastern Underwriters Association, the Supreme Court held that Congress could regulate insurance transactions that were truly interstate. In response, Congress enacted the McCarran-Ferguson Act in 1945, which gives states the power to regulate the insurance industry and authorizes state-supervised sharing of loss-related information among insurers. This was reiterated under the 1999 Gramm-Leach-Bliley Financial Services Modernization Act, which established a framework permitting affiliations among banks, securities firms and insurance companies but specifically protected 13 areas of state insurance regulation from federal preemption.

Legislative Bills

Over the last few years several attempts have been made at introducing OFC legislation, with limited success in moving towards an actual vote. The Insurance Industry Competition Act of 2007 (Senate Bill 618 and its companion bill H.R. 1081) was introduced in February 2007, and it would strip the industry of its limited antitrust exemption provided under the 1945 McCarran-Ferguson Act. The bills would give the US Department of Justice and the Federal Trade Commission the authority to apply federal antitrust laws to insurance companies. The legislation would not, however, affect the right of each individual state to continue regulating its insurance business. Neither bill made it out of committee.

The National Insurance Act of 2007 (Senate Bill 40 and its companion bill H.R. 3200) was introduced in May 2007 and would allow insurers to choose federal rather than state-based regulation under an OFC system. It would also provide a comprehensive system for federal regulation to provide for policyholder protections in the event of insolvency or the impairment of a national insurer, and for other purposes. These bills never left committee.

Following the Treasury report on financial services modernization, the House of Representatives introduced the Insurance Information Act of 2008 (H.R. 5840) in April 2008, and it would create a federal Office of Insurance Information within the Treasury that would represent the US internationally on insurance issues and coordinate with state insurance regulators on national concerns. This bill was referred to the House Committee on Financial Services.

Parties to the OFC Debate

Positions regarding the OFC hinge largely on size and scale of operations. Primary advocates consist of nationwide sellers of life insurance and investment products, large property/casualty insurers and their representative trade groups and industry associations. Detractors of OFC legislation largely consist of smaller regional and mutual insurers and their related industry groups.

The National Association of Insurance and Financial Advisors (NAIFA) recently moved from a position of neutrality to conditional support. Should the National Insurance Act become law, NAIFA wants its members to have the option to remain licensed and regulated at the state level.

Where Groups Stand on OFC Legislation

Supporters

Agents for Change
American Insurance Association
American Bankers Association
American Bankers Insurance Association
American Council of Life Insurers
American Insurance Association
Council of Insurance Agents and Brokers
Financial Services Forum
Financial Services Roundtable
Life Insurers Council
National Association of Independent Life Brokerage Agencies
Reinsurance Association of America

Opponents

Association of Financial Guaranty Insurers
Consumer Federation of America
Independent Insurance Agents and Brokers of America
National Alliance of Life Companies
National Association of Insurance Commissioners
National Association of Mutual Insurance Companies
National Association of Professional Insurance Agents
Property Casualty Insurers Association of America

Supporters' View

- Insurers who operate nationally and globally compete with other domestic and global financial services firms, who operate under more streamlined, efficient regulatory systems. Additionally, US insurers need a single federal regulator who can conduct direct negotiations with foreign countries when necessary. Many view this as a survival issue in an increasingly global marketplace.
- Having a regulator at the federal level could give the insurance industry stronger representation in Washington to influence the outcome of proposed congressional legislation.
- The dual-charter banking system has proven itself to be a successful model that preserves the best of state-based and federal regulation.
- Insurers face a myriad of state regulations regarding licensing, product approval, policy form, financial regulation and market conduct exams. Compliance with multiple jurisdictions and different state laws is burdensome and expensive. Insurers would realize significant cost savings from the elimination of duplicate compliance costs. The American Council of Life Insurers estimates the industry would save about \$11 billion over 10 years.
- Under the streamlined regulatory system contained in the OFC proposal, the level of competition for the consumer's insurance dollar should increase. This could reduce costs to the consumer and increase the choice of available products. Insurers will not have to postpone or shelve product rollouts as they do today because of state regulatory delays and differences in states laws. Additionally, it will allow greater participation of foreign firms in the US markets.
- To protect policyholders, national insurers would still be subject to some state laws including participation in mandatory residual risk pools and guarantee fund associations in each state where the national insurer does business. A national insurance guaranty corporation would be established to provide consumer protection and benefits in any state whose guaranty association does not meet specific standards established under the proposed law.

Opponents' View

- OFC would create an uneven playing field. What is being dubbed as "optional" is not really optional at all for small to medium-size companies who tend to operate regionally. The efficiencies achieved by the larger companies would force the smaller companies to move to federal regulation in order to survive.
- Creating a massive new federal bureaucracy far removed from the states and centralizing it in Washington will only complicate issues for insurance companies, agents and brokers, and consumers.
- If efficiency is the primary goal, state regulators have been making significant progress toward harmonization and modernization of state laws.
- Insurers would have increased exposure to potentially damaging regulations. Under the current state-based system, adverse regulations impact insurers in one state but not all states.
- The focus of reform should be on what is best for consumers, not the convenience of the industry. Protecting and benefiting consumers is the primary purpose of insurance regulation. Consumers are more comfortable dealing with local regulators than with remote Washington-based bureaucrats.

- States would have an incentive to make the regulation weak in order to attract insurers. Companies would “game” the system and choose the weakest.
- The dual-charter banking system was developed at a time of financial crisis, when federal intervention was needed to avert financial collapse. There is no such crisis in the insurance industry today.

Fitch’s View

As an unbiased observer of credit and insurance markets, Fitch is neutral as to the ultimate passage of OFC regulation. Our singular goal is to be in a position to understand and comment on the implications of possible regulatory change, and how they may impact the credit fundamentals of insurers rated by Fitch, and ultimately ratings.

Fitch believes that regulatory changes such as those proposed by the Treasury and Congress that create an OFC for insurers would not have an immediate effect on the ratings of US insurance organizations. As the regulatory landscape evolved over time, Fitch would evaluate the impact on a company’s competitive position relative to other insurers and financial services organizations, management decisions, profitability and capitalization. To the extent that a new regulatory paradigm changes these attributes, then rating changes could occur.

Overall, Fitch believes there are potential benefits for the industry’s competitive positioning and credit fundamentals. A more uniform regulatory environment would spur product innovation by removing multiple approval barriers that delay widespread introduction of new products and result in expense savings for multistate insurers by eliminating duplicate compliance costs. Given the innate competitiveness of the insurance business, these cost savings would likely translate into more attractive pricing for policyholders, rather than excess profitability.

A shift to more market-oriented pricing and less rate regulation could also be beneficial in promoting a competitive and less cyclical marketplace. Rate regulation that diverges sharply from true economic costs has led to shortages in available insurance coverage in many markets over time. However, Fitch has some doubts that a federal regulator would fully adopt freer market pricing practices in all insurance markets due to political pressures.

Finally, Fitch views the OFC as a means for large US insurance companies to compete in the international financial services marketplace, especially in light of Solvency II in Europe and the Financial Services Authority in the United Kingdom.

However, Fitch believes that a number of these beneficial changes could be enacted under the existing state regulatory framework through the NAIC. To date, changes in insurance regulation have been cumbersome and slow, in part due to delays in individual states following through in enacting NAIC model laws.

There may be significant differences between proposed insurance regulatory changes and what is ultimately passed into law. In addition, a major change in the regulatory framework could have unanticipated consequences. Fitch is not convinced that federal regulation will by definition be better regulation and may just turn out to be more regulation. This could overlap and conflict with remaining state regulations and could be ineffective in enhancing market efficiency, promoting insurer solvency or preventing market conduct problems.

Importantly, Fitch believes that the Treasury’s support of an OFC as part of a larger financial services modernization plan improves the prospects for ultimate passage of

this long-debated legislation, likely making passage more likely than at any point in recent history. However passage of any OFC regulation remains unlikely in the near term. Fitch will continue to evaluate the impact of proposed regulatory changes on insurance market conditions and individual insurer ratings as events progress.

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