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The Outer Limits of Insurance Regulation

Terri Vaughan's Crusade

In 1866, seventy-five leading stock insurance companies attempted to do something about the brutal price competition that had erupted in the insurance industry every few years: they formed the National Board of Fire Underwriters, a cartel whose goal was to establish uniform rates, commissions, and policy forms.

In the landmark 1869 decision *Paul v. Virginia*, the Supreme Court ruled that insurance is not interstate commerce and, therefore, not subject to federal regulation. A century before the phrase "post-industrial society" would become commonplace, that decision made a certain amount of sense. "[Insurance] policies are simple contracts of indemnity," wrote Chief Justice Stephen J. Field. "They are not commodities to be shipped or forwarded from one state to another...They are local transactions governed by local law."

In 1871, state insurance regulators formed the National Convention of Insurance Commissioners—now the National Association of Insurance Commissioners (NAIC)—in an attempt to coordinate the regulation of multistate insurers. The significance of *Paul* was confirmed nineteen years later, with the passage of federal antitrust regulation, from which the insurance industry was exempted.

In 1942, which was, perhaps coincidentally, the tenth year in a row of property-casualty underwriting profits, the Justice Department charged the South-Eastern Underwriters Association with restraint of trade. (South-Eastern was an Atlanta rating bureau owned by 196 fire-insurance companies that, collectively, controlled 90% of fire insurance in six southern states.) The matter went to the Supreme Court in 1944, which, this time around, ruled that insurance was interstate commerce subject to federal regulation. There was, of course, no system of federal insurance regulation in place, and Congress, responding to the states and insurers, passed the McCarran-Ferguson Act, which, in essence, delegated insurance regulation to the states.

"Variable annuities! Surplus notes! Asset-backed securities! Credit default swaps!"

According to the NAIC, state insurance departments employ about 12,500 people. In 2000, the states collected $10.4 billion in revenues from insurance regulation, of which only 8.5% ($880 million) was spent on insurance regulation. Viewed another way, the states' profits from regulating insurance is equal to what Microsoft will earn this year. Naturally, it's in the interest of the states, insurance-department employees, and the NAIC to preserve state regulation of insurance. Most insurance companies and their various trade associations also favor state regulation. (Insurance companies have greater political clout at the state level than at the federal level.) State regulation can be costly, however, and many insurance companies would prefer not to have to deal with fifty insurance departments, each enforcing a somewhat different set of laws and procedures. The problem, though, is that none of the aforementioned groups wants a Federal Department of Insurance. Insurance companies would rather take their chances with fifty regulators of various political bents than risk having a consumer advocate named federal insurance czar.

All too often, state insurance regulation has been part of a race to the bottom, as the states jiggered their laws to attract business rather than to protect consumers. Testifying at a 1997 New York State Assembly hearing, Harry Kamen, chairman and CEO of the Metropolitan Life Insurance Company, urged the passage of a mutual-insurance-holding-company bill that would have deprived policyholders of their rights, created conflicts of interest that favored the mutuals' managements, and set the stage for the siphoning of corporate funds and opportunities from the policyholders to the mutuals' officers. In a subtle threat, Kamen said that if the bill wasn't passed "it would not be good for the state of New York or the city of New York." He espoused other reasons why the bill should be passed: "[New York's mutual life-insurance companies] generate tax revenues, they employ thousands of New Yorkers, and they stimulate economic activity that sustains jobs for many thousands more." As if that's justification for looting policyholders. (For much more on the hearing and Kamen's duplicitous testimony, see *Schiff's Insurance Observer*, February 1998.)

Mutual-insurance-holding companies, which are now discredited, came into existence in 1996 when Des Moines based American Mutual (now AmerUs) got a law passed in the Hawkeye State. Iowa's insurance commissioner, Terri Vaughan, was proud that this hybrid corporate structure had been created under her administration, and traveled about the country promoting the concept. While she was acting as a shill for the new structure, an exposé in *Schiff's* detailed how, using a structure not too dissimilar from a mutual holding company, the directors of Iowa-domiciled Allied Mutual had shifted about $1 billion of value from Allied Mutual into Allied Group, a publicly traded stock affiliate they controlled.

Allied's scandalous behavior—which received a vast amount of press—took Vaughan by surprise. Although the Iowa insurance department had monitored Allied Mutual and had looked at many of the transactions that had taken place, it apparently had no idea what it was looking at and no idea what was really happening. Perhaps that's because the state has a large insurance industry and a small budget for insurance regulation.

Rather than get too involved in stemming the abuses at Allied—which, after all, was a large employer in Des Moines—Vaughan tried to steer clear of controversy and eventually approved the Allied com-

continued on next page

panies' merger into Nationwide, which resulted in further financial harm to the mutual policyholders, as well as an indemnification for Allied Mutual's officers and directors. Around the same time, Vaughan also approved Principal Mutual's deceptive mutual-holding-company conversion.

Vaughan, who had greater ambitions than serving as insurance commissioner in a state that spends $6 million on regulation, is a commissioner who can be counted on to serve her own interests and those of the insurance industry, no matter how much her actions hurt policyholders and consumers.

Which brings us to the following commentary by Kevin Hennosy, a writer, consumer advocate, and former public affairs manager for the National Association of Insurance Commissioners:

In March 2002, Iowa's insurance commissioner Terri Vaughan, in her role as president of the NAIC, proposed the Interstate Insurance Product Regulation Compact, the supposed purpose of which was to build a national state-based framework to provide uniform regulation for life-insurance products. The proposed compact called for the creation of an Interstate Insurance Product Regulation Commission—a *private corporation* unfettered by direct public accountability—to assume responsibility for regulating covered lines of insurance in participating states. In order to create this interstate compact, state legislatures in participating states would have to pass, and governors would have to sign, identical enabling legislation.

Vaughan's proposed compact had more to do with federal politics than with the public good. The NAIC's leadership offered it as a bone to life insurers that were supporting a proposal for national regulation in the form of an optional federal charter.

The compact had little support among state officials, and a coalition of consumer groups actively opposed it. The NAIC's officers tried but failed to win over several large consumer organizations, including the Consumer Federation of America, Consumers Union, and the American Association of Retired Persons (AARP). The officers achieved a small victory, however, when they convinced the AARP not to oppose the compact. (AARP's opposition probably would have meant defeat for the proposal.)

The insurance industry wasn't enthused about the compact either, and the property-casualty industry rejected the idea at its inception. As a result, the NAIC's proposal covers only life insurance, annuities, disability insurance, and long-term care. Sources said the American Council of Life Insurance Companies went along with the NAIC in order to gain concessions in future negotiations over national charter legislation.

The National Association of Attorneys General (NAAG) attacked the compact proposal, asking the NAIC to hold off final consideration until the proposal could be considered by other groups of state officials. "The proposed Compact purports to assign 'exclusive' powers to a private Commission to regulate false advertising and other matters of interest to Attorneys General," the NAAG wrote. "More generally, the proposed compact is structured such that it poses serious state and federal constitutional issues."

Two weeks before the NAIC's December 8, 2002 national meeting, the National Conference of Insurance Legislators (NCOIL), a conservative group that represents insurers' perspectives in state legislatures, met and discussed the compact proposal. According to industry attendees, Vaughan was repeatedly urged to delay the NAIC vote until the proposal could receive more vetting.

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Vaughan, however, had other plans. She was a popular and persuasive NAIC president who had staked her reputation on her ability to get the proposal approved by the NAIC, and approached the passage of *her* compact proposal with a deal-making fervor. Delaying the NAIC's vote would mean that the compact proposal would not be approved by the end of her term as president on December 8. Her strategy to avoid that outcome will long be remembered by her opponents as an act of deception.

At the December 8, 2002 national meeting, the NAIC's leadership brought its members a resolution to adopt the compact as (in Vaughan's words) a "work in progress." Vaughan promised to solicit input from other groups and interested parties. The resolution was adopted.

Immediately following the resolution's adoption, however, a *second* resolution was introduced to confer "final approval" upon the compact proposal. During the ensuing debate, Frank Fitzgerald, Michigan's insurance commissioner, announced that he would have the proposal—which had just been labeled a "work in progress"—introduced in the Michigan legislature. Once a single state adopts the compact, making changes becomes difficult since every state in the compact must adopt *identical* legislation. Thus, passage in one state sets a standard that other states would most likely have to follow. The compact's proponents argued that it was unwise to vary from the language of the "work in progress."

The second resolution was approved, effectively cutting off input from other state officials and interest groups. Thirteen states voted against the resolution, however, denying the NAIC's leadership the ability to claim credibly that there was a consensus support for the compact proposal. Indeed, some NAIC members voted for "Terri's compact" knowing that they would never support its adoption in their own states.

Only a small number of states are expected to introduce legislation to create the compact this year, and a substantial number of regulators have said that they will not support the compact in their legislatures. Many regulators who voted for the compact think it's "going nowhere" in the states. (Historical footnote: in the mid-1990s, the NAIC proposed a compact for interstate receiverships that was trumpeted as a national framework. It was eventually adopted by six states. Only three states participate in that compact today.)

The adoption of the compact by the NAIC was a personal victory for Vaughan. "The creation of an interstate insurance compact is a 'win-win-win' situation for consumers, industry and regulators," she said, asserting that the compact "maintains and enhances the state-based regulatory system that's been protecting American consumers for more than 150 years."

The compact, however, does not and can not address the aims of the life-insurance lobby. A compact among states can not constitutionally or legally deliver uniform national regulatory treatment: the U.S. Constitution reserves such power for the federal government, and the McCarran-Ferguson Act requires the states—not *a private corporation*—to regulate insurance.

The overreaching nature of Vaughan's proposal, the continued opposition of consumer organizations to it, and the lack of enthusiasm for it by most insurers will probably cause trouble for state officials. The interstate compact campaign could easily become a political quagmire that chews up the NAIC's funds, political prestige, and credibility.

The compact has already been cited as a financial drain on the NAIC. (Last year, when asked how the compact commission

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Editor and Writer . . . . David Schiff
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Publisher . . . . Alan Zimmerman
Subscription Manager . . . . . . Pat LaBua

Editorial Office
Schiff's Insurance Observer
300 Central Park West, Suite 4H
New York, NY 10024
Phone: (212) 724-2000
Fax: (212) 712-1999
E-mail: David@InsuranceObserver.com

Publishing Headquarters
Schiff's Insurance Observer
SNL c/o Insurance Communications Co.
321 East Main Street
P.O. Box 2056
Charlottesville, VA 22902
Phone: (434) 977-5877
Fax: (434) 984-8020
E-mail: Subscriptions@InsuranceObserver.com

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Private Regulation

Article 1 of the NAIC's Interstate Insurance Product Regulation Compact is below. The complete compact is available at www.naic.org/compact.

Purposes

The purposes of this Compact are, through means of joint and cooperative action among the Compacting States:

1. To promote and protect the interest of consumers of individual and group annuity, life insurance, disability income and long-term care insurance products;
2. To develop uniform standards for insurance products covered under the Compact;
3. To establish a central clearinghouse to receive and provide prompt review of insurance products covered under the Compact and, in certain cases, advertisements related thereto, submitted by insurers authorized to do business in one or more Compacting States;
4. To give appropriate regulatory approval to those product filings and advertisements satisfying the applicable uniform standard;
5. To improve coordination of regulatory resources and expertise between state insurance departments regarding the setting of uniform standards and review of insurance products covered under the Compact;
6. To create the Interstate Insurance Product Regulation Commission; and
7. To perform these and such other related functions as may be consistent with the state regulation of the business of insurance.

would be funded, Vaughan said it might require a loan from the NAIC.)

Under the most optimistic scenarios offered by the NAIC leadership, it would take three to five years to implement the proposed compact. As the political battles begin in the states, the NAIC will need a string of victories in major states. Even proponents of the compact acknowledge that the NAIC cannot afford to lose a battle.

The compact proposal has already attracted the attention of the American Trial Lawyers Association, which sent a representative to the NAIC meeting for the first time in over a decade. It has also prompted Attorneys General to pay more attention to insurance public policy than they have since the liability crisis of the 1980s.

Perhaps it's only be a matter of time before the General Accounting Office and members of Congress take a hard look at the compact. (Some NAIC leaders have said privately that they expect Congress at some point to "fix the compact.") Ironically, the compact's proponents who swore that the proposal would forestall congressional action have actually invited congressional action.

The compact vote was a political bait-and-switch that will, in the long term, diminish the credibility of state officials.

A version of Kevin Hennosy's commentary appeared in Rough Notes *(www.roughnotes.com). Hennosy, founder of* Spread the Risk, *is currently writing a history of insurance and its regulation in the United States. He can be reached at (816) 885-1717 or khennosy@spreadtherisk.org.*