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Overview of the Regulation of Insurance in the United States

PartnersFinancial and the NFP Advanced Sales Resources team are pleased to provide the second in a series of documents written for advisors that addresses the strength of the life insurance industry. The first white paper, entitled “Life Insurance Industry Safeguards: A Proven Safety Net for Policyholders,” addressed a broad range of topics in a question and answer format.

The following whitepaper, drafted by our outside counsel Greenberg Traurig, LLP, supplements the first white paper by providing a more detailed discussion of the regulation of the life insurance industry. The whitepaper concludes that the insurance regulatory scheme in place today is one of the most comprehensive systems of regulation imposed on any industry in the United States. In the current economic environment, the following points are particularly noteworthy:

Holding Company Activities – The whitepaper discusses the Insurance Holding Company Acts and explains that these laws are designed to protect the insurance company’s financial condition from the unrelated activities of the holding company. The discussion addresses a number of topics including, registration, changes in control, affiliated transactions and limitations on dividend.

Financial Matters – The whitepaper discusses a number of areas of state regulation that may promote carrier solvency, including: capitalization, permissible investments, accounting standards, liabilities and reserves, and limitations on encumbrance of assets.

Regulation of Reinsurance – The whitepaper explains that while the area of reinsurance is less regulated than direct insurance, state regulation of reinsurance has occurred in four areas: 1) licensing requirements; 2) the ability of ceding insurers to take financial statement credit for reinsurance; 3) restrictions on general agents and reinsurance intermediaries to whom many reinsurers delegate responsibilities; and 4) regulation of specific reinsurance transactions.

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Overview of the Regulation of Insurance in the United States

This paper provides an overview of the regulation of insurance in the United States, including a discussion of specific areas of state regulation. As demonstrated herein, the insurance industry is possibly the most regulated industry in the U.S.

I. Background -- Structure of the Regulation of Insurance

Currently, individual states are the primary regulators of insurance in the United States. That is not to say that the federal government has not played a role in the history of insurance regulation or that it does not continue to play a role today. In fact, the history of insurance regulation has involved periodic federal intervention.

Organized regulation of the insurance industry by the states began in the mid-1800s, and federal-state tensions in insurance regulation occurred as early as 1868, when, the Supreme Court decided *Paul v. Virginia*. In *Paul,* the Court held that insurers did not fall within the purview of the Privileges and Immunities Clause of the U.S. Constitution and that "[i]ssuing a policy of insurance was not a transaction of commerce" within Congress' Commerce power. Soon after the *Paul* decision, state insurance regulators formed the National Association of Insurance Commissioners (NAIC) in an effort to pursue uniformity in insurance regulation.

The federal-state interplay continued in 1944, when the Supreme Court in *United States v. South-Eastern Underwriters Ass'n,* reversed its earlier decision in *Paul* and held that insurance is interstate commerce subject to federal regulation under the Commerce Clause. In 1945, Congress enacted the McCarran-Ferguson Act. This law delegated the regulation of insurance to the states, except in instances where federal law specifically supersedes state law or in instances where the states fail to regulate the business of insurance.

The states' authority over the business of insurance has been curtailed somewhat by federal statutes enacted after the McCarran-Ferguson Act, including the Employee Retirement Income Security Act (ERISA), the Health Insurance Portability and Accountability Act (HIPAA), and the Gramm-Leach-Biley Act. Notwithstanding the passage of these federal statutes, the states have retained primary control over the industry.

Today, each state has a department within its executive branch to regulate the state's insurance industry. The state insurance department usually has broad, legislatively delegated powers to enforce state insurance laws, promulgate regulations, and conduct investigations. The head of each state insurance department is commonly referred to as the commissioner or the director of insurance. While some states elect their insurance commissioner, in other states, the commissioner is appointed by the governor. States with popularly elected commissioners tend to have more aggressive consumer-protection regulations and harsher enforcement thereof.

II. Industry Characteristics - Life and Annuity

Within the United States, there are four main lines of insurance-related business: accident and health, life and annuity, property and casualty, and retirement/pension. Within each line of business there are numerous distinct product categories. Most basic coverages are highly regulated and perceived by consumers as commodities, with distinguishing aspects being price and reputation of the insurer. Life insurance companies provide several types of products and services to their policyholders. They cover the risk of premature death through life insurance, they provide investment services for savings, and they cover longevity risks by providing annuities. Life and annuity reserves are established pursuant to insurance regulatory laws.

III. Areas of Regulation

Each state licenses and regulates the insurers that do business within its borders, i.e. issue policies covering lives and risks located in the state. Almost all aspects of an insurer's business are subject to some type of regulation or oversight. Through its state accreditation process, the NAIC attempts to bring uniformity and minimum standards to state regulation. The following discussion describes the main subjects of regulation.

A. Corporate and Financial Affairs

1. Formation and Licensure of Insurers

The state in which an insurance company is incorporated is the primary regulator with respect to its financial condition and its corporate affairs. Insurance companies are generally formed under a particular state's insurance code and may include several forms: stock corporations, mutual companies, Lloyd's plan companies, reciprocal exchanges, and others. To incorporate, insurance companies must first decide whether the form of ownership should be stock, the usual form of corporate ownership, or mutual, in which the capital and surplus of the company are considered to be owned by its policyholders. Next, insurance companies must decide whether they will enter the life, accident and health, or property-casualty insurance markets.

Insurance companies must also follow appropriate state licensing requirements. For example, state laws require insurers and insurance-related businesses to be licensed in each state in which they conduct business. Insurers are bound by regulations in their state of domicile and by regulations in other states in which they are licensed to sell insurance. The purpose of state licensure is to allow the insurance department to apply state financial standards to ensure a company's solvency and to monitor a company's affairs. Generally, licenses are specialized in scope and only allow insurers to write specific lines of insurance. Insurers, however, are normally licensed to write multiple lines of business and are licensed to do business, and operate, in many states. Some states may also have seasoning requirements, which require insurers to have operated in another jurisdiction for a minimum time period before being considered for licensure in a particular state.

2. Holding Companies Activities

Insurance companies are generally prohibited from engaging in any business other than insurance or certain incidental businesses. Ownership or control of insurance companies, however, is transferable, which means that insurance companies may be owned by other companies that may be engaged in many types of business other than the business of insurance. Companies that own insurance companies are called insurance holding companies. Laws governing holding companies are in effect in every state and are known as the Insurance Holding Company Acts. The Insurance Holding Company Acts require the separation of the activities and operations of the holding company from the business of the insurance company subsidiary. These laws are designed to protect the insurance company's financial condition from the unrelated activities of the holding company.

a. **Registration**

The insurer member of a holding company must file a registration statement with the regulator of its home state detailing the structure and organization of the holding company and all affiliates. It must be updated annually and periodically as changes occur.

b. **Changes of Control**

The acquisition of an insurance company or its holding company must be approved in advance by regulators of the state of domicile of the insurance company. Regulators carefully scrutinize such transactions to assure that the transaction does not adversely affect the insurance company. The threshold for "control" is at 10% of voting securities.

c. **Affiliated Transactions**

To prevent unfair dealings, holding company laws contain provisions that require transactions between the holding company (or its affiliates) and the controlled insurance company to be fair and equitable and to be approved in advance. Regulators will review the transactions to assure that the insurance company is not paying more than fair consideration for the services or goods being purchased from its affiliate.

d. **Limitations on Dividends**

In most states, insurance companies are not allowed to pay dividends to its shareholders that exceed the greater of 10% of its capital and surplus or the company's net gain from operations for the prior year, unless approved by state regulators. This is one measure by which regulators are able to assure that the company remains adequately capitalized. In addition, insurance companies are only allowed to pay dividends out of earnings.

3. **Financial Matters**

Arguably, the most important requirements in insurance regulation are those requiring insurers to file comprehensive quarterly as well as annual financial statements, on standard NAIC forms, and those requiring regulators to periodically examine insurers. The form of financial statements is standardized among the states and must include various exhibits, including an actuarial opinion (with respect to the company's reserves) and management's discussion and analysis. The majority of states require financial statements to be certified as accurate by officers of the insurer. In addition, most states require the financial statements to be audited annually by an independent accounting firm.

Most state laws also provide that regulators may examine licensed insurers as often as they deem necessary, although the regulator is required to examine each insurer at least every three or five years. The examinations are divided into financial condition and market conduct examinations and normally occur on a triennial basis.

a. Capitalization

The earliest state insurance laws focused primarily on the security of the insured party and on the enhancement of company solvency. To accomplish these goals, state lawmakers required minimum capital and surplus requirements for certain types of businesses. Today, virtually all states have risk-based capital (RBC) requirements for insurers. The NAIC has developed, and most states have adopted, RBC formulas which establish minimum amounts of capital needed by insurers based on their size and risk characteristics, including asset risk, credit risk, underwriting and pricing risk, and general business risk. The RBC formulas are set forth in state and NAIC regulations and compare the capitalization an insurer must maintain to the capitalization it actually possesses. Failure to maintain minimum capital and surplus adequate to support the insurer's particular risks may subject it to regulatory oversight by the state insurance department.

b. Permissible Investments

Another early method used by states to protect company solvency and assure sufficient liquidity as well as safety was to control the investments made by insurance companies. The underlying premise was that such assets must be reasonably secure, and not speculative, both as to the recovery of the amount invested and as to the rate of return, over a substantial period of time. Today, states accomplish this goal by monitoring the companies' investments and by assuring that money that is paid in as premium is invested conservatively, primarily in bonds, treasury bills, and other fixed-income securities. The statutes regulating investments by a life insurance company recognize the long term nature of its liabilities and permit matching of assets that have longer term outlooks. These statutes dictate what assets are admitted versus non-admitted and require conservatism and diversification, with limitations on equities, mortgage loans and real estate.

c. Accounting Standards

For insurance companies, most states follow what is known as statutory accounting principles (SAP), which has significant differences from the principles of accounting that apply to most businesses under generally accepted accounting principles (GAAP). SAP is generally considered to be a more conservative basis of accounting. Most states also specify the means or basis for the valuation of assets. Under SAP, assets may be classified as admitted or nonadmitted,

depending on their nature. For instance, admitted assets usually do not include goodwill or other intangibles. Nonadmitted assets are not considered when determining compliance with capitalization requirements.

d. Liabilities and Reserves

The basic premise underlying insurer liabilities is that all fixed and contingent liabilities, such as anticipated claims and other future obligations, must be recognized with a reasonable degree of accuracy. The liability side of an insurer's balance sheet is different from that of other kinds of businesses because most of what appears there is an estimate of future obligations owed. These estimates of liabilities to policyholders are called reserves. A loss reserve is an insurance company's reserve representing the estimated value of future payments for claims incurred under the company's policies. SAP standards require insurers to have a qualified actuary certify that their reserves are reasonably accurate and adequate on an annual basis. Reserve calculations for life insurers are primarily based on interest, expense and mortality assumptions. For certain life products, including universal life insurance, reserving methodologies known as XXX and AXXX were developed in the early 1990s. These methodologies are viewed by many as very conservative, possibly creating a redundancy in the reserves for policyholder obligations.

e. Statutory Deposits

As a condition to licensure, all companies are required to pledge a certain amount of assets for the benefit of its policyholders, for use in the event of insolvency. These so called statutory deposits are typically held by the state insurance department of the company's state of domicile. The statutory deposits remain in place indefinitely and typically are only returned in the event the company withdraws from business.

f. Triennial Examinations

One of the most important regulatory functions of state insurance departments is the examination of the records and affairs of the domestic and admitted foreign insurance companies. Examinations of multi-state insurers are often coordinated through the NAIC. The essential purpose of the examination is to discover any element which indicates that the company will be unable to meet its obligations to its policyholders. More broadly stated, the purpose of the examination is to determine the company's financial condition, whether it is conducting its business in accordance with the law, and whether it is carrying out its contractual obligations properly and fairly.

g. Limitations on Encumbrance of Assets

Most states have anti-hypothecation statutes which prohibit an insurer from pledging or otherwise encumbering its assets. Insurance companies usually do not have commercial debt on their balance sheets; most of the liabilities reflected on their balance sheet relate to policyholder obligations. Most states also prohibit an insurance company from guaranteeing the debts and obligations of other parties such as affiliates.

4. Charter Amendments

Unlike general business corporations, the corporate affairs of an insurance company are closely regulated. Amendments to corporate charters must be submitted for prior approval, and upon submission, the insurance company must demonstrate any effects the amendment will have on its financial condition or capital structure.

5. Sales of Books of Business

Most instances in which an insurance company proposes to sell its existing insurance business to another company require formal prior approval. Such transactions may come in the form of assumption reinsurance, and approval must be obtained by the state in which each of the applicable companies is domiciled.

6. Mergers and Acquisitions

The merger of insurance companies is a relatively rare event. Most mergers and acquisitions of insurance companies occur at the holding company level. It is relatively uncommon for an insurance company to be merged with another insurance company. When such a merger does occur, it requires the approval of the domiciliary state of each insurance company.

7. Solvency Regulation

Regulators continually attempt to implement rules that will more effectively predict and prevent insurer insolvencies. Coordination of multi-state efforts is a key function of the NAIC.

a. Insolvency Proceedings

State insurance receivership laws govern insurer insolvencies. This is contrary to the insolvencies in most industries, which are subject to the federal Bankruptcy Code. Many states follow the NAIC's Insurers Rehabilitation and Liquidation Model Act.

Prior to instituting formal receivership proceedings, states will pursue less intrusive forms of oversight including supervision, in which the company's management is left in place, and conservatorship, in which the insurance department staff will replace in whole or in part the company's management.

The common features of state insurance receiverships are as follows: 1) an insurer is considered to be "insolvent" whenever it does not have sufficient assets to pay its obligations as they arise; 2) the insurance commissioner seeks appointment by a state court as receiver of the insurer, and takes possession of the insurer's business and assets; 3) the receiver may petition the court for an order of liquidation if it appears that rehabilitation of the insurer and the continuation of its business are not possible; 4) in the liquidation, a certain priority of claims is established; 5) certain "preferential" transfers or payments made by the insurer within four months before the insolvency may be recovered by the receiver for the benefit of the insurer's estate; and 6) at the conclusion of the liquidation, the insurer is dissolved and ceases to exist.

b. Guaranty Fund Protection

Today, almost every state has a life insurance guaranty association to cover the unpaid claims of insolvent insurance companies. Guaranty associations are statutorily mandated organizations designed to protect policyholders and claimants by spreading a company's cost of insolvency equitably among member companies. The majority of these funds operate on an assessment system. There is no permanent fund in place, but participating insurance companies are assessed after a known insolvency. Upon the occurrence of an insolvency, the guaranty funds are utilized to pay policyholder obligations of the insolvent company, up to certain limits that vary by state.

B. Insurance Products

1. Forms and Rating Practices

Because insurance policies are generally not subject to much negotiation, the content and the format of insurance contracts, as well as the fairness of their terms and conditions, are important subjects of insurance regulation. All states have comprehensive laws establishing regulations for insurance contracts. These regulations fall into the following categories: 1) mandated coverages; 2) contract specifications such as mandatory grace periods, incontestability provisions, and cancellation/termination requirements; and 3) requirements pertaining to issuance and renewability.

Nearly every state has also passed laws limiting insurers' rating practices. While state laws vary, three uniform principles guide each state's rate regulation system: 1) rates must be adequate; 2) rates must not be excessive; and 3) rates must not be unfairly discriminatory. In adopting regulatory schemes that adhere to these principles, states utilize differing methods of regulating insurance rates, including implementing file-and-use rating laws and prior-approval rating laws. The file-and-use method allows insurers to implement new rates by filing the rates with the state insurance department, with no prior approval. The department may later limit insurers' rates by conducting rating and market conduct examinations to determine whether the insurers' rates comply with the states' laws.

2. Marketing and Underwriting Practices

Many states regulate insurance companies by limiting the form and the content of insurance advertisements. Advertising regulations are designed to prevent unfair, misleading, and deceptive advertising. With a few exceptions, advertising materials are not required to be filed with state insurance departments.

States regulate underwriting by requiring insurers to file a copy of their underwriting guidelines with the department, by requiring guidelines to be sound, actuarially justified, or otherwise substantially commensurate with the contemplated risk, and by ensuring that the guidelines are not unfairly discriminatory.

3. Plans of Withdrawal

States regulate the extent to which insurers may withdraw or discontinue insurance coverage. Most states require insurers to submit a plan of withdrawal to the department prior to the commencement of any withdrawal activity. Insurance departments may require insurers to submit plans of withdrawal under the following circumstances: 1) the insurer intends to discontinue the issuance of a policy at the end of the policy term; 2) the insurer intends to transition business to another insurer; 3) the insurer does not intend to offer renewal to a block of business for a specific reason; or 4) the insurer intends to reduce coverage at renewal by imposing caps, limits, exclusions etc. The plan of withdrawal generally contains information regarding the specific reason for the insurer's action, the number of policyholders affected, and a number of other items to ensure that the transaction will be accomplished lawfully and orderly.

C. Reinsurance

Life insurance companies often cede some portion of their policyholder obligations to reinsurers or a pool of reinsurers. By spreading its risk to other insurers, life insurers obtain mortality risk protection and access to capital management resources.

The area of reinsurance is less regulated than direct insurance. For example, reinsurance premiums and products are not regulated, unlike their counterparts in the direct insurance industry. Reinsurance is not, however, free from regulation. In fact, a number of changes in the marketplace, including increases in uncollectible reinsurance and insurer insolvencies, have increased the demand for and regulation of reinsurance. Heightened state regulation of reinsurance has occurred in four areas: 1) licensing requirements; 2) the ability of ceding insurers to take financial statement credit for reinsurance; 3) restrictions on general agents and reinsurance intermediaries to whom many reinsurers delegate responsibilities; and 4) regulation of specific reinsurance transactions.

The circumstances under which ceding insurers may take financial statement credit for reinsurance is often enumerated specifically under state insurance laws. For instance, amounts that are recoverable under reinsurance contracts are allowed as admitted assets or deductions from liability only in certain defined circumstances. Another requirement for an insurer to obtain credit for reinsurance ceded is that either 1) the reinsurance be ceded to an authorized or accredited reinsurer or 2) funds are withheld or set aside to fund the ceded liabilities. Further, as a condition to taking reinsurance credit on a balance sheet, most states require a reinsurance contract to contain an "insolvency clause," which is a provision stating that the reinsurance company remains liable for its predetermined portion of an insured's claim even though the primary insurance company is no longer in business.

States place restrictions on the general agents and the reinsurance intermediaries to whom many reinsurers delegate their responsibilities and decisions. The NAIC has adopted model laws placing numerous restrictions on the delegation of responsibilities to managing general agents and to intermediaries.

D. Market Conduct

1. Trade Practices

Shortly after the enactment of the McCarran-Ferguson Act, many states passed laws prohibiting unfair and deceptive practices in the insurance business. The types of conduct prohibited under these laws include: 1) falsification of an insurer's records; 2) improper advertisements of an insurer's financial condition; 3) misrepresentation and defamation generally; 4) rebates of premium or commission; 5) geographical risk declination; 6) discrimination in underwriting as to rates and benefits; 7) unlawful sales inducements; and 8) improper claims practices.

2. Claims Payment Practices

Insurance contracts typically contain provisions concerning the process by which claims should be presented to the insurer by an insured or other claimant. Most states have regulations providing for prompt payment of claims and penalties for an insurer's nonpayment or late payment of a valid claim.

E. Licensing of Agents and Other Industry Participants

Every state also has licensing requirements for insurance agents. Insurance agents must be licensed in their state of domicile and must obtain a non-resident license for each state in which they sell insurance products or receive commissions. States require different licenses for the life business and for the property-casualty business. Additionally, many states require agents to meet certain educational standards and to pass a written test or series of tests. Failure to comply with the proper licensing requirements will subject insurers, agents, and similar representatives to the possibility of license suspension, revocation, or fines.

IV. Insurance Rating Agencies

Many industries have debt rating services and stock analysts that provide insight and opinions on the soundness of publicly traded companies and their ability to meet their obligations. A separate group of rating organizations (A.M. Best, Fitch, Moody's and Standard & Poors) offer their opinions, typically in terms of a letter grade, as to an insurance company's ability to meet ongoing obligations to policyholders. The rating is an independent opinion based on an evaluation of a company's balance sheet, operating performance, and business profile. This is different from a company's ability to service debt in that policyholders are the senior creditors of an insurance company and have the most senior claim on assets in the case of a default. Whereas upgrades and ratings rarely translate into immediate market momentum, perhaps unfairly, a down grade can more quickly affect market share.

A downgrade involves some subjective analysis and does not, by itself, affect an insurer's ability to meet its policyholders obligations.

V. Conclusion

As mentioned at the outset, almost all aspects of an insurer's business are subject to some type of federal or state regulation. While states are the primary regulators of the business of insurance, the federal government continues to play a role in insurance regulation today. The regulatory scheme in place today is one of the most comprehensive systems of regulation imposed on any industry in the U.S.

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