

Regulating Insurance Sales or Selling Insurance Regulation? Against Regulatory Competition in Insurance

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The global financial panic of the last two years is virtually certain to reshape the way that financial markets are regulated, both domestically and internationally.¹ In some domains, the direction of this evolution is relatively easy to anticipate. For instance, financial regulation in the future will almost certainly focus more on regulating derivatives markets and limiting predatory lending.² But in other domains, the trajectory of financial regulatory reform is still far from clear. This is particularly true with respect to the regulation of property, casualty, and life insurance markets.³

For the last two centuries, individual states have been entrusted with the primary responsibility for regulating insurance markets.⁴ This system, however, has long been assailed as antiquated and inefficient, especially for multistate insurers who are forced to comply with numerous states' regulatory regimes.⁵ Seizing on the momentum for financial regulatory reform in general, as well as the prominence of American Insurance Group's (AIG) role in the financial meltdown, advocates for insurance regulatory reform have increased their lobbying efforts dramatically in recent months.⁶

¹ For an overview of the global financial crisis, see HAL SCOTT, *THE GLOBAL FINANCIAL CRISIS* (2009) and Steven Schwarcz, *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown*, 93 MINN. L. REV. 373 (2008).

² See Lawrence Summers & Timothy Geithner, *A New Financial Foundation*, WASH. POST, June 15, 2009, at A15 (describing Obama Administration's framework for financial regulatory modernization, and noting that such reform must prevent predatory lending and increase transparency in derivatives markets); Congress, the Banks, and Derivatives, NY Times Editorial, June 7 (2009) (describing and critiquing Obama Administration's proposal to regulate the sale of derivatives). Editorial, *Harmful Lending Practices*, N.Y. TIMES, Nov. 22, 2008 at A20 (describing reform efforts to curb predatory lending in light of the financial crisis).

³ Throughout, the Article focuses on the regulation of consumer-oriented property, casualty and life insurance markets. It explicitly excludes from the analysis both health insurance and insurance against credit risks, including bond insurance and Credit Default Swaps. Each of these markets raises distinctive regulatory issues, and most reform proposals sensibly acknowledge this. The Article's limited discussion of commercial property/casualty insurance markets is a product of the fact that such regulation is relatively limited and generally not the impetus for regulatory reform proposals. See generally Donald Cleasby & Nancy M. Schroeder, *Point/Counter Point: Is the NAIC Commercial Lines Deregulation Effort On-Track?*, 18-3 *Journal of Insurance Regulation* 288 (2000).

⁴ See generally Geoffrey Miller & Jonathan Macey, *The McCarran Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13 (1993); Susan Randall, *Insurance Regulation in the United States, Regulatory Federalism and the NAIC*, 26 FLA. ST. L. REV. 625 (1999).

⁵ See generally THE FUTURE OF INSURANCE REGULATION (Grace & Klein eds. 2009).

⁶ See, e.g., Tom Wilson, *Regulate Me Please*, N.Y. TIMES, Apr. 15, 2009, at A29 (op-ed from CEO of Allstate calling for federal reform of regulation in light of AIG's collapse); *Trade Groups Applaud Fed Action on AIG*, BUSINESS INSURANCE, Sept. 17, 2008 (reporting a statement from Marc Racicot, president of the American Insurance Association, arguing that the (AIG) situation highlights the need for insurance regulatory reform). Congressional committees have held numerous hearings on insurance regulatory reform in light of AIG's collapse in the last year as well. See, e.g., *Perspectives on Modernizing Insurance Regulation: Hearing before the S. Comm. on Banking, Housing and Urban Affairs 111th Cong.* (2009); *The Causes and Effects of AIG's Bailouts, before the H. Comm. on Oversight and Government Reform 111th Cong.* (2008).

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Two reform proposals have received particular attention in policy circles in the last year. First, and most prominently, an Optional Federal Charter (OFC) proposal would allow insurers to opt out of the current state-based regulatory regime in favor of a newly-created federal regulatory scheme.⁷ This proposal, which is based on the dual banking system, dates back at least 60 years, to the passage of the McCarran Ferguson Act of 1945.⁸ Second, several commentators have recently resurrected a proposal to permit insurers to select a single state regulator that would govern all of their insurance operations across the country.⁹ This so-called Single License Solution (SLS), which was initially proposed almost a decade ago, would replicate the state-based system of corporate chartering.¹⁰

Nowhere do these reform proposals more clearly show their true vintage than in their promotion of regulatory competition in insurance. Both proposals empower insurers to choose among different jurisdictions' regulatory schemes. Such competition is designed to afford insurers a "safety valve" against excessive regulation and motivate regulators to design efficient and responsive regimes in order to attract insurers.¹¹ Yet many commentators claim that similar forms of regulatory competition played a substantial role in causing the current economic crisis in the first place. In the banking realm, for instance, allowing banks to "shop" among competing regulators at the state and federal level may have induced those regulators to consciously ignore wide-spread predatory lending and overlook the immense risks borne by individual banks.¹² Similarly,

⁷ See Martin Grace & Hal Scott, *An Optional Federal Charter for Insurance: Rationale and Design*, in THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES 55 (Martin F. Grace & Robert W. Klein eds. 2009); Scott Harrington, *Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation* (Networks Financial Institute at Indiana State University Policy Brief No. 2006-PB-02), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=923605; OPTIONAL FEDERAL CHARTERING AND REGULATION OF INSURANCE COMPANIES (Peter Wallison ed. 2000).

⁸ See Grace and Scott, *supra* note 7, at 55.

⁹ Henry Butler & Larry Ribstein, *The Single License Solution*, 31 REGULATION 36 (2008) [hereinafter Butler & Ribstein, *The Single License*]; see also Henry Butler & Larry Ribstein, *A Single-License Approach to Regulating Insurance*, (Northwestern Law & Econ Research Paper No. 08-10; U Illinois Law & Economics Research Paper No. LE08-015), available at <http://ssrn.com/abstract=1134792> [hereinafter Butler & Ribstein, *A Single-License*]; Harrington, *supra* note 7, at 28-29.

¹⁰ See Harrington, *supra* note 7, at 28-29 (noting that single-license proposal was floated by the American Insurance Association in early part of this decade).

¹¹ See Grace and Scott, *supra* note 7, at 57 (arguing in favor of an OFC because "efficiency in the provision of public goods can also be enhanced competition among government agencies for their provision, since government regulators can be monopolists and suffer from principal-agent problems of their own"); Butler & Ribstein, *The Single License*, *supra* note 9, at 10.

¹² Indeed, the New York Times carried an editorial on the subject of regulatory competition in insurance law on May 20, 2009. Editorial, *Regulator Shopping*, N.Y. TIMES, May 20, 2008, at A34 ("legislation recently introduced in the House would allow insurance companies, currently regulated by the states, to opt for federal regulation instead — and, in general, if they don't like that, to switch back after a spell. If the bill were enacted, the race to the regulatory depths would continue, and the nation would be headed in exactly the wrong regulatory direction."); See also

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regulatory competition in corporate law may arguably have contributed to the executive compensation schemes that incentivized firms to focus too much on short term profits and too little on long term risks.¹³

Despite the centrality of regulatory competition to insurance reform and the controversy surrounding this design feature in policy debates, the desirability of regulatory competition in insurance has received only minimal sustained scholarly attention.¹⁴ This is particularly surprising given that regulatory competition has been analyzed exhaustively in the legal academy when it comes to the related fields of corporate law, securities law, and banking law.¹⁵ This Article attempts to fill this hole in the extant literature by exploring the theoretical case for regulatory competition in insurance markets in light of the recent financial crisis. It concludes that regulatory competition of any type is a bad idea for the regulation of property, casualty, and life insurance markets. Such regulatory competition would promote a race to the bottom that would harm policyholders, third parties, and the insurance industry as a whole. Consequently, the Article concludes that while reforms to eliminate the

Federal Involvement in Regulation of the Insurance Industry Before the S. Comm. on Commerce, Science, and Transportation 107th Cong. 2 (2003) (testimony of J Robert Hunter, Director of Insurance, Consumer Federation of America) (“Consumer organizations strongly oppose an optional federal charter, where the regulated, at its sole discretion, gets to pick its regulator. This is a prescription for regulatory arbitrage that can only undermine needed consumer protection.”). By contrast, various commentators have recently come out in favor of regulatory competition in insurance. See, e.g., *Forbes Says Insurers Should Have Their Choice of Regulator*, NATIONAL UNDERWRITER, 10 May 25, 2009.

¹³ See LUCIAN BEBCHUK & JESSE FRIED, *PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION* (2004); Claire Hill & Brett McDonnell, *Avoiding “Short-Term Capital Management:” Can Better Corporate Governance Prevent Future Crises?*, (draft on file with author).

¹⁴ Although insurance commentators frequently mention regulatory competition, they rarely analyze extensively. For instance, Lissa Lamkin Broome note the risk that an OFC may promote a race to the bottom given the history of banking, but does not explore the topic in depth. See Lissa Lamkin Broome, *A Federal Charter Option for Insurance Companies: Lessons from the Bank Experience*, in *THE FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY* 208 (Patricia A. McCoy, ed. 2002). Elizabeth Brown devotes also devotes a paragraph or two to noting that regulatory competition in insurance might promote a race to the bottom. Elizabeth Brown, *The Fatal Flaw of Proposals to Federalize Insurance* 37 (U. of St. Thomas Legal Studies Research Paper No. 07-25, 2003), available at <http://ssrn.com/abstract=1008993>. On the other side, Scott Harrington devotes a half-page to explaining why “optional federal chartering could promote beneficial competition,” arguing that it could “discipline the potential excesses of either state or federal regulators. See Harrington, *supra* note 7, at 22. Martin Grace and Hal Scott briefly note that the OFC might be beneficial because “efficiency in the provision of public goods can also be enhanced competition among government agencies for their provision, since government regulators can be monopolists and suffer from principal-agent problems of their own.” Grace & Scott, *supra* note 7, at 57. Finally Butler and Ribstein do spend a good deal of time arguing that “the major problem with the current system of insurance regulation that needs to be fixed is that it turns what could be the big advantage for the United States in the global market place – the ‘genius’ of our federal system – into a significant disadvantage, where domestic firms are crippled by multiple state regulation and foreign firms are deterred from entering.” See Butler & Ribstein, *A Single-License*, *supra* note 9, at 10.

¹⁵ See generally Daniel C. Esty & Damien Geradin, *Introduction to REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES* ix, ix- xxxi (Daniel C. Esty & Damien Geradin eds., 2000).

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overlapping and duplicative features of state based insurance regulation may be desirable, neither the OFC proposal nor the Single License proposal provide an attractive route to reaching that outcome.

This Article’s analysis is organized around three issues. The first issue concerns the *demand side of regulatory markets*, as it focuses on how insurers – the “buyers” in regulatory markets – would select among competing regulators – the “sellers” in these markets. The second major issue concerns the *supply side of regulatory markets*, or how competing regulators would respond to insurers’ demand for regulation. The third, and final, issue looks at whether regulatory competition can be designed so as to overcome these problems. Continuing to conceptualize regulatory competition in market terms, the Article refers to this set of issues as *regulation of regulatory markets*. Part I further explains this three-part analytical framework and provides an overview of the current OFC and SLS proposals that promote regulatory competition.

Part II examines the first element of this tripartite framework – the demand side of regulatory markets – analyzing how individual insurers would choose among multiple regulators were they empowered to do so. It concludes that insurer “demand” for regulatory services would tend to undermine the core goals of insurance regulation. In particular, market forces could not be expected to discipline insurers’ regulatory choices, either with respect to protecting policyholders or third parties. Moreover, insurers’ regulatory demand might actually harm the interests of insurers themselves by destabilizing regulatory solutions to collective action problems while failing to enhance the “services” that insurance regulators provide to the industry.

Part III moves on to regulatory supply, the second component of the overarching framework developed in Part I, analyzing the extent to which regulatory competition would improve the political economy of state insurance regulation. It first argues that regulatory competition is neither necessary nor sufficient to address the duplicative and overlapping nature of state insurance regulation. Regulatory competition would, however, exacerbate other political economy problems in the state-based regulatory system, at least with respect to market conduct regulation and other forms of non-solvency regulation. In the solvency realm, regulatory competition would create different problems, undermining principles-based regulation and increasing the risk of regulatory forbearance.

Finally, Part IV applies the third part of the regulatory competition framework, evaluating whether regulatory competition could be structured so as to harness the benefits of such competition but limit its costs. Part IV argues that such regulation of regulatory markets would be exceedingly difficult. With respect to market conduct regulation and other

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forms of non-solvency regulation, it suggests that safeguards against excessive deregulation, such as expanding the jurisdiction of the proposed Consumer Products Safety Commission or increased reliance on the judiciary, have limited promise. Designing regulatory competition to promote effective solvency regulation is also a challenge, as neither guarantee funds nor market-oriented approaches would prove effective in either an OFC or SLS scheme.

I. An Overview of Regulatory Competition

Regulatory competition has two basic ingredients. First, business entities or individuals must have some degree of choice among at least two regulatory systems. They may exercise that choice by physically locating in a jurisdiction, by filing documents with the jurisdiction, or simply by writing contracts that reference that jurisdiction. Second, individual jurisdictions must have some incentive to attract regulated parties to their regime. These incentives can include increasing tax revenues, promoting economic growth, or simply expanding their influence.¹⁶

The desirability of regulatory competition is usually controversial and always context dependent.¹⁷ As a result, regulatory competition theory has evolved within numerous different doctrinal silos.¹⁸ Section A provides a brief overview of the regulatory reform debate in insurance, and the two reform proposals that would inject regulatory competition into the insurance arena. Section B then examines three key issues that frame the debate in the extant literature about the desirability of regulatory competition. These three issues organize the remainder of the Article.

A. Regulatory Competition and Insurance Reform

Proposals to reform insurance regulation are largely motivated by claims that the current regulatory scheme creates duplicative compliance costs and substantive inconsistencies.¹⁹ This system entrusts individual states to regulate insurance sold within their boundaries.²⁰ Regulatory competition is thus minimized as insurers can only influence who their

¹⁶ *See id.*

¹⁷ *See generally* Esty & Geradin, *supra* note 15 (discussing the evolution of regulatory competition theory in different substantive literatures); *see also* William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 204-05 (1997) (arguing that legal literature often over-simplifies the economics of regulatory competition, and setting forth basic principles that help to determine when regulatory competition might be expected to produce desirable results).

¹⁸ *See generally* Esty & Geradin, *supra* note 15, at ix, ix- xxxi.

¹⁹ *See generally* THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES (Martin F. Grace & Robert W. Klein eds. 2009) [hereinafter THE FUTURE OF INSURANCE]. Among other activities, the NAIC drafts model laws; collects and aggregates state-level data; helps to administer solvency regulation by an insurer's state of domicile; and helps to coordinate market conduct regulation to reduce duplicative compliance costs.

²⁰ *See generally* Miller & Macey, *supra* note 4; Randall, *supra* note 4.

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regulator is by changing where they sell coverage.²¹ At the same time, though, this system means that multistate insurers must comply with multiple regulatory regimes. This potentially means that they must endure market conduct exams by multiple regulators; design different products to conform with different regulatory standards in different states; acquire licenses from multiple states; and employ differing underwriting models in different states.²² Although states attempt to coordinate their regulatory activities through the National Association of Insurance Commissioners (NAIC), national insurers have long complained that these efforts are ineffective.²³

Numerous proposals have been advanced in the last several decades to address these claimed costs of the state-based insurance scheme. For instance, the State Modernization and Regulatory Transparency Act (SMART Act) would have created a federal agency to help coordinate state insurance regulation and expanded the influence of the NAIC.²⁴ The Insurance Company Protection Act of 2003 would have required all multistate insurers to be chartered at the federal level, but left single-state insurers to be chartered at the state level.²⁵ And, of course, some proposals would scrap the state-based system of insurance regulation entirely and replace it with a single federal regulatory scheme.²⁶

Two other reform proposals, which are the primary subject of this Article, would reform the state based system of insurance regulation by

²¹ Although insurers occasionally choose not to sell insurance in certain states in order to avoid regulation, this is rare as the profits to be made from insurance sales usually outweigh regulatory costs. See KENNETH MEIER, *THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* 53 (1998). The system of solvency regulation may create some limited regulatory competition, as an insurers' state of domicile take the lead on solvency regulation. See But this force is unlikely to be significant, as states need not defer to this solvency regulation and they carefully monitor one another through the NAIC's accreditation program.

²² See *THE FUTURE OF INSURANCE*, *supra* note 19; SHELIA BAIR, *CONSUMER RAMIFICATIONS OF AN OPTIONAL FEDERAL CHARTER FOR LIFE INSURERS* (2004) (attempting to quantify the costs of duplicative regulation in the life insurance industry).

²³ See generally Randall, *supra* note 420; Robert Klein & James Schacht, *An Assessment of Insurance Market Conduct Surveillances*, J. OF INS. REG. 51, 79 (noting that "insurers believe there is a duplication of effort and overlap... by the various state insurance departments conducting market conduct exams."); Robert Klein, *The Insurance Industry and its Regulation: An Overview*, in *THE FUTURE OF INSURANCE*, *supra* note 19, at 42 (arguing that states have "embark[ed] on an ambitious policy and institutional reforms" designed to "streamline, harmonize, and rationalize the current system of state regulation," but noting that "there is a limit to how far harmonization can go."). See, e.g., Tom Wilson, *Regulate Me Please*, N.Y. TIMES (April 15, 2009) (op-ed from CEO of Allstate complaining about hodgepodge of state insurance regulation).

²⁴ See Brown, *supra* note 12; Klein, *supra* note 23, at 13.

²⁵ See Brown, *supra* note 24, at 33-35. A similar proposal, advanced by Richard Cooper, envisions that "the federal government would be the rule-maker and the state insurance commissioners would enforce those rules within their states." Richard Cooper, *OFC: Is it Really Overkill?*, 26 J. INS. REG. 5 (2008) Unfortunately, this proposal is clearly unconstitutional under Supreme Court caselaw preventing the federal government from commandeering state governments. See generally *Printz v. United States*, 521 U.S. 898 (1997). This is just one example of how the debate on regulatory reform can be improved by increasing the dialogue between those who focus on insurance issues in law schools and business schools.

²⁶ See, e.g., Brown, *supra* note 14, at 39-74; Klein, *supra* note 23, at 49.

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introducing a scheme of regulatory competition into insurance. The first, dubbed the Single License Solution (SLS), would mimic the structure of jurisdictional competition in corporate law.²⁷ Corporations have long been permitted to incorporate, or reincorporate, in any state, and individual states receive various potential benefits from attracting incorporations, including increased tax revenue.²⁸ The SLS would mimic this basic structure by permitting insurers to select a single state insurance regulator to govern all of their insurance operations and allowing states to tax the sales of the insurers they regulate.²⁹ The proposal would also permit choice-of-law-provisions in insurance policies, allowing insurers to select a state judiciary of their choice.³⁰ In order to limit the risk of a race to the bottom in consumer protection, individual states would be permitted to override these choice-of-law provisions.³¹ To avert a race to the bottom in solvency regulation, insurers would be required to issue solvency bonds that default if their state regulator's guaranty fund failed.³²

A second prominent reform proposal, known as the Optional Federal Charter (OFC), would introduce a more limited form of regulatory competition into insurance regulation. The OFC proposal is modeled on the dual banking system, which allows banks to acquire a charter at either the state or federal level. Banks that opt for a state charter, however, must select the state in which they have their principal place of business.³³ The OFC would similarly give insurers and certain insurance agencies the option of opting out of the current system of state insurance regulation, in

²⁷ Butler & Ribstein, *The Single License*, *supra* note 9, at 39; *see also* Butler & Ribstein, *A Single-License*, *supra* note 9; *see also* Harrington, *supra* note 7, at 28-29.

²⁸ *See generally* ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* (1994). *But cf.* Mark Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 588 (2003) (noting that federal law often limits, or threatens to limit, states' authority to regulate internal affairs). Delaware generally dominates this regulatory competition, swamping all other states in attracting incorporations. Nevada and New Jersey have also made substantial efforts to enter the market as well. In general, though, most corporations choose to incorporate either in the state of their principal place of business or in Delaware. *See* Mark Roe, *Delaware's Politics*, 118 HARV. L. REV. 2491, 2500-02 (2004).

²⁹ *See* Butler & Ribstein, *The Single License*, *supra* note 9, at 39-40.

³⁰ *See id.* at 40.

³¹ They would require four pre-requisites to such opt out: "(1) any state override must be by the legislature; (2) the override only applies if enacted in a state where policies are sold; (3) the override is effective only as to policies sold after the legislation is enacted; and (4) the insurer has a clear right to exit the state." *See id.*

³² *See id.* For further explanation of how these bonds would work, see Part IV.B. *infra*.

³³ *See generally* GEOFFREY MILLER, JONATHAN MACEY & RICHARD CARNELL, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 95, 120-21 (3rd ed. 2001); *see also* Geoffrey Miller, *The Future of the Dual Banking System*, 53 BROOK. L. REV. 1 (1987). Banks that charter at the federal level have some degree of choice among multiple regulatory bodies, including the Office of Comptroller of Currency, the Office of Thrift Supervision, and the Federal Reserve. Although current reform proposals could alter the extent of regulatory competition among federal banking regulators, they all leave intact the dual system of banking regulation. *See* Helene Cooper, *Obama Pushes Financial Reforms*, N.Y. TIMES, June 20, 2009, at A1; Damien Paletta, *Historic Overhaul of Finance Rules*, WALL ST. J., June 18, 2009, at A1; Brian Wingfield, *Bank Regulation Blowout*, NEWSWEEK, June 17, 2009, <http://www.newsweek.com/id/202379>.

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favor of a single federal regulator.³⁴ As in the banking system, insurers would be free to switch back and forth between the state and federal regulator.³⁵ The competing state and federal regulators would have strong incentives to attract insurers to their system under most OFC proposals. For states, those incentives would include their receipt of regulatory fees and avoiding the de facto nationalization of insurance regulation.³⁶ The incentives of a federal insurance regulator to attract insurers are dependent on the details of different OFC proposals.³⁷ But most OFC proposals envision that the federal insurance regulator would be funded through fees imposed on regulated entities, and an insurer's choice to charter federally could also impact the scope of the federal regulators' power and authority.³⁸

B. The Desirability of Regulatory Competition

Although the desirability of regulatory competition has received only minimal sustained scholarly attention in insurance,³⁹ it has been analyzed exhaustively in corporate law, securities law, and banking law. This Section distills this literature by describing three major issues that frame the regulatory competition debate in these areas. It first isolates arguments concerning regulatory demand, or the process by which regulated entities select their regulators within a scheme of regulatory competition. Second, it describes arguments concerning regulatory supply, or the likely actions of regulators operating in a competitive

³⁴ See generally Grace & Scott, *supra* note 7, at 55. Under most proposals, the federal insurance regulator would be housed within the Department of the Treasury. See Broome, *supra* note 14. Recent OFC proposals have been introduced in the House in April 2009, by Representatives Bean and Royce, and the Senate in May 2007, by Senators Sununu and Johnson. See Martin Grace, *A Reexamination of Federal Regulation in the Insurance Industry 5-7* (Policy Brief, Networks Financial Institution) (2009). Grace criticizes some recent OFC proposals for “merely copying the structure of the banking system.” See *id.* at 8.

³⁵ See Grace & Scott, *supra* note 7, at 55. For large national insurers, the OFC might be a “one-way street” if the benefits of moving from the current state-based system of regulation to a single regulator were large. See Broom, *supra* note 14, at 220; Ribstein & Butler, *supra* note 27, at 38. This depends on the cost-savings that could be achieved if national insurers were not subject to multiple regulators, as in the current state based system. If the cost savings to large insurers from a single regulator are not as large as many claim, then large national insurers might indeed be willing to switch from a federal charter back to a state charter. Even so, small and medium-sized insurers and agencies would still choose between competing regulators based on the substance of their regulatory policies.

³⁶ Although most OFC proposals permit states to continue to tax insurers that opt for a federal charter, “the removal of a significant portion of the industry from state oversight could substantially reduce other state-imposed regulatory fees, which have served as a major source of funding for state insurance departments.” Klein, *supra* note 23, at 47.

³⁷ OFC proposals do diverge on several important issues of regulatory design. The most important issue on which they diverge is the design of guarantee funds that would protect policyholders in the event of an insurer's insolvency. Some proposals leave in place the current system of state guarantee funds, whereas other would create a federal guarantee fund for insurers who chose an OFC option. This issue is dealt with more fully in Part IV.

³⁸ Butler & Ribstein, *The Single License*, *supra* note 9, at 39-40. The scope of the federal regulators' authority might be particularly important to a new federal insurance regulator interested in establishing its authority and stature.

³⁹ See note 12, *supra*.

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environment. Third, it reviews several potential mechanisms for “regulating” the process of regulatory competition in order to prevent a race to the bottom but nonetheless retain some of the benefits of regulatory competition.⁴⁰

1. Regulatory Demand and Alignment of Interests

One of the most common defenses of regulatory competition is that the interests of regulated entities in selecting among competing regulators match the interests of the intended beneficiaries of regulation. This argument is particularly important in corporate law. Proponents of state chartering argue that managers will incorporate in the state that best promotes the interests of shareholders, the intended beneficiaries of corporate law.⁴¹ Although shareholders cannot easily observe managers’ every-day decisions, they can monitor and react to managers’ selection of a regulatory regime.⁴² The efficiency of capital markets consequently means that this selection will be accurately reflected in the price of the corporation’s shares.⁴³ Because managers are driven to maximize the price of corporate stock – doing so results in higher pay, greater job security, more valuable stock options, and enhanced reputation – they will select an optimal regulatory regime for shareholders.⁴⁴ This, in turn, motivates jurisdictions to compete in generating efficient corporate law.⁴⁵

By contrast, detractors of regulatory competition in corporate law generally dispute the claim that managers are driven solely to increase the price of corporate stock.⁴⁶ Although increases in stock price will generally

⁴⁰ These three issues clearly do not cover all of the arguments that are made in the regulatory competition literature. Rather, they are intended to provide a framework for understanding some of the most fundamental issues in this literature.

⁴¹ See FRANK H. EASTERBROOK & DANIEL R. FISCHEL, *THE ECONOMIC STRUCTURE OF CORPORATE LAW* 6-7 (1991); ROMANO, *supra* note 28; Robert M. Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525 (2001) (arguing that empirical evidence favors a race to the top, as Delaware firms are worth more than similar firms incorporated in other jurisdictions); Ralph Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 257-66 (1977). Notably, most jurisdictional competition advocates in corporate law dismiss the notion that corporate law should be seriously concerned about non-shareholder corporate stakeholders. See, e.g., Ribstein...

⁴² See FISCHEL & EASTERBROOK, *supra* note 41, at 1-3 (describing the agency problem of corporate law and how various different mechanisms of corporate law – such as fiduciary duties, shareholder voting, and hostile takeovers – help to address these agency problems). This formulation for the role of corporate law stems from ADOLF A. BERLE, JR. & GARDINER C. MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932).

⁴³ See EASTERBROOK & FISCHEL, *supra* note 41, at 17-21; Winter, *supra* note 41, at 275-76. Romano, *supra* note 43, at 2366-67.

⁴⁴ See Winter, *supra* note 41, at 257-66.

⁴⁵ See EASTERBROOK & FISCHEL, *supra* note 41, at 17-21; Winter, *supra* note 41, at 275-76. Romano, *supra* note 43, at 2366-67. As in all markets, the pace of evolution towards this efficient market outcome may be slow, and punctuated by wrong terms. See EASTERBROOK & FISCHEL, *supra* note 41, at 220-22; see also Michael Abramowicz, *Speeding Up the Crawl to the Top*, 20 YALE J. ON REG. 139, 168-70 (2003).

⁴⁶ Lucian Bebchuk, *Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law*, 105 HARV. L. REV. 1435, 1445 (1992); William L. Cary, *Federalism and*

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improve managers' job security and compensation, occasionally managers' personal interests may be best served by choices that decrease share price. In particular, corporate laws that directly enhance managers' job security and compensation may more than offset the indirect costs to managers of a decreased share price.⁴⁷ At least with respect to these issues, critics of jurisdictional competition argue that the status quo system has promoted a "race to the bottom" in corporate law.⁴⁸

The corporate law scheme of regulatory competition has prompted reform proposals in a number of other fields, including securities law, where some have argued that issuers ought to be allowed to opt out of the federal regime and choose a single state that would govern their securities transactions.⁴⁹ As in corporate law, defenders of regulatory competition argue that issuers would select a disclosure regime that best met the interests of investors because doing so would maximize the price of their securities.⁵⁰ Similarly, critics of such regulatory competition argue that the interests of issuers are not, in fact, aligned with regulatory objectives, emphasizing that issuers would not internalize the social benefits of disclosure in selecting among regulatory regimes.⁵¹

Unlike in corporate and securities law, the literature in banking law rarely defends regulatory competition based on claims that banks would demand efficient regulation.⁵² The reason is that a core goal of banking

Corporate Law: Reflections Upon Delaware, 83 YALE L.J. 663, 666 (1974); Melvin Eisenberg, *The Structure of Corporation Law*, 89 COLUM. L. REV. 1461, 1510 (1989).

⁴⁷ Lucian Bebchuk & Allen Ferrell, *Federalism and Takeover Law: The Race to Protect Managers from Takeovers*, in REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES 68,73-74; Lucian Bebchuk, Alma Cohen & Allen Ferrell, *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1800 (2002); Eisenberg, *supra* note 46, at 1510.

⁴⁸ Bebchuk, *supra* note 46, 1435, 1458-68 (arguing that jurisdictional competition may benefit certain elements of corporate law, even while it promotes a race to the bottom elsewhere, where the interests of managers and shareholders are not aligned).

⁴⁹ See generally Romano, *supra* note 43, at 2367 (arguing that jurisdictional competition should govern the registration of securities and continuous disclosure requirements); Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657 (2002); Stephen Choi & Andrew Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 (1998) (extending regulatory competition model to international sphere by arguing that international issuers of securities ought to be permitted to choose any regulatory regime). Others have advocated for extending such regulatory competition to the regulation of securities exchanges as well. Jonathan Macey, *Regulatory Competition in the US Federal System: Banking and Financial Services*, in REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES 95, 105-09 (Daniel C. Esty & Damien Geradin eds., 2000).

⁵⁰ See, e.g., Macey, *supra* note 49; Choi, *supra* note 49; Romano, *supra* note 43.

⁵¹ See Merrit B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1342-69 (1999).

⁵² *But cf.* Arthur E. Wilmarth, Jr., *The Expansion of State Bank Powers, the Federal Response, and the Case for Preserving the Dual Banking System*, 58 FORDHAM L. REV. 1133, 1250 (1990) (arguing that "[a]s in the case of corporate chartering, investor discipline could play a substantial role in restraining state competition in bank chartering, provided that state banks are required to maintain substantial amounts of equity capital.").

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law is to promote the safety and soundness of banks.⁵³ Although such regulation is partially directed at protecting depositors, it is principally aimed at limiting the externalities associated with failed banks, including systemic risk.⁵⁴ There is little reason to expect that banks would fully take this risk into consideration in selecting a regulator, as these costs (by definition) fall on unrelated third parties. As such, most banking scholarship implicitly recognizes that bank “demand” for regulation may insufficiently take into account the objectives of banking regulation.

2. Regulatory Supply: The Political Economy of Regulation

Firms operating in a scheme of regulatory competition may select regulators that minimize costs and regulatory constraints, irrespective of whether they protect the interests of the intended beneficiaries of regulation.⁵⁵ But the mere fact that regulated entities would *demand* an inefficiently-minimalist regulatory regime does not necessarily mean that competing regulators would *supply* such a regime. Competing regulators will almost always care about considerations other than attracting regulated entities, and these considerations will often weigh against simply dismantling regulatory restrictions. In balancing these factors, competing regulators may woo regulated entities by providing more efficient or innovative regulation without unduly sacrificing the effectiveness of that regulation.

These arguments about regulatory supply are particularly important in the banking literature. Proponents of regulatory competition in banking typically emphasize the tendency of ordinary regulation towards excessive conservatism, insufficient innovation, and, on occasion, outright incompetence.⁵⁶ Regulatory competition can offset these political economy failings, according to its defenders. First, it encourages regulators to experiment with innovative regulations in order to attract banks.⁵⁷ Second, it provides banks with at least one “escape valve”

⁵³ MILLER, MACEY & CARNELL, *supra* note 33, at 251.

⁵⁴ *See id.*

⁵⁵ *See* Kenneth Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 36 (1977) (noting that regulatory competition in banking generally results in broader operating authority of banks and fewer constraints on profitability, but largely refraining from judging the normative implications of this trend).

⁵⁶ MILLER, MACEY & CARNELL, *supra* note 33, at 67 (quoting Fed. Reserve) (Ordinary, “monopolistic” bank regulation would “have a long-term bias against risk-taking and innovation” because regulators “receive no plaudits for contributing to economic growth through facilitating prudent risk-taking, but [they are] severely criticized for too many bank failures.”); *See* Scott, *supra* note 55; Henry Butler & Jonathan Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 678, 716 (1988) (arguing that non-competitive regulation may encourage bank regulators to affirmatively stifle competition in the underlying markets in order to maximize their receipt of political rents).

⁵⁷ *See* Wilmarth, *supra* note 52, at 1156 (noting various examples, including checking accounts, branch banking, real estate lending, and trust services).

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against the most oppressive forms of regulation.⁵⁸ Finally, it allows regulators to specialize in the regulation of particular types of banks.⁵⁹ At the same time, limited regulatory competition – between two competing regulators rather than fifty – is unlikely to promote excessive deregulation, from this vantage point, because it merely counter-balances, but does not eliminate, the natural conservatism of regulators.⁶⁰

These political economy arguments in favor of regulatory competition are also found in the securities literature. For instance, proponents of regulatory competition in securities law argue that ordinary monopolistic regulation has resulted in the SEC's regulatory ineptness, such as its historical refusal to permit firms to disclose projected earnings and its failure to heed early concerns about fraudster Bernard Madoff.⁶¹ Regulatory competition might improve securities regulation by promoting innovations such as the increased use of default rules or a greater role for regulation by exchanges.⁶² It also could allow different regulators to specialize in different types of issuers.⁶³

3. Regulating the Regulatory Market

The forces of regulatory supply and demand may sometimes produce inefficiently lax regulation. In particular, regulated entities may demand regulation that is excessively laissez-faire, and regulators may be willing to supply such regulation in order to capture the “business” of regulated entities. This process may even trigger a “race to the bottom” as regulators compete with each other to offer less and less intrusive regulatory schemes.⁶⁴ In some cases, this risk can be offset by structural

⁵⁸ See GEORGE J. BENTSON ET AL., *Perspectives ON SAFE AND SOUND BANKING: PAST, PRESENT, AND FUTURE* 276 (1986); W. BROWN, *THE DUAL BANKING SYSTEM IN THE UNITED STATES* 64-65 (1968); MILLER, MACEY & CARNELL, *supra* note 33.

⁵⁹ See Richard J. Rosen, *Is Three a Crowd? Competition Among Regulators in Banking*, 35 *J. Money, Credit & Banking* 967, 969 (2003) (arguing that the OCC specializes in banks with consumer loan portfolios, the Fed with banks with commercial loan portfolios, and the FDIC with banks with construction loan portfolios).

⁶⁰ See; BENTSEN ET AL., *supra* note 58, at 276-78; Daniel R. Fischel, Andrew M. Rosenfield & Robert S. Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 *VA. L. REV.* 301, 335 (1987); Wilmarth, *supra* note 52, at 1242 (“[T]he competition in laxity argument overlooks the strong incentive of both elected public officials and bank regulators to avoid bank failures.”). The risk that excessively lax regulation would prompt federal action to dismantle the scheme of regulatory competition might similarly prevent excessive deregulation. See Tamar Frankel, *The Dual State-Federal Regulation of Financial Institutions – A Policy Perspective*, 53 *BROOK. L. REV.* 53, 60 (1987).

⁶¹ Romano, *supra* note 43, at 2378-79; Binyamin Appelbaum & David S. Hilzenrath, *SEC Didn't Act on Madoff Tips*, *WASHINGTON POST*, Dec. 16, 2008, at D01; Joe Nocera, *Chasing Small Fry, S.E.C. Let Madoff Get Away*, *N.Y. TIMES*, June 26, 2009, at B1.

⁶² Romano, *supra* note 43, at 2395-401.

⁶³ See Choi, *supra* note 49, at 1705.

⁶⁴ The risk of such a race to the bottom has been particularly salient in banking. Historically, banking commentators focused on the risk of a “race of laxity” in the regulation of banks’ safety and soundness. See Elizabeth Brown, *A Single Financial Services Agency*, 14 *U. MIAMI BUS. L. REV.* 1, 52-57; Fein, *The Fragmented Depository Institutions System: A Case for Unification*, 29

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elements of regulatory markets, which (continuing with the analogy to ordinary markets) effectively “regulate” the market for regulatory competition.

First, and most obviously, a system of regulatory competition may incorporate safeguards that limit the capacity or willingness of competing regulators to deregulate beyond a certain point. Such safeguards are an important way in which banking regulation attempts to prevent regulatory competition from inducing excessive deregulation of safety and soundness.⁶⁵ For example, the Federal Reserve sets reserve requirements for all depository institutions, irrespective of their chosen regulator.⁶⁶ This ensures that the forces of regulatory competition do not impact reserve requirements – a central element of banks’ safety and soundness – by removing this issue from the domain of regulatory competition.⁶⁷ Similarly, deposit insurance in banking may help safeguard against a race to the bottom in safety and soundness, as the FDIC offers such insurance to all banks and monitors the financial health of its policyholders.⁶⁸

Recently, and especially in light of the global financial meltdown of 2007-2009, banking commentators have also proposed safeguards against a race to the bottom in more conventional consumer protection arenas, such as predatory lending and unfair/inefficient contract design.⁶⁹ The most notable such safeguard – recently embraced by the Obama Administration in its proposal for a Consumer Products Safety Commission – would create a new federal consumer protection agency with broad rule-making authority to protect banking consumers.⁷⁰ The agency would have authority to set a regulatory floor for all banks on a

AM. U. L. REV. 633, 675-700 (1980) (arguing that dual banking system promotes a race in laxity with respect to safety and soundness regulation).

⁶⁵ In fact, this form of a race to the bottom is so central in banking that it has acquired its own name – a race in laxity. Although the text focuses on safeguards in banking, safeguards against excessive deregulation in others areas also exist. For instance, some understand federal securities laws as a check on state corporate law’s domain of competition. See Roe, *supra* note, at 2498 (describing how federal securities law restricts the competition that the states can practically and legally engage in).

⁶⁶ See *id.* at 693-96 (referencing the Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. 461 (1998)).

⁶⁷ See Butler & Macey, *supra* note.

⁶⁸ See MACEY, MILLER, & CARNELL, *supra* note 33, at 147 (describing restrictions that FDIC imposes on state banks with deposit insurance).

⁶⁹ See Bar-Gill & Warren, *supra* note, at 186-195 (arguing that bank regulators do not have a motivation to effectively regulate credit products due to forces of regulatory competition); Pat McCoy & Kathleen Engel, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002); Prentiss Cox, *The Importance of Deceptive Practice Enforcement in Financial Institution Regulation*, PACE L. REV. (forthcoming 2009). Cox details substantial evidence suggesting that banks engaged in charter shopping in order to avoid consumer protections, and that competing regulators – particularly the OCC and OTS..

⁷⁰ Bar-Gill & Warren, *supra* note at 198-200. I have also proposed that the products safety is a useful analogy for the regulation of financial products, focusing on insurance products rather than credit products. See Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance*, 48 WM. & MARY L. REV. 1389, 1424 (2007).

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variety of consumer protection issues, but would permit competing regulators to go beyond that floor in their own domains.⁷¹ A different proposal – presciently made well before the recent financial crisis – would create suitability standards for the sale of mortgages.⁷² Because the proposal would create a private cause of action for violations, it would empower the judiciary to check the risk of lax enforcement due to regulatory competition.⁷³

These safeguards operate on *regulatory supply*, as they attempt to influence how competing regulators respond to industry demands. But regulatory competition schemes can also be designed to improve *regulatory demand* for effective regulation. This is particularly true with respect to solvency regulation, where regulatory failures are relatively easy to spot *ex post*. The best example of this approach to structuring a system of regulatory competition is the risk-based deposit insurance that the FDIC attempts to charge to regulated banks.⁷⁴ Such deposit insurance, if priced accurately (which is a big “if”), should increase banks’ willingness to choose an effective regulator, at least with respect to safety and soundness issues. That is because such a scheme forces banks to internalize *ex ante* the expected social costs of their insolvency risk.

II. Regulatory Demand and Alignment of Interests

Regulatory competition transforms regulated business entities into customers by empowering them to shop in a market comprised of different regulators. As with any market, these customers’ preferences are central to predicting the market’s outputs. If customers in a market of regulatory competition prefer regulators who would efficiently promote regulatory objectives, a race to the top – or at least a crawl – is virtually inevitable.⁷⁵ Regulatory competition in both corporate law and securities regulation is primarily defended on this basis. By contrast, if these customers prefer a minimally intrusive regulatory regime that fails to promote regulatory objectives, then the market for regulatory competition may produce such a result.⁷⁶ This, according to critics, is exactly what has happened with respect to corporate laws’ regulation of takeovers and executive compensation.⁷⁷

⁷¹ See Consumer Financial Protection Agency Act of 2009, 111th Cong. (2009) available at http://www.house.gov/apps/list/press/financialsvcs_dem/21frank_011_xml.pdf

⁷² See McCoy and Engel, *supra* note 69, at 1318-67.

⁷³ See *id.* at 1337-58.

⁷⁴ See Butler & Macey, *supra* note at 712-16.

⁷⁵ Among proponents of regulatory competition in corporate law, there is some debate about the speed at which the market evolves to the efficient outcome. See Michael Abramowicz, *Speeding Up the Crawl to the Top*, 20 YALE J. ON REG. 139, 145 (2003).

⁷⁶ As explained in Part I, regulatory supply and the rules governing the over-arching market also impact whether regulatory competition promotes a race to the bottom.

⁷⁷ Of course, regulated entities might have incentives to choose regulators who promote some regulatory goals, but not others. In these cases, the desirability of regulatory competition turns on the relative importance of the competing regulatory issues. See Bebchuk, *supra* note 46, at 1458-

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Although the nature of firms’ regulatory demand is important for evaluating any system of regulatory competition, it is particularly crucial with respect to schemes, such as the SLS, that envision numerous competing regulators.⁷⁸ As the number of competing jurisdictions increases, the likelihood that at least one of those jurisdictions will implement a regulatory scheme that meets customers’ demands obviously also increases. As a result, the competitive pressure on regulators to satisfy regulatory demand also increases as the number of competing regulators increases. The resulting competitive pressure can produce a powerful “race to the top” if firm demand for regulation is aligned with regulatory objectives. For similar reasons, when firms demand minimally intrusive and costly regulation irrespective of regulatory goals, regulatory competition will be more likely to generate a race to the bottom when the number of competing jurisdictions increases.

This Part takes up the issue of insurer “demand,” evaluating the extent to which insurers who were empowered to choose among competing regulators would do so in a way that benefited the intended beneficiaries of insurance regulation.⁷⁹ Section A focuses on policyholders, the primary beneficiaries of insurance regulation, and contends that most insurers operating in a scheme of regulatory competition could be expected to “demand” excessively lax consumer protections. Section B then considers two other potential beneficiaries of insurance regulation: insurers and third parties. It argues that insurer demand for competing regulators would ignore the interests of third parties to the insurance relationship. It also suggests that insurer demand would undermine the interests of insurers themselves. In sum, this Part argues that insurers would tend to select regulators with the least restrictive regulatory regimes, irrespective of the efficiency of that result.

A. Insurer Demand and Consumer Protection

Consumer protection is perhaps the central objective of insurance regulation. Indeed, most of the core functions of insurance regulators are directed primarily to this goal. For instance, form and price regulations attempt to ensure that policyholders receive reasonable policy terms at fair prices that are not unduly discriminatory.⁸⁰ Claims handling regulations

68 (arguing that corporations demand efficient law with respect to certain issues, but not others, like manager compensation and take-over rules).

⁷⁸ See TAN (discussing SLS proposal).

⁷⁹ See Fox, *supra* note 58, at 1342 (“The obvious starting point for an inquiry into the social welfare effects of adopting issuer choice is to ask what kind of disclosure regime each US issuer would select if given that choice.”).

⁸⁰ Almost every state reviews, and pre-approves, insurers’ policy forms. This process is designed to protect consumers from unfair or surprising terms that may result from the adhesive nature of insurance policies. See generally Schwarcz, *supra* note 70, at 1424. In the life insurance sphere, many states permit insurers to seek product approval through the Interstate Insurance Product

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are intended to protect insureds by limiting insurers' ability to deny or delay claim payments.⁸¹ Licensing is designed to ensure that market actors have sufficient expertise and resources to advise and insure policyholders.⁸² Even solvency regulation, which is primarily associated with limiting externalities in domains such as banking,⁸³ are often described in consumer protection terms by insurance regulators.

This Section analyzes whether insurer choices among competing regulators would promote the interests of policyholders. It first shows that this depends on the extent to which insurance consumers would know, and rationally respond to, insurers' choices among competing regulators. More than a small minority of such consumers would be necessary, it claims, to discipline insurers to choose regulators that promoted policyholders' interests. This Section then shows that this condition is unlikely to be met in most consumer insurance markets.

1. The Character of Insurer Regulatory Demand

It is tempting to assume that insurer demand in a scheme of regulatory competition could never promote efficient consumer protections.⁸⁴ After all, if insurers were incentivized to look after policyholder interests, most forms of consumer protection would not be

Regulation Commission. See INTERSTATE INSURANCE PRODUCT REGULATION COMMISSION, <http://www.insurancecompact.org>. With respect to insurers' pricing, most states require insurers in some consumer lines of insurance, particularly homeowners and auto insurance, to have rate changes approved by state regulators. See generally J. David Cummins, *Property-Liability Insurance Price Deregulation: The Last Bastion?*, in DEREGULATING PROPERTY-LIABILITY INSURANCE 1-25 (J. David Cummins ed., 2002).

⁸¹ Every state has an Unfair Claims Practices Act that gives the state regulator authority to impose fees or issue cease and desist orders in cases of flagrant or repeated unfair claims practices. Unfair claims practices include a wide range of potential conduct, such as failing to pay claims without conducting a reasonable investigation, knowingly misrepresenting facts or policy terms, and failing to effectuate prompt, fair and equitable settlement of claims submitted in which liability has become reasonably clear. See generally Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurances Claims Conflict*, 83 TUL. L. REV. 735, 745 (2009).

⁸² KATHLEEN HEALD ETTINGER ET AL., STATE INSURANCE REGULATION 103 (1st ed. 1995).

⁸³ See *Regulatory Restructuring: Enhancing Consumer Protection before H. Comm. on Financial Services*, 111th Cong. 5 (statement of Gary E. Hughes, Executive Vice President and General Counsel, American Council of Life Insurers) ("The primary objective of insurance regulation is solvency, which is the most important consumer protection of all."). Solvency regulation limits the investments that insurers can make, the capital they can deploy, and the accounting methods they can use. See generally Steven W. Pottier & David W. Summer, *The Effectiveness of Public and Private Sector Summary Risk Measures in Predicting Insurer Insolvencies*, 21 J. FINANC. SERV. RES. 101 (2000). Guaranty funds provide policyholders with additional protection, ensuring them of the continuation of policies and (at least partial) payouts even if their insurer does become insolvent. See *Insurance Regulation and Competition for the 21st Century Before the Subcomm. On Capital Markets, Insurance, and Government Sponsored Entities*, 107th Cong. 16 (statement of Tony Nicely, CEO, Chairman, President, GEICO Insurance Companies).

⁸⁴ See, e.g., MARTIN F. GRACE & HAL S. SCOTT, AN OPTIONAL FEDERAL CHARTER FOR INSURANCE 74 (rejecting the Butler and Ribstein Single License proposal because "a key reason for insurance regulation is consumers' asymmetric and imperfect information").

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necessary in the first place.⁸⁵ But this logic ignores a key point from the regulatory competition literature: the incentives of firms and policyholders may diverge in numerous cases, yet nonetheless be aligned *with respect to the selection of a regulatory regime*.⁸⁶ Thus, even if market forces are insufficient to protect insureds against risks such as unfair claims handling and exploitive policy forms, it does not logically follow that they are insufficient to effectively constrain insurers' choices among competing regulators.⁸⁷

Whether market forces would effectively discipline insurers' choices among competing regulators depends on the extent to which insurance consumers would know, and rationally respond to, insurers' choices among competing regulators. If all insurance consumers were "sophisticated" – in the limited sense that they rationally considered insurers' choices among competing regulators when they purchased coverage – then insurers would select regulators that promoted consumers' interests.⁸⁸ Doing so would be necessary for insurers to compete for these consumers' business.⁸⁹ By contrast, if all insurance consumers were "unsophisticated" – either because they were unaware of insurers' choices among competing regulators or failed to appreciate the implications of those choices – then insurers would demand regulatory regimes with minimalist consumer protections, irrespective of the social desirability of this result.⁹⁰ Such a regime would decrease insurers' costs of regulatory compliance and maximize their choices of business strategies without any offsetting cost in policyholder demand.

Insurers' would prefer a minimalistic regulatory regime when consumers are not "sophisticated" even though consumer protections benefit insurer interests as well as policyholder interests.⁹¹ Many consumer protections arguably promote insurance industry interests by

⁸⁵ The one potential exception involves policyholder protections that can be understood to solve the commitment problem of insurance. *See infra*, TAN 94.

⁸⁶ *See* TAN 47-52. This point is summed up well by Roberta Romano, who notes that "a theoretical need for government regulation to prevent market failure is not equivalent to a need for a monopolist regulator." *See* Roberta Romano, *Empowering Investors: A Market Based Approach to Securities Regulation*, 107 *YALE L.J.* 2359, 2367 (1998).

⁸⁷ *See* Romano, *supra* note 43, at 2367 ("[A] theoretical need for government regulation to prevent market failure is not equivalent to a need for a monopolist regulator.").

⁸⁸ *See* BUTLER & RIBSTEIN, *THE SINGLE LICENSE*, *supra* note 9, at 40.

⁸⁹ *See id.*; *See also* Martin Grace and Richard Klein, *The Effects of an Optional Federal Charter on Competition in the Life Insurance Industry* 3 ("Some have expressed concerns that an oFC would lead to competition between federal and state regulators that would ultimately degrade rather than improve insurance regulation. However, we argue that if good regulation benefits consumers and they value these benefits, then insurers will be motivated to seek optimal regulatory jurisdictions that would increase rather than diminish firm value.").

⁹⁰ *Cf.* Cary, *supra* note 46.

⁹¹ This analysis assumes that there are no "safeguards" in place to prevent this result. In particular, it assumes that firms are not required to pay for the consequences of other firms' insolvencies via guarantee funds and are not charged actuarially fair prices for deposit insurance. These safeguards, and their potential effectiveness at inducing firms to seek out improved regulation, are addressed separately, in Part IV, *infra*.

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solving collective action problems among insurers. For instance, consumer protections may protect the industry's overall reputation from the actions of "bad-apple" insurers who would ignore the industry-wide reputational costs of their own misfeasance.⁹² Similarly, consumer protections may increase overall demand for insurance by warranting that all available coverage meets certain minimum standards, thereby reducing consumer search costs.⁹³ But insurers who were choosing among competing regulatory regimes would ignore, or at least largely discount, these potential industry benefits of consumer protection for the very reason these benefits exist in the first place – while regulatory restrictions benefit the entire insurance industry, individual insurers have an incentive to cheat from the collective optimum.⁹⁴

Although the nature of insurers' choices among competing regulatory regimes is easy to assess in a state of the world where consumers are either completely informed or completely uninformed about those choices, the real world obviously does not fit either characterization. In reality some insurance purchasers in a scheme of regulatory competition would be "sophisticated" and others would not be. Predicting what level of consumer sophistication would correspond to what percentage of insurers' pursuing policyholder interests in their regulatory choices is a complicated and speculative enterprise.

Nonetheless, it is highly unlikely that a small percentage of sophisticated consumers could discipline a large percentage of insurers to select a robust regulatory scheme.⁹⁵ Ironically, this is because of the

⁹² See TOM BAKER, *INSURANCE LAW AND POLICY*, at 7 (2nd ed. 2008) (describing the race to the bottom that occurred due to insurer-side adverse selection in the fire insurance market in the late nineteenth century); Daniel Schwarcz, *Race to the Bottom in Consumer Insurance Markets*, 8 CONN. INS. L.J. 131 (2009) (arguing that a similar race to the bottom may characterize insurers' claims handling practices in the current market)

⁹³ Regulation traditionally reduces search costs through disclosure oriented strategies.

⁹⁴ Alternatively, consumer protections may benefit individual insurers by serving as an effective commitment device to potential policyholders. Informed consumers of insurance will generally want to purchase coverage from insurers who will pay claims fairly and adhere to conservative financial strategies that preserve their claims-paying ability. But individual insurers may find it difficult to credibly commit to these policies: even if they promise at T=0 to do so, they may face different incentives at T=1. See THOMAS C. SCHELLING, *THE STRATEGY OF CONFLICT* (1960) (first describing and analyzing commitment problems); David Moss, *Risk, Responsibility and the Role of Government*, 56 Drake L. Rev. 541, 546-48 (2008) (noting the import of commitment problems to the government's role in insurance markets); Alan O. Sykes, "Bad Faith" Breach of Contract by First Party Insurers 25 J. LEGAL STUD. 405, 418-19 (1996) (discussing commitment problems associated with the prompt and fair payment of claims). Regulation may enhance an insurer's ability to credibly commit to policyholders, which may promote consumer demand for the insurer's product. But this explanation for how consumer protections benefit insurers is itself contingent on consumers' familiarity with an insurers' chosen regulatory regime. If consumers were not aware of an insurers' selected regime, then consumer protection regulations could not enhance the insurers' capacity to commit to those insurers.

⁹⁵ The "informed minority" argument is important in contract law. See Alan Schwartz & Louis L. Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 VA. L. REV. 1387, 1389 (1983); R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother's Keeper: The Inability of the Informed Minority to Correct for Imperfect Information*, 47

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intense price competition that characterizes most consumer insurance markets.⁹⁶ Insurers that selected a less intrusive regulatory regime would enjoy a competitive advantage over other insurers in attracting the business of unsophisticated consumers, as they could partially pass on to these consumers the cost savings associated with lax regulation.⁹⁷ Unlike sophisticated consumers, who would decide whether they were willing to pay higher premiums for enhanced consumer protections, “unsophisticated” consumers would tend to purchase their coverage from these low-cost insurers irrespective of their actual willingness to pay for consumer protections. That is because only one side of the relevant tradeoff – the decrease in premiums – would be visible to those consumers. Although these insurers might risk losing the business of sophisticated consumers, many insurers would find this to be a worthwhile trade-off even if a substantial minority of the marketplace were sophisticated consumers.

The experience of fire insurance companies in the late nineteenth century is illustrative. In the absence of form regulation, fire insurers that sold highly-limited coverage began to drive other fire insurers with more comprehensive coverage out of the market place, as consumers could not differentiate the quality of coverage that these competing insurers offered and so based their purchasing decisions largely on price. The resulting fire insurance coverage was riddled with exceptions, resulting in largely illusory coverage for many policyholders.⁹⁸ Similarly, price regulation in insurance markets was originally justified as a way of ensuring that insurance prices did not become too low to support policy payments due to “ruinous” price competition.⁹⁹ Such ruinous competition allegedly

HAST. L. REV. 635, 675 (1998). Much of the analysis is identical for choice of regulators in a scheme of regulatory competition, which can itself be understood simply as one type of choice that could be contractually specified.

⁹⁶ See J. David Cummins, *supra* note 80, at 2-3 (J. David Cummins ed., 2002) (property/casualty); Jeffrey R. Brown & Austan Goolsbee, *Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry*, 110 J. POLIT. ECON. 481 (2002) (term life); Paul Joskow, *Cartels Competition and Regulation in the Property-Liability Insurance Industry*, 4 RAND J. ECON. 375 (1973) (property/casualty).

⁹⁷ None of this necessarily means that a lax consumer protection regime would not, in fact, be best for many, or most, consumers. Rather, the point here is that demand from most insurers for lax consumer protections would be the inevitable result of regulatory competition unless a very high percentage of insurance consumers were informed about insurers’ regulatory choices.

⁹⁸ See TOM BAKER, *INSURANCE LAW AND POLICY* 7 (2nd ed. 2008). It is illuminating to contrast this analysis with the arguments made by defenders of regulatory competition in the securities and corporate law contexts. Firms’ incentives to demand efficient regulations stem from their desire to maximize the price of their shares. And capital markets, according to the analysis, do a good job of ensuring that a firm’s share prices accurately reflect the efficiency of their regulatory choices. But unlike in the insurance products context, there is no quality dimension along which markets must function well. And, for that reason, uninformed investors are protected by sophisticated investors who help ensure that the price of securities converge on the market’s best guess about their actual value. Jeffrey Gordon & Lewis Kornhauser, *Efficient Markets, Costly Information, and Institutional Research*, 60 N.Y.U. L. REV. 761 (1985) (describing the Efficient Capital Markets Hypothesis and its limitations).

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resulted in the failures of insurance companies from the San Francisco Earthquake of 1908 to Hurricane Andrew of 1994 precisely because most consumers, unaware of their insurers' financial strength, gravitated to the cheapest coverage available.

2. Consumer Sophistication and Insurer Regulatory Demand

Determining how well-informed insurance consumers would be about insurers' choices of regulators in a scheme of regulatory competition is fundamentally a prediction about consumer information in a hypothetical market setting. But, the basic features of both consumer property/casualty and life insurance markets provide strong reason to believe that a substantial majority of consumers would not meaningfully take into account insurers' choices of regulatory regimes in making their purchasing decisions. First, and most importantly, there is little reason to expect that consumers would be familiar with the information necessary to meaningfully evaluate insurers' choices of regulatory regimes. Second, even if that information were known to consumers, they would be likely to discount its significance due to well-known cognitive errors that characterize insurance purchasing decisions.

a. Information and Regulatory Choice

Consumers must know more than simply the identity of an insurer's choice of regulator in order to evaluate that choice.¹⁰⁰ Without a sense of the relative quality of different regulators' consumer protections, consumers would have no basis for interpreting an insurer's selection of a regulator. Yet the character of consumers' insurance purchases makes it very unlikely that a substantial percentage of consumers would consider and be able to interpret this information when choosing among competing insurers.

First, consumers choosing among competing insurers generally conduct only minimally time-consuming and cognitively-taxing *independent* research that does not rely on market intermediaries such as insurance agents. The majority of consumers in automobile and homeowner insurance markets report that their primary source of information about competing insurers are their family and friends.¹⁰¹

¹⁰⁰ Any scheme of regulatory competition would presumably be accompanied by a requirement that insurers disclose their chosen regulator. See Butler & Ribstein, *The Single License*, *supra* note 9; cf. Romano, *supra* note 43, at 2413 (proposing that firms would need to disclose which regulator they selected).

¹⁰¹ See Jeffrey E. Thomas, *An Interdisciplinary Critique of the Reasonable Expectations Doctrine*, 5 CONN. INS. L. J. 295, 311 (1998) (citing INSURANCE RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 1995 at 15, fig. 2-7, 31 fig. 2-27 (hereinafter PAM 1995)). One 1995 study found that 51% of homeowner insureds and 54% of auto insureds relied on word of mouth to learn about insurance, eclipsing all other sources of information. A more recent 2001 study found that 56% of

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Other common sources of information similarly require minimal research and effort from consumers, including insurance company literature, advertisements, television, and the yellow pages.¹⁰² Recently, more consumers also report using internet platforms such as *einsurance.com* in selecting among competing insurers.¹⁰³ By contrast, a very small percentage of insurance consumers report conducting more extensive independent research of competing insurers: only 3% report consulting state government hotlines and only 7% report using consumer-oriented magazines.¹⁰⁴ Perhaps even more notably, such consumers generally found these sources of information less useful than more accessible sources of information, such as advice from friends and family.¹⁰⁵

When consumers do conduct independent research, they focus principally on price. One recent study found that only 10% of automobile insurance customers reported selecting a carrier that did not offer the lowest price.¹⁰⁶ Price distinctions are obviously easy for consumers to understand and compare. Consumers who choose among competing carriers for reasons other than price often do not generally do so because their independent research has revealed relevant information other than price. Rather they do so because they personally received poor service or experienced a claims problem.¹⁰⁷

The evidence from life insurance markets largely mirrors the evidence from property/casualty markets. Studies of life insurance purchasing decisions prior to the advent of the internet tended to find that the vast majority of consumers did not comparison shop or read literature other than that provided by their insurers. Of 194 respondents, none

recent consumers relied on information from someone they knew when buying auto insurance, and 98% of those consumers considered this information somewhat or very valuable. INSURANCE RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 2001, Issue 2, at 6, fig. 2-5 (hereinafter PAM 2001). Again, no other source of information was as frequently cited by insureds as a basis upon which they made their insurance-purchasing decision. Insurance is one arena where such advice is usually close to useless, as the vast majority of consumers never use the most important features of the insurance that they purchase. For that reason, it is hardly surprising that *virtually all* consumers report being satisfied with their auto and homeowners insurance. PAM 2001, *supra* note XX

¹⁰² *See id.*

¹⁰³ *See* Randy E. Dumm & Robert E. Hoyt, *Insurance Distribution Channels: Markets in Transition*, 22-1 J. INS. REG. 27 (2003).

¹⁰⁴ Only 6% of recent insureds report learning about insurance through the state government, and only 10% report consulting a consumer organization magazine. *See* PAM 2001, *supra* note 101, at 6 fig. 2-5.

¹⁰⁵ The percent who found public information helpful was 83%, substantially lower than the percent that found consulting with friends and family to be helpful. *See id.* Although the percent finding consumer magazines helpful was higher, at 92%, it did not approach the 98% level of information from friends and family. When consumers change insurers, they most frequently cite price as the reason, though they often also cite service considerations or a bad claims experience as well. PAM 2001 *supra* note 101. Survey by JD Power and Associates, 2001, cited in 22-1 J. INS. REG. 27 (2003).

¹⁰⁶ *See* JD Power and Associates, *2009 Insurance Shopping Study*, <http://www.jdpower.com/insurance/articles/2009-Insurance-Shopping-Study>.

¹⁰⁷ Dumm & Hoyt, *supra* note 103.

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reported consulting Best’s review in purchasing their coverage, 2 reported consulting consumer reports, and one reported consulting with their state insurance commissioner.¹⁰⁸ The overwhelming majority of survey respondents chose a life insurer based on the recommendations of others.¹⁰⁹ More recent research finds a significant amount of comparison shopping based on price in the term life insurance market, which has helped to lower premia substantially. However, it finds limited evidence of such comparison shopping in the whole life insurance markets, where products are much more complicated and heterogeneous.¹¹⁰

Consumers’ general lack of effort in independently researching competing insurers is hardly surprising given the circumstances under which they tend to select among competing insurers. Non-price distinctions among competing insurers are complex, contingent, and difficult to interpret.¹¹¹ Yet first-time decisions among competing insurers are generally made during eventful and stressful times in peoples’ lives.¹¹² In the property/casualty context, consumers first select a carrier when they buy a home or automobile, or move.¹¹³ First-time life insurance decisions are often made when people take a new job or have a sudden change in family structure.¹¹⁴ And once consumers select an insurer, they tend not to switch.¹¹⁵

The second reason why consumers’ purchasing decisions would be unlikely to reflect insurers’ regulatory decisions is that market intermediaries could not be relied upon to advise consumers about this issue. Only a small percentage of consumers in both property/casualty and life insurance markets now purchase insurance through independent agents. Instead, consumer markets are increasingly populated by captive agents and direct writers, who only offer coverage with a single insurer. This distribution mechanism tends to produce cost savings that can be

¹⁰⁸ See Roger A Formisano, Richard W. Olshavsky & Shelley Tapp, *Choice Strategies in Difficult Task Environments*, 8 J. CONS. RES. 474, 476 (1982).

¹⁰⁹ See *id.* at 477.

¹¹⁰ See Brown & Goolsbee, *supra* note 96.

¹¹¹ CASS SUNSTEIN & RICHARD THALER, *NUDGE* 77 (2008). As Cass Sunstein and Richard Thaler recently observed, “the benefits from holding [] insurance are delayed, the probability of having a claim is hard to analyze, consumers do not get useful feedback about whether they are getting a good return on their insurance purchases, and mapping from what they are buying to what they are getting can be ambiguous.”

¹¹² Consumers making decisions under these circumstances rationally “adopt simple[] choice strategies” that balance “the desire to achieve accuracy with the desire to minimize effort.” See Russel Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1223-34 (2003) (reviewing literature).

¹¹³ Once they select a carrier, they tend to stay with it unless they can save substantial sums of money for switching. But the evidence suggests that this happens rarely, and, when it does, the driving motivation is almost always a desire to decrease premium payments. INSURANCE RESEARCH COUNCIL, *PUBLIC ATTITUDE MONITOR 2001*, Issue 2, at 5, fig. 2-3; See *id.* at 6, fig. 2-4.

¹¹⁴ *id.*

¹¹⁵ PAM 2001, *supra* note 101.

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passed on to consumers, but it eliminates expert advice about choosing among competing carriers.¹¹⁶

Even consumers who do purchase insurance through independent agents often receive slanted advice about competing insurers.¹¹⁷ Most independent insurance agents receive contingent commission payments or other forms of differential compensation from insurers based on the amount of business they direct to the insurer. These payments create incentives for independent agents to steer consumers to specific insurers who pay the highest kickback and to consolidate their clients with a limited number of insurers. These incentives obviously undermine the extent to which independent agents can be relied upon to offer objective advice about competing carriers.

Third, and finally, neither advertising nor disclosure requirements could be expected to meaningfully inform a large percentage of consumers about insurers' regulatory choices. Information about the relative quality of different jurisdictions' consumer protections is *both* controversial and complex. Its complexity means that, in order to be effective, any disclosure regime or advertising campaign would need to discuss the underlying issues by boiling them down to simplistic metrics or slogans.¹¹⁸ This is entirely possible, of course – rating agencies such as A.M. Best have developed letter grades that are intended to reflect the financial health of individual insurers.¹¹⁹ But in contrast to financial ratings, where there is substantial agreement at least with respect to the basics,¹²⁰ any rating of a jurisdiction's regulatory "quality" could be immensely subjective, depending in large part on the political philosophies of the entity doing the rating. As a result, different ratings organizations could easily have largely inconsistent ratings of different regulators, and challenging the accuracy of these different ratings would be costly and difficult.¹²¹

¹¹⁶ See L. Regan & Sharon Tennyson, *Insurance Distribution Systems*, in HANDBOOK OF INSURANCE 709 (2000).

¹¹⁷ See Daniel Schwarcz, *Beyond Disclosure: The Case for Banning Contingent Commissions*, 25 YALE L. & POL'Y REV. 289; Schwarcz, *supra* note 92.

¹¹⁸ See Aaron D. Twerski et al., *The Use and Abuse of Warnings in Products Liability – Design Defect Litigation Comes of Age*, 61 CORNELL L. REV. 495, 511-16 (1976) ("Warnings in order to be effective must be selective... The warning process, in order to have an impact, will have to select carefully the items which are to become part of the consumer's mental apparatus while using the product.").

¹¹⁹ Cf. Tom Baker & David Moss, *Government as Risk Manager*, in PRINCIPLES OF REGULATION (John Cisternino & David Moss, eds. 2009).

¹²⁰ The "rating process involves a comprehensive quantitative and qualitative analysis of a company's balance sheet strength, operating performance and business profile. This includes comparisons to peers and industry standards as well as assessments of operating plans, philosophy and management". Best's Rating Center – Rating Methodology, <http://www.ambest.com/ratings/methodology.asp>, (last visited Aug. 11, 2009).

¹²¹ Although an individual insurer might overcome these difficulties in consumer education with substantial marketing expenditures describing the relative benefits of certain regulatory regimes, insurers are unlikely to invest in such marketing. Any such advertising or marketing would be

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Even if disclosure and/or advertising could credibly convey to consumers the relative quality of insurers' choices of regulatory regimes, it is unlikely that it could empower consumers to assess the implications of those choices. Unlike the identity of the regulating jurisdiction or the quality of that jurisdiction, this form of information cannot be reduced to a simple numeric grade or metric. Rather, it requires consumers to affirmatively consider the risks involved in insurance transactions, and the extent to which regulation could effectively mitigate those risks. Disclosure-based approaches have repeatedly been demonstrated to do a poor job at conveying these forms of information.¹²² It is for precisely this reason that regulators still regulate insurers' solvency even though it is relatively easy for consumers to get objective measures of different insurers' financial strength.¹²³ The mere fact that information is relatively available to consumers when they choose among competing regulators does not mean that they will be able to meaningfully assess the relative value of that information.

None of the above analysis addresses the prospect that insurers' regulatory choices would impact their general reputations for consumer friendliness, which would in turn influence consumer behavior. In other words, even if consumers did not have sufficient information to base their purchasing decisions on insurers' selections of regulatory regimes, they might nonetheless base decisions on insurers' general reputations, which would track their regulatory choices. Although possible, this argument assumes a state of the world in which reputational forces in insurance markets accurately inform consumers about different insurers' practices. In this world, consumer protections would themselves be largely unnecessary, as market forces would be sufficient on their own to ensure that consumers were adequately protected. A defense of regulatory competition that is contingent on markets working sufficiently well that consumer protections are unnecessary is hardly compelling. More generally, there are good reasons to think that reputational forces in consumer insurance markets do not work well. First, most consumers never get any feedback about their insurer's market conduct practices or financial strength because they rarely use their insurance in a meaningful way.¹²⁴ Second, most consumers are ill-equipped to evaluate whether they have been treated well by an insurer after they made a claim.¹²⁵ Both of

subject to a free-rider problem: it would accrue to the benefit not just of the advertising insurer, but all other insurers who used a particular regulator.

¹²² Richard Craswell, *Taking Information Seriously: Misrepresentation in Contract Law and Elsewhere*, 92 VA. L. REV. 565 (2006).

¹²³ Of course, some commentators suggest that

¹²⁴ In property/casualty markets, most policyholders submit no claims, or only relatively small claims, in the course of their coverage with a particular company. Schwarcz, *supra* note 70. The same is true for traditional life insurance markets, where many policyholders permit their coverage to lapse or submit a claim only once. .

¹²⁵ *See id.*

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these factors undermine the meaningfulness of consumer word-of-mouth about different insurers, which is normally the key driver of reputational forces.¹²⁶

b. Cognitive Errors

Even if consumers were to possess accurate information about different insurers' regulatory regimes of choice, there is good reason to believe that their purchasing decisions would irrationally discount this information.¹²⁷ Behavioral research reveals that individuals systematically base their insurance decisions on underestimates of the likelihood that they will suffer an insurable loss. Studies have repeatedly shown that people are overly optimistic that they will not be injured in an earthquake,¹²⁸ lose their job,¹²⁹ be involved in a car accident,¹³⁰ suffer from health problems,¹³¹ and die young.¹³² Much of this over-optimism stems from the persistent tendency of people to believe that they are above-average: healthier, safer, smarter and even luckier than others.¹³³ Individuals' underestimation of their risk of loss corresponds directly with an

¹²⁶ *See id.*

¹²⁷ There is a substantial body of literature documenting the fact that there is a "systematic tendency for insurance in practice to differ from insurance in theory." David M. Cutler & Richard Zeckhauser, *Extending the Theory to Meet the Practice of Insurance 3* (Harvard University working paper) (2004) ; *See also* Howard Kunreuther & Mark V. Pauly, *Rules Rather Than Discretion: Lessons From Hurricane Katrina*, (Nat'l Bureau of Econ. Research, Working Paper No. W12503, 2006). Much of this literature has a limited application to the problems in this Article, for two reasons. First, the normative implications of these departures from rational actor models are not always clear. Although government policy clearly ought to respond to simple errors in insurance decisions making, such as underestimation of risks, many behavioral anomalies are not so easily described as errors, rather than preferences. Second, many behavioral anomalies would have an ambiguous impact on how consumers would evaluate insurers' regulatory choices in a system of regulatory competition. To take one important example, empirical investigation has found that people strongly dislike "probabilistic insurance," wherein the underlying policy pays the insured with some probability that is less than one. Peter Wakker, Richard Thaler & Amos Tversky, *Probabilistic Insurance*, 15 J. RISK & INS. 7 (1997). But the implications of this for regulatory competition are hard to predict. On one hand, this may suggest that consumers would be willing to pay more for a regulatory scheme that appeared to convert a probabilistic policy into a non-probabilistic one. On the other, hand, though, no insurance policy can provide certainty, irrespective of the regulatory regime. As such, insurance marketing may tend to under-emphasize the relevance of insurers' regulatory regime, as such an emphasis could trigger a decreased demand for insurance because consumers would be reminded of the inherently probabilistic nature of real world insurance. *See* Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories and Insurance Contract Damages*, 72 TEX. L. REV. 1395 (1994).

¹²⁸ Jerry M. Burger & Michele L. Palmer, *Changes in and Generalization of Unrealistic Optimism Following Experiences with Stressful Events: Reactions to the 1989 California Earthquake*, 18 PERSONALITY & SOC. PSYCHOL. BULL. 39, 40-1 (1992).

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¹³⁰ David Dunning et al., *Ambiguity and Self Evaluation: The Role of Idiosyncratic Trait Definitions in Self-Serving Assessments of Ability*, in HEURISTICS AND BIASES 324 (Thomas Gilovich et al., eds., 2002); Ola Svenson, *Are we All Less Risky and More Skillful than Our Fellow Drivers?*, 47 Acta Psychologica 143, 147 (1981).

¹³¹ Neil D. Weinstein, *Unrealistic Optimism About Future Life Events*, 39 J. PERSONALITY & SOC. PSYCHOL. 806, 807 (1980).

¹³² *See* Kyle D. Logue, *The Current Life Insurance Crisis: How the Law Should Respond*, 32 CUMB. L. REV. 1, 2, 4, 23 (2001-2002).

¹³³ *See* SUNSTEIN & THALER, *supra* note 111, at 31-33. Such "unrealistic optimism is a pervasive feature of human life; it characterizes most people in most social categories."

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underestimation of the value of regulatory protections, given that such protections only tend to matter when consumers suffer a loss. More speculatively, consumers' over-optimism may also lead consumers to discount the importance of regulation even if they do suffer a loss, as they may believe that they would be particularly adept at negotiating a favorable resolution on their own.

B. Insurer Demand and Other Beneficiaries of Insurance Regulation.

Although consumers are the primary intended beneficiaries of insurance regulation, they are not the only such beneficiaries. Broadly speaking, at least two other potential groups of beneficiaries exist. First, insurance regulation might be intended to promote the interests of insurers. Second, insurance regulation can also be conceptualized as benefiting third parties outside of the insurer/policyholder relationship.¹³⁴ This Section examines these potential beneficiaries of insurance regulation, looking at the extent to which "insurer demand" among competing regulators would promote these interests. It first argues that while insurer demand could be expected to promote regulatory objectives that directly improve industry operations, this objective is not an important function of insurance regulation. Section Two then argues that insurer demand could be expected to harm the interests of third parties. The protection of such third parties is an important goal of insurance regulation even though systemic risk is much less substantial in the insurance domain than the banking domain.

1. Insurers as Beneficiaries of Insurance Regulation

Financial regulation is often claimed to benefit the regulated industry itself, as well as that industry's consumers and investors.¹³⁵ Usually, such claims are premised on the idea that consumer protections benefit financial firms by solving prisoner dilemma or other collective action problems. Section A showed why individual insurers' preferences among competing regulatory regimes could not be expected to promote these goals.¹³⁶ In short, regulatory solutions to these problems typically require that those solutions are mandatory, as individual insurers will have an individual incentive to opt out of the collective optimum or free ride off of the efforts of others.

¹³⁴ See generally Howell Jackson, *Regulation in a Multi-sectored Financial Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319, 343 (identifying financial regulation as primarily concerned with regulating risk, and protecting consumers/investors and third parties).

¹³⁵ See Lawrence Summers & Timothy Geithner, *supra* note 2 (describing Obama Administration's framework for regulatory modernization of banking, and noting that such modernization is in the industry's own interest because it will restore the public's trust in the financial system).

¹³⁶ See *supra* TAN 84-133.

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Financial regulation can also promote industry interests more directly. First, regulators are sometimes uniquely situated to provide direct services or products to regulated entities. In some cases, this is because regulators can exploit economies of scales and avoid coordination problems associated with certain services.¹³⁷ Consider the banking sphere, where these considerations prompt the Fed to provide private banks with check clearing services, wire transfer services, and automated clearinghouse transaction services.¹³⁸ In other cases, regulators may be well situated to help develop products because of their distinctive expertise, ability to identify common problems, and obvious ability to navigate regulatory hurdles. This helps to explain why state bank regulators have themselves developed widely-used bank products such as negotiable order of withdrawal accounts.¹³⁹ Arguably, modern corporate law provides another example of such a regulatory service, with Delaware courts opining at length about voluntary best practices for corporate governance.¹⁴⁰

Second, to the extent that regulatory systems include the judiciary or other dispute resolution mechanisms, they are often well-situated to decrease transactions costs by filling in gaps in contractual understandings *ex post*.¹⁴¹ Many commentators claim that this function is a central explanation for corporate law, which consists largely of default rules.¹⁴² Corporate charters, on this view, are inherently incomplete due to the transactions costs of anticipating and specifying every conceivable scenario. Through the Delaware courts, corporate law fills in these gaps to match the *ex ante* preferences of the parties without requiring them to incur the transactions costs of specifying those rules.¹⁴³

With respect to these forms of regulation, which are designed to directly improve the operations of regulated entities, there is good reason

¹³⁷ Regulation that facilitates industry coordination should be distinguished from regulatory efforts to coordinate the process of regulation itself. *See generally*, Richard McAdams, *Beyond the Prisoner's Dilemma: Coordination, Game Theory, and Law*, 82 S. CAL. L. REV. 209 (2009).

¹³⁸ *See* Adam Levitan, *Public Private Competition in Payments: The Role of the Federal Reserve*, <http://ssrn.com/abstract=1420061> (arguing that in each case, the Fed serves industry interests by introducing competition into the marketplace where none would exist).

¹³⁹ *See* Wilmarth, *supra* note 52, at 1156.

¹⁴⁰ *See* Claire A. Hill & Brett McDonnell, *Disney, Good Faith, and Structural Bias*, 32 J. Corp. L. 833 (2006); *See* Edward B. Rock, *Saints and Sinners: How Does Delaware Corporate Law Work?*, 44 UCLA L. REV. 1009, 1017 (1997). This form of best-practices arguably also exists in securities law. For instance, the Sarbanes-Oxley Act provides that public companies can adopt a code of ethics for senior financial officers and have a financial expert on its audit committee, but can also opt out of these requirements. *See id.*

¹⁴¹ Many reform proposals in the insurance domain would permit insurers to select both their regulators and their choice of state common law. *See infra*, notes 297-299.

¹⁴² *See generally* Symposium, *Contractual Freedom in Corporate Law*, 89 COLUM. L. REV. 395 (1989); *Cf.* Jeffrey Gordon, *The Mandatory Structure of Corporate Law*, 89 COLUM. L. REV. 1549 (1989) (describing this view of corporate law, and arguing that mandatory rules may be desirable to allow corporation to credibly commit not to pursue opportunism).

¹⁴³ Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 401-03 (1983).

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to suspect that firms' regulatory demand would indeed promote regulatory objectives.¹⁴⁴ But unlike in banking, this regulatory role is not important in insurance. First consider regulators' direct provision of services to industry, such as the Fed's role in transactional services. Regulators need not perform such services because industry associations already do an excellent job of doing so.¹⁴⁵ The most important example is the Insurance Services Organization (ISO).¹⁴⁶ The ISO facilitates the drafting of standard insurance policies by convening drafting committees from major carriers.¹⁴⁷ It also facilitates collective data analysis by collecting loss data from member insurers and making the aggregate data available to them.¹⁴⁸ But there are numerous other examples aside from the ISO. For instance, the Coalition Against Insurance Fraud serves as a national clearinghouse for information about insurance fraud.¹⁴⁹ And the Insurance Marketplace Standards Association helps develop best practices for life insurers.¹⁵⁰

The success of industry associations in providing products and services that might not otherwise arise in the marketplace is not a coincidence. Rather, it is a product of the insurance industry's distinctive history. First, the insurance industry has been largely exempt from federal antitrust laws since the McCarran Ferguson Act was passed in 1945.¹⁵¹ This has allowed private industry associations to play a large role in identifying common issues and coordinating activities without facing

¹⁴⁴ Of course, even here it is possible that externalities and economies of scale may, in fact, mean that such services are best provided through a single monopolistic regulator. See Daniel C. Esty & Geradin Damien, *Regulatory Co-opetition*, in *Regulatory Competition and Economic Integration* (Esty & Geradin ed. 2000). But competition among regulators may produce this result if it is most efficient, as evidenced by Delaware's prominence in corporate law.

¹⁴⁵ Coordination in securities is also significantly facilitated by private associations. First, the Financial Accounting Standards Board, a private association, sets accounting rules that are adhered to in all public disclosures. See Romano, *supra* note 43100, at 2394. Second, exchanges set various trading rules that are forms of coordination. See Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations be Treated as Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151 (2009).

¹⁴⁶
¹⁴⁷ See KEN ABRAHAM, *INSURANCE LAW AND POLICY* (5th ed.).

¹⁴⁸ See *id.* Property/casualty insurers derive substantial value from these services. Aggregating loss data allows them to more accurately price their policies and evaluate their exposures to different risks, because it gives them a larger and, therefore more reliable, data set. Such data pooling would be virtually impossible were it not for the coordination of policy forms among insurers. This contributes to the accuracy of data sharing, by ensuring that the underlying loss data is relatively comparable across companies. See *id.* Moreover, it also serves the important function of increasing the predictability of court interpretation of policy language: because policy language is standardized, insurers can be relatively sure that court cases interpreting another insurer's use of that policy language will be equally applicable to them. Michelle Boardman, *Contra Proferentum: The Allure of Ambiguous Boilerplate*, 104 MICH. L. REV. 1105 (2006).

¹⁴⁹ About the Coalition, <http://www.insurancefraud.org/aboutus.htm> (last visited Aug. 10, 2009).

¹⁵⁰ Insurance Marketplace Standards Association FAQ, http://www.imsaethics.org/Content/FAQs_47.aspx (last visited Aug. 10, 2009).

¹⁵¹ Geoffrey Miller & Jonathon Macey, *The McCarran Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13 (1993).

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significant antitrust scrutiny.¹⁵² Second, insurance regulators have historically been poorly situated to facilitate industry coordination because those regulators have themselves been uncoordinated. This historical lack of coordination among state regulators helped induce the industry to develop strong and active industry associations to help individual insurers navigate the patchwork regulatory system.¹⁵³ This, in turn, has allowed industry associations to take on roles that might otherwise not be efficiently provided in markets without regulatory competition.

Second, the role of courts in filling gaps in insurance policies is not generally aimed at reducing transactions costs. Much to the contrary, the key default rule in insurance law is *contra proferentum* – that ambiguities should be interpreted against the drafter.¹⁵⁴ This is a penalty default rule that is designed to induce insurers to draft their policies more clearly, rather than a preference-matching default rule that is intended to decrease the costs of contract drafting.¹⁵⁵ Of course, the normative desirability of the *contra proferentum* rule in insurance can be, and has been, challenged.¹⁵⁶ However, most commentators conclude that the benefits of the rule outweigh its costs.¹⁵⁷ Perhaps even more importantly, a shift from the ambiguity rule would impose immense costs on the insurance industry by unsettling the set of precedents and corresponding policy forms that have evolved within that doctrinal system.¹⁵⁸ Finally, courts can provide only limited value by attempting to reduce transaction costs associated with drafting insurance policies. Insurers naturally devote an immense amount of time to drafting and redrafting their forms, which have gradually evolved over centuries. To the extent there are gaps in these contracts, those gaps are largely a result of the conscious choices of insurers, rather than a reflection of the costs of drafting.¹⁵⁹

2. Third Parties as Beneficiaries of Insurance Regulation

¹⁵² Indeed, such industry groups occasionally went too far in the past, conspiring both to fix prices in conjunction with the sharing of actuarial data and to boycott insurers who refused to move to a claims made policy form. If anything, though, these transgressions illustrate that industry groups in the insurance arena have perceived themselves as having wider authority to coordinate industry efforts (for both good and ill) than other industry associations, without antitrust scrutiny, have historically had.

¹⁵³ In addition to drafting individual policy forms, the ISO also negotiates with individual state regulators to secure regulatory approval over the new form. This process essentially allows the industry as a whole to navigate the 50-state regulatory system once with respect to policy forms.

¹⁵⁴ See Ken Abraham, *A Theory of Insurance Policy Interpretation*, 95 MICH. L. REV. 531 (1996).

¹⁵⁵ See generally Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L. J. 87 (1989).

¹⁵⁶ See, e.g., Michael Rappaport, *The Ambiguity Rule and Insurance Law: Why Insurance Contracts Should Not be Construed Against the Drafter*, 30 GA. L. REV. 171 (1995).

¹⁵⁷ See, e.g., James M. Fischer, *Why are Insurance Contracts Subject to Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. ST. L.J. 995 (1992).

¹⁵⁸ See Boardman, *supra* note 148 (describing network effects and path dependency effects that are particularly forceful in insurance and are intimately tied up with the ambiguity rule).

¹⁵⁹ See *id.*

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As noted in Part I, there is virtually no reason to expect that regulated entities would select regulators that provided the optimal measure of protections to third parties or larger social interests.¹⁶⁰ These benefits of regulation are costly to regulated entities and, unlike with consumer protections, provide them with virtually no potential benefit. This point is a familiar one from the regulatory competition literature.¹⁶¹ Indeed, the significance of systemic risk in banking has resulted in the banking regulation literature largely ignoring the possibility that banks would demand efficient regulation.¹⁶²

Unlike in banking, protecting the interests of third parties to the insurance relationship is not a central goal of insurance regulation. The reason, as Sub-Section A details, is that insurance – defined to exclude “insurance” against losses to credit risks – generally does not create substantial systemic risks. Nonetheless, as Sub-Section B explains, insurance regulation does play a role in protecting third parties and larger social interests in other ways. And insurer demand for regulation could be expected to discount this set of third party and social interests.

a. Systemic Risk

Unlike banking regulation, the regulation of property/casualty and life insurance markets is not substantially aimed at limiting systemic risk.¹⁶³ First, and most importantly, insurance failures are not particularly contagious. In fact, there is almost zero risk of contagion in property/casualty insurance markets. In banking, contagion is triggered by depositors who fear that their bank may be financially weak and therefore choose to withdraw their deposits. This can devastate even healthy banks, which keep available only a small fraction of outstanding accounts. It can also promote contagion, as depositors at other banks seek to withdraw funds for fear that their own bank is financially weak.¹⁶⁴ This dynamic

¹⁶⁰ See *supra* Part I.B.1.

¹⁶¹ Much of the debate about regulatory competition in securities law turns on the potential third party effects of securities regulation. Compare Fox, *supra* note 51, at 1342-63 with Romano, *supra* note 43, at 2380-2381. In the corporate law context, most proponents of jurisdictional competition dismiss the claim that corporate law should promote the interests of non-shareholder-stakeholders. See Ribstein article.

¹⁶² See *supra* .

¹⁶³ See *Perspectives on Systemic Risk Before the S. Comm. on Capital Markets, Insurance, and Government Sponsored Enterprises* (statement of Terry Vaughan, CEO, NAIC) (“The insurance industry is more likely to be the recipient of systemic risk from other economic agents rather than the driving force that creates systemic risk.”); Klein, *The Insurance Industry and its Regulation* 28 (“With the exception of the problems suffered by the American Insurance group and financial guaranty insurers, it is not clear that the insurance industry poses the kind of systemic risk to other markets as that posed by banks or other financial institutions.”); Richard Herring and Til Schuermann, *Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies*, 23-24, In *Capital Regulation Beyond Basel*.

¹⁶⁴ Banking regulation helps to solve this incentive for individual banks to cheat from the collective optimum by imposing solvency rules on banks. It also limits the underlying risk of a bank run by providing deposit insurance, which limits the incentives of wary depositors to withdraw their funds.

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does not exist in the property/casualty insurance realm because policyholders, unlike bank depositors, only have a right to demand payment on the occurrence of a contractually specified event. Indeed, this fact is fundamental to insurance – in order to prevent moral hazard, policy payouts must be designed so that they are not within the control of policyholders.¹⁶⁵

Life insurers are more susceptible to contagion because life insurance products often include savings vehicles from which policyholders can withdraw funds.¹⁶⁶ But even here, contagious risks are quite limited. In part, this is because most common forms of life insurance – term life insurance and basic annuities – do not permit policyholders to withdraw funds.¹⁶⁷ Even when permitted, withdrawals are often penalized.¹⁶⁸ Perhaps more importantly, policyholders conceptualize life insurance products differently than they conceptualize demand deposits in banks.¹⁶⁹ Life insurance is not meant to be a source of instant liquidity, even when withdrawals are possible. History bears these distinctions out: there has never been a run on the life insurance industry, despite occasional predictions of such runs in the popular press.¹⁷⁰ Even the near collapse of insurance giant AIG has not triggered an “insurance run” from AIG itself or from other insurers.¹⁷¹

Systemic risk is also less of a concern for insurance regulation than banking regulation because the availability and proper functioning of insurance are not systemically necessary. Unlike credit, insurance is generally not a pre-requisite to most systemically important economic activities. Indeed, many have suggested that the purchase of insurance by large public entities is itself somewhat of a mystery.¹⁷² To the extent that

This model helps to explain why the American banking system was characterized by continuous waves of bank runs until effective banking regulation was implemented in the wake of the great depression. See DAVID MOSS, *WHEN ALL ELSE FAILS: GOVERNMENT AS THE ULTIMATE RISK MANAGER* (2002).

¹⁶⁵ Tom Baker, *On the Genealogy of Moral Hazard*, 75 *TEX. L. REV.* 237 (1996).

¹⁶⁶ Elizabeth Brown, *The Fatal Flaw of Proposals to Federalize Insurance Regulation* (U of St. Thomas Legal Studies Research Paper No. 07-25).

¹⁶⁷ ROBERT JERRY, *UNDERSTANDING INSURANCE LAW* (4th ed. 2007).

¹⁶⁸ *Id.*

¹⁶⁹ Any empirical literature on how people view life insurance: maybe from context of viatical settlements?

¹⁷⁰ See Grace, *supra* note 34, at 12 (“Historically insurers did not present a real contagion to the financial system.”). Grace argues that this may no longer be true given the inter-connections between insurers and other financial institutions, like banks. Grace is surely right in that insurers can be impacted by systemic risk. They can also create systemic risk to the extent that their operations include non-traditional insurance functions, including the insurance of financial transactions. But nothing Grace says persuasively suggests that the traditional forms of insurance regulation create substantial systemic risks themselves.

¹⁷¹ This is hardly the only instance in which life insurers have avoided a run in the wake of large insolvencies. Another example is the failures of Executive Life and Mutual Benefit Life in 1991. Scott Harrington, OFC 34; Newspaper accounts of AIG.

¹⁷² See Sean Griffith and Tom Baker, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 *G'TOWN L.J.* 1795 (2007); Victor Goldberg, *The Devil*

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insurance unavailability did pose systemic concerns, ex post government intervention could relatively easily fix the problem by temporarily reinsuring the risk, or providing the insurance directly.¹⁷³ Such a program would not need to be long term because the availability of insurance is characterized not by precipitous and self-reinforcing shocks in availability (as in banking), but rather by natural cycles of availability.¹⁷⁴

Nor is the inability of an insurer to pay claims systemically significant. While insurer insolvencies can be devastating for individuals, and even communities, they tend to pose limited systemic risk because the exposure of insurers is naturally limited by their own efforts to avoid concentrated and correlated risks.¹⁷⁵ Indeed, this is why truly massive natural disasters are already not privately insured in the status quo. All flood insurance is federally provided, a significant amount of earthquake insurance is state provided, terrorism insurance is partly illusory, and nuclear hazard insurance does not exist.¹⁷⁶

b. Other Externalities

The general absence of systemic risk in insurance does not mean that addressing externalities to the insurer-policyholder relationship is irrelevant to insurance regulation.¹⁷⁷ Much to the contrary, regulations promoting the payment of liability insurance claims protect accident victims as well as policyholders.¹⁷⁸ Regulations in the property insurance sphere shield neighborhoods and families from the consequences of destroyed homes and businesses.¹⁷⁹ And the regulation of virtually all forms of insurance helps to keep individuals from relying on publicly-

Made Me Do It: The Corporate Purchase of Insurance (Columbia Law and Econ. Working Paper No. 346), available at <http://ssrn.com/abstract=1338336>. Thus, while many decried an insurance crisis in the mid-1980s, when many forms of insurance suddenly became unavailable, this crisis hardly ravaged the national or world economies. See George Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L. J. 1521 (1987). To the extent there was any systemic impact, it was on certain classes of individuals, such as doctors unable to find medical malpractice insurance, rather than on systemically important entities.

¹⁷³ There is ample precedent for such measures, most notably the Terrorism Risk Insurance Act. See Michelle Boardman, *Known Unknowns: The Illusion of Terrorism Insurance*, 93 GEO. L.J. 783 (2005).

¹⁷⁴ See Sean Fitzpatrick, *Fear is the Key: A Behavioral Explanation for the Underwriting Cycle*, 10 CONN. INS. L.J. 255 (2004).

¹⁷⁵ See generally Boardman, *supra* note 173.

¹⁷⁶ See *id.*

¹⁷⁷ See Jackson, *supra* note 134, at 336 (describing the goal of protecting third parties from externalities as a central goal of financial services regulation generally). For reasons discussed *infra*, systemic economic concerns are not included here in the goals of insurance regulation. Cf. Jackson, *supra* note 134, at 336. But the argument in the text would only be strengthened to the extent that one viewed limiting systemic risk as a goal of insurance regulation.

¹⁷⁸ See TOM BAKER, *INSURANCE LAW AND POLICY* 642 (2nd ed. 2008)

¹⁷⁹ See *id.*

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funded social insurance programs, such as bankruptcy, social security, and unemployment insurance.¹⁸⁰

Insurance regulation also serves a broader set of social interests in fairness that are not fully captured by the self-interests of consumers and insurers.¹⁸¹ For instance, regulations forbid the use of certain underwriting classifications, such as gender, race and genetics.¹⁸² Underlying these prohibitions is a judgment that people ought not to be financially responsible for certain personal characteristics. Furthermore, insurance regulation mandates certain types of coverage – such as property insurance coverage for innocent co-insureds or life insurance coverage for suicides¹⁸³ – at least partially for similar reasons. Consequently, although insurance regulation may be *less* concerned with protecting third parties than banking regulation, such protection is nonetheless an important goal of insurance regulation. And it is a goal that insurers' demand for competing regulators would ignore.

III. Regulatory Supply and the Political Economy of Insurance Regulation

The mere fact that insurers in a scheme of regulatory competition would demand a minimalist regulatory regime that imposed as few costs and constraints on them as possible does not necessarily mean that regulators would supply such a regime. Simply put, even regulators in a scheme of regulatory competition would have various incentives other than attracting customers to their regime. These include generating good publicity, currying favor from political and industry interests, avoiding public scandals and, of course, following through on their stated regulatory objectives.

The importance of these generic regulatory incentives that are independent of regulatory competition depends in large part on the number of competing regulators. As noted at the outset of Part II, regulatory demand will exert more influence over regulatory schemes as the number of competing regulators increases. As such, while regulatory demand would almost surely determine outcomes in an SLS scheme with 50

¹⁸⁰ See Ken Abraham and Lance Liebman, *Private Insurance, Social Insurance, and Tort Reform: Towards a New Vision of Compensation for Illness and Injury*, 93 COLUM. L. REV. 75 (1993) (describing the many interconnections between public and private insurance programs).

¹⁸¹ The relevance of these types of rationales for regulation depends on deep questions about one's commitments to normative analysis in law. But even from a strict welfarist perspective, fairness rationales are relevant to the extent that people have preferences for outcomes that they perceive to be fair. See Louis Kaplow & Steven Shavell, *Fairness Versus Welfare*, 114 HARV. L. REV. 961 (2001); Dan Faber, *Review Essay: What (If Anything) Can Economics Say About Equity?*, 101 MICH. L. REV. 1791 (2003). Whether "fairness" considerations ought to extend beyond this initial barrier does not substantially impact the analysis.

¹⁸² See KEN ABRAHAM, *DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY* (1986); Regina Austin, *The Insurance Classification Controversy*, 131 U. PA. L. REV. 517 (1983).

¹⁸³ See Jerry, *supra* note 65, at 28.

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competing regulators, it would almost certainly not completely dominate all other regulatory incentives in an OFC scheme, which contained only two competing regulatory schemes

In fact, defenders of the dual regulatory system in banking argue that regulators' *limited* incentive to attract competing firms tends to offset some of the more pernicious political economy features of regulation. In particular, they have argued that the dual banking system causes regulators to reduce regulatory costs and embrace innovation, whereas ordinary "monopolistic" regulators tend to shun change and embrace excess conservatism. At the same time, bank regulation remains effective, according to defenders of the dual banking system, precisely because regulators must balance the desire to attract firms with the political consequences of overseeing failed banks.¹⁸⁴

This Part evaluates these arguments in the insurance context, looking at the extent to which limited regulatory competition, such as that envisioned in the OFC, could improve the political economy of insurance regulation.¹⁸⁵ Section A begins by considering whether regulatory competition could improve the political economy of market conduct regulation and other non-solvency related forms of regulation.¹⁸⁶ First, it demonstrates that regulatory competition is neither necessary nor sufficient to address concerns about the duplicative and overlapping nature of state market conduct regulation. It then argues that regulatory competition would actually exacerbate political economy problems with market conduct regulation rather than offset those problems. Section B turns to solvency regulation, which suffers from a distinctive set of political economy problems that have resulted in an antiquated regulatory approach. But Section B argues that regulatory competition is not a good solution to these problems. It would stand in the way of the most promising approach to regulatory reform, simultaneously increasing the risk of regulatory forbearance and jeopardizing a scheme worked reasonably well in the recent financial crisis.

A. Market Conduct and other Non-Solvency Regulation

1. Duplicative and Overlapping State Regulation

¹⁸⁴ See *supra* Part I.B.3.

¹⁸⁵ This Part refrains from analyzing how a federal regulator would respond to insurer demand for deregulation because this depends almost entirely on the way in which the federal regulator was structured and who was chosen to lead such a regulator. Moreover, there is no track record, as with the states, to understand how a federal regulator would respond.

¹⁸⁶ See Klein, 37 (noting that insurance regulation can be split among three categories – market conduct, solvency, and other, which includes producer licensing, consumer information, and operating residual markets)

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The most common argument in favor of reforming insurance regulation is that such regulation is duplicative and overlapping, at least outside of the solvency context.¹⁸⁷ Market conduct exams are poorly coordinated, licenses must be acquired from multiple states, and product approvals are excessively slow and cumbersome for similar reasons.¹⁸⁸ Not only does this produce costs for the industry, but it also create inefficiencies in the regulatory process itself, as states free-ride off of each other when it comes to regulating multi-state insurers.¹⁸⁹ This Article assumes that these complaints about non-solvency state insurance regulation are legitimate.¹⁹⁰ But even so, regulatory competition is neither necessary nor sufficient to address this problem.

The duplicative and overlapping nature of state insurance regulation stems from the simple fact that insurers operating in multiple states are subject to multiple regulatory regimes. Any reform proposal that eliminated this feature of state insurance regulation would address this concern. As described in Part I, numerous reform proposals have been advanced that achieve this objective but do not introduce regulatory competition.¹⁹¹ These include proposals to create a single federal insurance regulator, to empower a federal agency to coordinate state regulation, or to require that all multi-state insurers be regulated at the federal level.¹⁹²

The reason that regulatory competition is not necessary to address this problem is that the duplicative and overlapping nature of state insurance regulation has nothing to do with the features of regulation that regulatory competition is aimed at offsetting, such as incompetence, intransigence, or excessive conservatism.¹⁹³ In fact, state regulators have pursued an aggressive agenda in the last decade to limit the structural problems created by a state regulatory system.¹⁹⁴ For instance, they have formed an Interstate Insurance Compact through which life insurers can

¹⁸⁷ See, e.g., Martin Grace & Robert Klein, *Efficiency Implications for Alternative Regulatory Structures in Insurance*, in *OPTIONAL FEDERAL CHARTERING AND IMPLICATIONS FOR INSURANCE COMPANIES*, *supra* note 7, at 58-72.

¹⁸⁸ See *id.*; Robert Klein, *The Insurance Industry and its Regulation*, in *THE FUTURE OF INSURANCE*, *supra* note 5, at 13.

¹⁸⁹ See Martin Grace & Richard Phillips, *The Allocation of Governmental Regulatory Authority: Federalism and the Case of Insurance Regulation*, 74 J. OF INS. REG. 207, 235-36 (2007).

¹⁹⁰ As noted *infra*, there are reasons to believe that state regulators have made substantial progress in this arena in the last ten years. The extent to which these efforts have effectively reduced the costs of the state regulatory system for national players in the market place is a subject for another day.

¹⁹¹ See *supra* TAN 23-25 (reviewing alternative reform proposals that do not introduce regulatory competition).

¹⁹² See *id.*

¹⁹³ See *supra* Part I.B (discussing the potential virtues of regulatory competition).

¹⁹⁴ Indeed, they have been motivated to do so, in large part, to limit the risk of federal intervention in insurance markets. In many ways, this is analogous to the way in which some scholars claim that the threat of federal preemption in corporate and securities law disciplines state regulators. See generally Roe, *supra* note

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seek product approval relatively quickly,¹⁹⁵ they have automated the document submission process to regulators by developing a single electronic filing system used by all of the states,¹⁹⁶ and they have coordinated the analysis of market conduct data as well as certain targeted multi-state investigations.¹⁹⁷ Although the effectiveness of these programs can be legitimately challenged,¹⁹⁸ they clearly demonstrate that the problem of duplicative and overlapping state regulation is not attributable to the effort or motivations of individual state regulators.

Not only is regulatory competition unnecessary to eliminate the duplicative and overlapping nature of state insurance regulation, but it is also not sufficient to achieve this objective. The American scheme of banking regulation is illustrative. Although the dual banking regime produces competition between state and federal bank regulators, neither state nor federally chartered banks are regulated by only a single entity.¹⁹⁹ In fact, a single bank may be regulated by state regulators, the Fed, and the FDIC.²⁰⁰

In sum, regulatory competition can not be convincingly defended based on claims that it would remedy the duplicative and overlapping nature of state insurance regulation. Although both the OFC and the SLS accomplish this objective, they do so not by introducing regulatory competition. Rather, they do so by subjecting multi-state insurers to a single regulatory scheme, a design element of numerous potential reforms that do not promote regulatory competition.

2. Excessive Restrictions on Insurers

Regulatory competition is often defended on supply-side grounds based on the claim that the underlying scheme of regulation tends to be excessive. Regulatory competition, from this perspective, can improve regulatory supply by offsetting this natural tendency of regulation. At the very least, it can give regulated entities a safety-valve against the worst regulatory excesses.²⁰¹ Moreover, regulators' natural inclination to over-regulate mitigates the prospect that competing regulators would go too far in promoting deregulation to attract regulatory demand.²⁰²

¹⁹⁵ Interstate Insurance Product Regulation Commission Web Site, <http://www.insurancecompact.org/index.htm> (last visited Aug. 23, 2009).

¹⁹⁶ System for Electronic and Rate Form Filing Website, <http://www.serff.com/index.htm> (last visited Aug. 23, 2009).

¹⁹⁷ Robert Klein & James Schacht, *An Assessment of Insurance Market Conduct Surveillance*, 20 J. INS. REG. 51 (2003).

¹⁹⁸ See, e.g., Grace, *supra* note 34, at 21 (arguing that “joint actions by the states are never going to be able to solve national problems regarding compliance costs and uniformity quickly and efficiently” is therefore still not clear).

¹⁹⁹ See generally Butler & Macey, *supra* note

²⁰⁰ *Id.*

²⁰¹ See *supra* Part I.B.2 (nothing this argument in the banking context).

²⁰² See *id.*

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Such supply-side arguments are common among proponents of insurance regulatory reform, who often cite price regulation in homeowners and automobile markets to argue that political forces promote excessive state regulation of insurers' market behavior.²⁰³ And a fair reading of the evidence supports these claims. Both automobile and homeowners insurance premiums are highly salient political issues in certain states.²⁰⁴ This political pressure has often generated regulatory efforts to prohibit or limit price increases in insurance markets.²⁰⁵ Yet most economic studies of insurance markets conclude that such price regulation results in premiums artificially cycling between low and high levels without decreasing consumer costs in the long term.²⁰⁶ The reason is that automobile and homeowners insurance markets are naturally quite price competitive,²⁰⁷ meaning that artificially low prices must be offset by artificially high prices or else insurers will simply refuse to write coverage in the state.²⁰⁸ This pattern not only results in artificially large price changes and volatility in the availability of coverage, but it also promotes moral hazard and adverse selection.²⁰⁹

²⁰³ See, e.g., Robert Litan & Phil O'Connor, *Consumer Benefits of an Optional Federal Charter: The Case of Auto Insurance*, in *THE FUTURE OF INSURANCE*, *supra* note 5, at 145-46; Klein, *supra* note 23, at 31; Grace & Scott, *supra* note 7, at 74 ("A key feature of the current system is strong insurance regulation by most states. Those states (and Congress) will not accept the possibility of their consumers being exposed to lax regulation by another state.").

²⁰⁴ Cummins, *supra* note 79, at 10-11 ("Auto insurance prices have been a potent political issue in legislative and gubernatorial races for decades in states such as New Jersey and Massachusetts."); Martin Grace & Robert Klein, *The Perfect Storm: Hurricanes, Insurance and Regulation*, 12 *RISK MANAGEMENT & INSURANCE REV.* 81, 105 (2009) ("The cost and availability of property insurance has been a potent issue in many coastal areas, none more so than Florida.").

²⁰⁵ See Cummins, *supra* note 89, at 10; Grace & Klein, *supra* note 204, at 105. This is hardly surprising, as state insurance commissioners are either elected or appointed by the state governor, and thus operated in a highly politicized environment. Martin Grace & Richard Phillips, *Regulator Performance, Regulatory Environment and Outcomes: An Examination of Insurance Regulator Career Incentives on State Insurance Markets*, 32 *J. OF BANKING & FINANCE* 116 (2008).

²⁰⁶ See Scott Harrington, *Effects of Prior Approval Rate Regulation in Auto Insurance*, in *DEREGULATING PROPERTY-LIABILITY INSURANCE* 285 (J. David Cummins ed., 2002); Stephen D'Arcy, *Insurance Price Deregulation: The Illinois Experience*, in *DEREGULATING PROPERTY-LIABILITY INSURANCE* 248 (J. David Cummins ed., 2002).

²⁰⁷ See Harrington, *supra* note, at 309-310.

²⁰⁸ This is particularly evident in Florida, where homeowners must increasingly purchase their coverage from a state-run insurer because so many private insurers refuse to operate in that market. See Grace & Klein, *supra* note 204, at 90. The problem may be about to get even worse, as State Farm, the leading homeowners insurer in Florida, recently announced that it is pulling out of the market altogether. See Julie Patel, *State Farm Departure Spurs Shopping for Property Insurance; Here's How*, S. FLA SUN-SENTINEL, Aug. 8, 2009 at Florida insurance regulators are actively fighting state farm's departure. See Source. The ability of regulators to prohibit insurers from exiting a jurisdiction is controversial. See generally Richard Epstein, *Exit Rights and Insurance Regulation: From Federalism to Takings*, 7 *GEO. MASON L. REV.* 293 (1998).

²⁰⁹ See Tennyson, *Efficiency Consequences of Rate Regulation in Insurance Markets* (Policy Brief, Networks Financial Institute) (2007); Harrington, *supra* note (causing them to persist at above-market rates when political pressures are low in order to compensate for times when they are forced to charge below-market rates).

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Although some states' price regulations are indeed excessive, state market conduct regulation is actually dominated by problems of precisely the opposite character. In part, this is because the significance of price regulation has generally declined across the country in the last decade. Only sixteen states currently employ the most aggressive form of price regulation, wherein insurers' pricing schemes must be approved before they are offered in the market place.²¹⁰ And with the notable exception of Florida, even those states are increasingly using this authority to ensure that rates are adequate and non-discriminatory, rather than to keep them at below market rates.²¹¹

Even more importantly, insurance market conduct regulation outside of price regulation is generally subject to political forces that lead to under-regulation rather than over-regulation. Consider regulations governing the qualifications and duties of insurance agents,²¹² the accuracy and effectiveness of disclosures,²¹³ the substance of insurance policies,²¹⁴ and the willingness of insurers to settle claims promptly and fairly.²¹⁵ In contrast to price regulation, these forms of market conduct regulation only matters to consumers who actually *use* their insurance. Yet many property/casualty and life policyholders never suffer substantial losses and so generally have no first-hand experience with these regulatory issues.²¹⁶ And when consumers do experiences losses and potentially encounter market conduct regulatory issues, those experiences are normally discrete and non-correlated, at least outside of the mass-disaster scenario.²¹⁷ Not only are most forms of market conduct regulation not politically salient, but they are also quite complex. Unlike premiums, they tend to implicate questions involving contractual and regulatory rules governing insurers and their sales force.

²¹⁰ [sonia mentioned only 16 now do this?]

²¹¹ I need more research on this.

²¹² See generally Robert W. Cooper & Mark S. Dorfman, *Producer Licensing: The Trend Toward Reciprocity in the United States and the European Union*, 21-4 J. OF INSUR. REG. 21 (2003).

²¹³ Numerous insurance regulations concern the accuracy and effectiveness of disclosures. See, e.g., *Beyond Disclosure*, *supra* note 116, at 292-93 (discussing disclosure of contingent commission arrangements).

²¹⁴ See JERRY, *supra* note 167, at 119-122.

²¹⁵ See *id.* at 122-124; Robert Works, *Coverage Clauses and Incontestability Statutes: The Regulation of Post-Claims Underwriting*, 1979 U. ILL. FORUM 809.

²¹⁶ See Schwarcz, *supra* note 70, at 1414 ("Unlike virtually any other product, the most important element of insurance policies – the protection they provide against low-probability, high-cost losses – is also an element that only a few insureds actually use or experience.").

²¹⁷ This is not an accident: insurance is specifically designed to aggregate uncorrelated individual risks losses so that they occur in predictable and steady fashion. The major exception to this involves natural catastrophes, when insurance regulatory issues can be come quite politically salient because numerous policyholders simultaneously experience a sizeable and publicly accessible loss. And, indeed, there is good reason to believe that insurance regulators tend to be less captured by industry interests in such scenarios. For instance, regulators provide more substantial dispute resolution forums, which appear to produce more consistent settlements for policyholders, in the wake of natural disasters. See Schwarcz, *supra* note 7080.

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Because the vast majority of non-solvency insurance consumer protections are complex and non-salient, they are more prone to regulatory capture and under-regulation than the excesses that characterize price regulation. The leading study of the political economy of insurance regulation concluded that industry interests historically dominate debates about regulatory issues at the state level when those issues are complex and not politically salient.²¹⁸ In this context, political forces are relatively weak, but industry interests can be quite strong, especially when the industry is relatively unified in its position.²¹⁹ This is hardly surprising, as state insurance regulators interact constantly with industry representatives.²²⁰ Even more importantly, there is also a significant amount of cross-fertilization between the industry and top state regulators, with 17% of state insurance commissioners employed in the insurance industry before becoming commissioners, and 50% of commissioners going directly to insurance industry positions after their tenure as a commissioner.²²¹ Recent research also suggests that insurance commissioners who aspire to higher office (about 8%) tend to adopt pro-

²¹⁸ See KENNETH MEIER, *THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE* 167-171 (1988). See also Randall, *supra* note 4, at 670-685 (emphasizing that industry often dominates state insurance regulation given public disinterest in insurance, the ability of industry to organize around specific regulatory preferences, and, in particular, the role of the NAIC, whose budget is dependent on the industry and which provides a central arena for coordinating lobbying efforts).

²¹⁹ Meier's excellent book reviews a number of examples of this phenomenon in depth. Consider two of the most important examples that he discusses. First, the Armstrong Committee of 1906 was formed by the New York legislature in the wake of massive publicity concerning the extravagant lifestyles of insurance industry executives. The Committee uncovered substantial abuses in the life insurance industry, leading to comprehensive reform of the life insurance business. By contrast, the Merritt Committee was formed around the same time in response to the San Francisco earthquake, which bankrupted several property/casualty insurance companies. Unlike the Armstrong Committee, insurers were able to control the agenda of the Merritt Committee in order to develop a scheme of collaborative rate-making that ultimately created a state-run system for fixing fire insurance premiums. See MEIER, *supra* note 217, at 57-64. Meier concludes that property/casualty insurers fared better than life insurers because "the Merritt Committee asked reasons why fire insurance companies failed and the Armstrong committee addressed political and economic abuses by the life insurance industry. The former, dealing with adequate rates and other technical issues, is more complex than the latter. The insurance industry was able to improve its position with the Merritt Committee because it was able to control information in a complex area." *Id.* at 84-85. Second, consider the fact that the property/casualty industry operated largely under a state-sponsored cartel during the first half of the twentieth century. Insurance rates were set by industry rate bureaus, which were minimally regulated. Such regulation permitted specified levels of underwriting profits, and excluded any investment income in calculating these profits, even though investing the float on insurance premiums is a substantial portion of the insurance business model. *Id.* at 64. It was only when antitrust charges were brought against the insurance industry, resulting in the Supreme Court case *SouthEastern Underwriters* that this model changed. Prior to that, "thirty five states filed briefs opposing the Justice Department's" position that insurance was commerce that was subject to the authority of the federal government, suggesting that "the dominant partner in the symbiotic relationship between state regulators and the insurance companies was the insurance companies." *Id.* at 66.

²²⁰ See Randall, *supra* note 4, at 677-82 (discussing interaction between industry and regulators at NAIC meetings).

²²¹ Grace & Phillips, *supra* note 205, at Table 1. The numbers in the text are adjusted so that those who are either currently in office are not counted.

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industry positions on pricing regulations to gain financial support in future political campaigns.²²²

This trend is evident in some of the most important insurance consumer protection issues of the last decade. First, industry interests have dominated debates about the public release of company-specific information. For years, consumer advocates have sought the release of data about individual insurers' market conduct practices, such as how often claims were paid within specified time periods, how often claims were denied, how often policyholders complained, and how often policies were canceled or non-renewed.²²³ Such information, while absolutely necessary to assess the relative quality of different insurance options, is almost entirely absent from the public domain.²²⁴ In 2008, under the leadership of a pro-consumer state insurance commissioner, the Market Conduct and Consumer Affairs Committee of the NAIC proposed collecting and publicly disclosing this data. Organizing through the American Council of Life Insurers, the American Insurance Association, the National Association of Mutual Insurers, and the Property Casualty Insurers of North America, the industry successfully defeated the proposal through a massive lobbying campaign.²²⁵

Second, industry interests have prevailed with respect to the use of credit scoring in insurance, which has been consistently attacked by numerous consumer groups over the last decade.²²⁶ The vast majority of automobile and homeowners insurers use consumers' credit scores to price their policies. This is not surprising, given that there is substantial evidence that individuals' credit scores correspond to their losses.²²⁷ However, it is still unclear *why* this is the case – there is limited reason to expect that consumers' likelihood of paying back loans would predict their

²²² *Id.* at 24-25.

²²³ See PROPOSAL FOR CENTRALIZED DATA COLLECTION, NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (Market Regulation Committee Proposal). Unfortunately, insurers' have bitterly resisted the proposal under the guise of confidentiality and trade secrets. See *supra* note 225.

²²⁴ See Schwarcz, *supra* note 92.

²²⁵ See Jim Connolly, *NAIC Insurer Conduct Data Scheme Riles Insurers*, NATIONAL UNDERWRITER, Sept. 25, 2008, available at <http://www.propertyandcasualtyinsurancenews.com/cms/nupc/Breaking%20News/2008/09/25-CONDUCTRULE-jc>; Chad Hemenway, *NCOIL Committee Votes Against NAIC Market Conduct Data Proposal*, BESTWIRE, Jul., 11 2008; Sean Carr, *NAIC Sets September Vote for Market Conduct Plan*, BESTWIRE, Jul. 28, 2008; Letter from Am. Health Ins. Plans, Am. Council of Life Insurers, Am. Ins. Ass'n, Blue Cross and Blue Shield Ass'n, Nat'l Ass'n of Mut. Ins. Cos., and Prop. Cas. Insurers Ass'n of Am. to Sandy Praeger, President of the Nat'l Ass'n of Ins. Comm'rs (May 27, 2008) available at http://www.naic.org/documents/committees_d_data_collection_comments_namic0527.pdf.

²²⁶ See, e.g., NATIONAL CONSUMER LAW CENTER & CENTER FOR ECONOMY JUSTICE, CREDIT SCORING AND INSURANCE (2007) available at http://www.cej-online.org/NCLC_CEJ_Insurance_Scoring_Racial_Divide_0706.pdf.

²²⁷ See FEDERAL TRADE COMMISSION, CREDIT-BASED INSURANCE SCORES: IMPACTS ON CONSUMERS OF AUTOMOBILE INSURANCE: A REPORT TO CONGRESS BY THE FEDERAL TRADE COMMISSION (July 2007) [hereinafter FTC STUDY].

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likelihood of suffering an insurance loss.²²⁸ This is significant because insurers have long been prohibited from relying on certain underwriting factors *even though* they may be predictive of losses, such as race and home value.²²⁹ Yet credit scores serve as strong proxies for these characteristics.²³⁰

Third, the insurance industry has dominated state insurance regulators' responses to insurance intermediaries' compensation arrangements. In 2004, the New York Attorney General sued several prominent insurance brokers for accepting kickbacks from insurers to whom they steered business.²³¹ Although the lawsuit resulted in the leading insurance brokers abandoning this practice, state insurance regulators have done virtually nothing to address the larger issues that the lawsuits identified, particularly in consumer insurance markets.²³² No state has passed any substantive regulations of agents' commission arrangements, and the disclosure regulations that do exist are extremely limited.²³³ New York has recently advocated for more extensive disclosure requirements, which has prompted extensive industry outcry.²³⁴

In sum, the available evidence simply does not suggest that insurance market conduct regulation as a whole can accurately be characterized as excessive. To be sure, state insurance regulation is occasionally unwarranted. But more frequently it is subject to substantial regulatory capture that produces under-regulation. Even limited regulatory competition embodied by the OFC would only exacerbate this problem, without solving any substantial political economy problems in the process.

B. Antiquated Solvency Regulation

Regulatory competition in insurance can plausibly be defended on supply-side grounds with respect to solvency regulation. Indeed, the two key elements of state solvency regulation – capital and reserve requirements²³⁵ – have remained relatively static over the last two

²²⁸ *See id.*

²²⁹ *See generally* Austin, *supra* note 181, at 528.

²³⁰ FTC STUDY, *supra* note 226.

²³¹ *See* Schwarcz, *Beyond Disclosure*, *supra* note 116, at 290. *See also* Sean M. Fitzpatrick, *The Small Laws: Elliott Spitzer and the Way to Insurance Market Reform*, 74 *FORDHAM L. REV.* 3041 (2006).

²³² *See* Schwarcz, *supra* note 92, at 291. Richard W. Cooper, *Spitzer's Allegations of the Anticompetitive Effects of Contingent Commissions: A Shot Truly Heard Around the World*, *J. OF INS. REG.* 83, 100 (2007).

²³³ *See id.*

²³⁴ National Underwriter Article (cover with dog, I think).

²³⁵ Of course, solvency regulation encompasses various other regulatory restrictions. Most notably, they impose limits on the types of assets that insurers can hold. Additionally, it includes less quantitative restrictions, such as scrutiny of insurers' management. *See generally*, Klein, Introduction to Insurance Regulation for Regulators. All solvency rules are enforced via quarterly

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decades, even though their shortcomings have become increasingly apparent during that time.²³⁶

First, state regulators have done very little since the early 1990s to modernize their approach to setting capital requirements for insurers. Currently, insurers' capital requirements are primarily determined by a risk-based formula that attempts to measure insurers' underwriting risk, asset risk, interest rate risk, and business risk.²³⁷ Various remedial measures are required when insurers fall below the requisite capital measures dictated by the risk-based formula.²³⁸ In the last two decades, though, the limits of this approach to setting capital requirements have become increasingly clear. First, it does not take into account substantial factors associated with insolvencies, including management risk and catastrophe risk.²³⁹ Second, it assigns crude ratings to different assets and liabilities that only partially reflect the actual associated risks.²⁴⁰ Third, it

and annual reports that insurers must file with state regulators, as well as by regular examinations of insurers' records to ensure the accuracy of more regular reports.

²³⁶ The current state solvency regime was largely constructed in the early 1990s, when several highly visible insurance failures forced state regulators to modernize their approach to insurance regulation. See Grace, Reexamination of Federal Regulation of Insurance, ("solvency regulation as practiced by the states as the NAIC has not been scrutinized since Congress made them do so in the late 1980s and early 1990s."). Grace, *supra* note, at 10 "solvency regulation as practiced by the states and the NAIC has not been scrutinized since Congress made them do so in the late 1980s and early 1990s."

²³⁷ There are actually three different models, one for life insurers, one for property/casualty, and one for health. See Martin Eling & Ines Horzmuller, *An Overview and Comparison of Risk-Based Capital Standards*, 26 J. INSUR. REG. 31,34 (2008). In order to be accredited, states are required to adopt the Risk Based Capital for Insurers Model Act ("RBC Model Act") or substantially similar provisions. NAIC MODEL LAWS, REGULATIONS AND GUIDELINES 312-1, § 2 (1990). The Act sets insurers' capital requirements by aggregating risk charges for an insurer's assets, liabilities, and other risks into a number that represents the level of capital required to support ongoing operations. See Pottier & Summer, *supra* note, at 4. The formula incorporates several insurer-specific adjustments, which account for factors such as the diversification of a specific insurer's portfolio and the insurer's average loss ratio for the past ten years relative to the industry as a whole. With respect to property-liability insurers, the RBC formula takes into account asset risk (stock, bond, real estate investments), underwriting risk (mispricing and/or underestimating reserves), credit risk (reinsurance), and off balance sheet risk (derivative instruments and contingent liabilities). *Id.* For life insurers, RBC encompasses asset risk, insurance or pricing risk, interest rate risk, and business risk. Robert W. Klein, *Regulating Insurer Solvency In a Brave New World* 30 (Georgia State University Center for Risk Management, Working Paper No. 00-4, 2000). Insurers' Annual Statements to regulators are completed according to Statutory Accounting Principles (SAP). These are designed to be more conservative than Generally Accepted Accounting Principles (GAAP). In particular, both assets and liabilities are valued on a liquidation basis, rather than a going-concern basis. See SEAN MOONEY & LARRY COHEN, BASIC CONCEPTS OF ACCOUNTING & TAXATION OF PROPERTY/CASUALTY INSURANCE COMPANIES 22-26 (1991)

²³⁸ For instance, while insurers who fall below the first threshold must file with a remedial plan with regulators, insurers who fall below the last threshold must be seized by insurance regulators. See Klein.

²³⁹ See Martin Eling & Ines Horzmuller, *An Overview and Comparison of Risk-Based Capital Standards*, 26 J. INSUR. REG. 31,56 (2008) This is striking given the significance of these two factors in most insurer insolvencies and the fact that other countries do include these factors in risk-based capital models. See Ashby Sharm and McDonnell, *Journal of insurance research and practice*, 18(2) 4-15

²⁴⁰ See Scott Harrington, *Capital Adequacy in Insurance and reinsurance*, in *Beyond Basel*, 104-05 (noting that NAIC's risk based capital standards are crude measures of real risk); J. David Cummins, Scott Harrington, and Robert Klein, *Insolvency Experience, risk-based Capital, and*

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does a poor job accounting for insurers' diversification and risk mitigation measures, employing a simple co-variance formula that does not credit standard hedging techniques, much less sophisticated portfolio design.²⁴¹

Reserve requirements, the second core element of insurance solvency regulation, have similarly evolved quite slowly over the last twenty years, especially with respect to life insurance. Regulations require that insurers set aside dedicated reserves to pay for anticipated losses on their policies in the future.²⁴² In the life insurance industry, the criteria that insurers must use to predict those losses are strictly specified by regulators.²⁴³ Yet life insurance products have evolved dramatically in the last decade as life insurers have increasingly competed with banks and securities firms to develop capital accumulation products.²⁴⁴ Regulators' formulaic rules for establishing reserves do not come close to keeping up with this rapid pace of product development.²⁴⁵ Regulations governing reserves can consequently be both over- and under- inclusive: they sometimes damage life insurers' capacity to compete with other financial services firms by requiring excessive reserves, and they sometimes create large insolvency risk by requiring inadequate reserves.²⁴⁶

Embracing an OFC or other scheme of limited regulatory competition is one plausible approach to inducing more rapid modernization of solvency regulation. A key benefit of regulatory competition is that it tends to improve regulators' responsiveness to industry needs and incentives to embrace innovation.²⁴⁷ An OFC, for instance, might well prompt state and federal regulators to more quickly develop appropriate solvency requirements for new products, as failing to do so could mean losing the "business" of insurers.²⁴⁸ Similarly, it might prompt competing federal and state regulators to develop more sophisticated tools for setting capital requirements, which take into account the diversification of insurers' portfolios and their exposure to catastrophe and operational risk.

Prompt Corrective Action in Property-Liability Insurance, 19 *Journal of Banking and Finance* 511 (1995) (finding that the predictive accuracy of RBC formula for property-casualty companies is low, and proposing several modifications that could improve its accuracy).

²⁴¹ See Herring and Schuerman, in *Beyond Basel*, at 30 (noting that rules-based systems for setting capital standards "do not take into account the diversification benefits achieved through less than perfect correlation (the so-called portfolio effect)"; *id.* at 38 (describing ways in which NAIC RBC approach does, and does not, take into account diversification).

²⁴² See Larry Bruning, *Principles Based Reserving: A Regulator's Perspective*

²⁴³ See *id.*

²⁴⁴ See Peter Wallison, *Convergence in Financial Services Markets: Effects on Insurance Regulation*, in Grace and Klein; Elizabeth Brown, *The Fatal Flaw*, *supra* note xx, at yy..

²⁴⁵ See *id.*; see Bruning.

²⁴⁶ See Wallison.; see Bruning.

²⁴⁷ See *supra* TAN xx-yy.

²⁴⁸ Do Grace and Klein make this argument in "The effects of an optional federal charter for the life insurance industry.?"

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Regulatory competition nonetheless does not represent an attractive option for improving state solvency regulation. First, and most importantly, regulatory competition is fundamentally incompatible with the most promising *substantive* approach to improving solvency regulation, a principles-based solvency paradigm. A principles-based approach to solvency regulation deemphasizes prescribed formulas and requirements, shifting regulatory attention to *the internal process* by which firms set their reserves and capital levels.²⁴⁹ This approach has numerous potential benefits. First, it harnesses the experience and sophistication of firms.²⁵⁰ Second, insurers generally derive measures for capital and reserves as part of creating new products, so regulation could more easily keep up with innovation.²⁵¹ Third, internal models are specifically designed to take diversification into account.²⁵² Finally, it is possible that relying on insurers to derive these values will create internal forces within insurers to manage risk more effectively, thereby aligning the interests of regulators and insurers.²⁵³ In recognition of these benefits, state insurance regulation has gradually been moving to a principles-based approach to solvency regulation in the last several years.²⁵⁴ A similar movement towards principles-based regulation is a fundamental component of international reform in banking regulation, although the desirability of such reform is substantially more controversial than in insurance given the major systemic risks associated with banking.²⁵⁵

Like any regulatory approach, a principles-based solvency scheme also has several important drawbacks. Primary among these is the fact that the effectiveness of a principles-based solvency regime is dependent

²⁴⁹ See Theresa Vaughan, *The Implications of Solvency II for Regulation 3-5* (Policy Brief, Networks Financial Institute) (2009). Unlike American regulators, insurance regulators in the European Union are on the cusp of embracing this more fluid approach to determining capital requirements, in a project known as Solvency II. As Vaughan notes, a principles based and rules based approach to solvency regulation are not mutually exclusive. Indeed, Vaughn advocates for a principles based approach that is back-stopped by a more rules based approach. This is a sensible proposal that is not at odds with the material in the text.

²⁵⁰ Herring and Scheurman, *supra* note xx, at 33 (permitting the supervised use of internal models is “an implicit recognition of the complexity and the fast pace of innovation in financial instruments and institutions, where any rule written to set capital charges for a given set of instruments may spur innovations to reduce or avoid the charge. Only an internal models approach is likely to be able to address the portfolio of risks comprehensively and dynamically”).

²⁵² See Herring and Scheurman, *supra* note xx, at 30.

²⁵³ See *id.* (quoting Hendricks and Hirtle, who emphasize this point).

²⁵⁴ First, the NAIC has just recently [fill in update on principles based reserving]. Second, state insurance regulators have slowly introduced a principles-based approach into their risk based capital requirements. For instance, the NAIC has implemented limited programs to rely on internal models for assessing interest rate risk on fixed annuities in 2000, and variable annuities in 2005 Vaughan, *supra* note , at 7-8.

²⁵⁵ The extent to which US banking regulation will incorporate elements of Basel II is currently unclear, especially in the wake of the financial crisis. See Macey Miller & Carnell, 272-73. The case for principles-based solvency regulation in insurance is much stronger than the case for using such an approach in banking, as banking implicates various systemic risks that are largely absent in the insurance arena. See Harrington, & Herring & Schuerman. For an explanation of why the insurance industry creates limited systemic risk, see *supra*.

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on regulators' sophistication, experience, and willingness to interrogate insurers' assumptions and internal models. The primary task of regulators in a principles-based solvency scheme is to ensure that firms' complex internal models and risk management practices meet broad regulatory principles and are based on sound assumptions. To do this, of course, regulators "have to understand how those risks are modeled and make judgments at whether they are modeled adequately."²⁵⁶ By contrast, the rules-based solvency regulation of the last twenty years makes both capital and reserve calculations largely formulaic, mitigating the burden on regulators to understand and closely scrutinize individual insurers' models.²⁵⁷

This downside to principles-based regulation can potentially be managed in a "monopolistic" regulatory scheme through the use of rules-based safeguards and gradual implementation.²⁵⁸ But a scheme of regulatory competition would substantially amplify this downside of principles-based regulation. Regulatory competition is *specifically designed* to put pressure on competing regulators to innovate quickly. Such pressure would undermine the capacity of regulators to carefully study insurers' individual internal models and approaches to risk.²⁵⁹ Perhaps even worse, regulatory competition would substantially decrease regulators' leverage with individual insurers in negotiations regarding their capital and reserve levels. Because insurers would always have the option of switching between federal and state regulators even in a limited scheme of regulatory competition such as the OFC, regulators would enjoy a reduced capacity to insist on revisions to internal models' designs and assumptions. Regulatory competition would put insurers in the driver-seat of negotiations, even though principles-based reregulation necessitates precisely the opposite.²⁶⁰

The second key reason that regulatory competition does not represent an attractive option for improving state solvency regulation is

²⁵⁶ See Vaughan, at 16.

²⁵⁷ A Regulators' perspective on principles based reserving, at 4 (noting that rules-based approach to setting reserves has the benefit of "clarity and specificity" meaning that "regulators have a good understanding of just how reserves are calculated" by insurers) ; Eling and Holzmuller, at 54 (The US system [of RBC] has relatively strict rules with clear sanctions..."); *id* at 53 (noting that a solvency scheme that permits insurers to use internal models to set capital levels means that regulators need more resources to review different sophisticated models).

²⁵⁸ In order to ensure that capital requirements are not thereby set "unreasonable low, particularly given the lack of experience in applying internal models in this context," the NAIC has combined this with rules-based safeguard. *Id*.

²⁵⁹ See Vaughan.

²⁶⁰ See Vaughn, *supra* note at 16-17. Vaughn quotes a lecture from Avenish Perasaud in which he argues that complexity increases the risk of regulatory capture. Perasaud notes that "Regulatory capture is ... much more subtle and sophisticated than in the past. It's not about bribery and corruption of officials... It's about big business persuading regulators about certain principles that seem eminently reasonable, although on further examination I believe are hollow and bankrupt; principles that the regulators grab hold of and believe are right, but actually ultimately support big businesses and the regulated." See *id.* at note 22.

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that it would increase the problem of regulatory forbearance. As firms find themselves in financial trouble, regulators have strong incentives to defer aggressive intervention in the hopes that the firms' prospects will turn around.²⁶¹ Although such forbearance can appear attractive to regulators because of the salience and political costs of seizing a failing financial institution, it can substantially exacerbate the ultimate costs of financial failure. Such regulatory forbearance is a well-known problem associated with virtually all solvency regulation. But researchers have found that it is a particularly large problem in the state-based insurance system.²⁶²

Regulatory competition would exacerbate the risk of such forbearance. For the reasons described in Part II – and reserving for now the prospect that appropriately-designed guarantee funds could change matters – insurers would generally be less likely to choose a regulator with a strict reputation for shutting down insurers who run into financial trouble. It is perhaps for this reason that banking regulation seeks to limit the risk of regulatory forbearance by eliminating regulatory competition with respect to the decision of whether to shut down a bank, relying almost exclusively on a single agency – the FDIC – to close a bank in financial distress.²⁶³

The prospect that regulatory competition would exacerbate regulatory forbearance would be even starker in a principles-based solvency regime. Such a regime limits the possibility of effective prompt corrective action requirements, which constrain regulators' discretion to forbear by requiring intervention when firms' capital levels fall below specified benchmarks. This is because principles-based solvency regime means that insurers' risks would not be measured on commensurate scales, but rather on individualized scales that were the result of individually designed models. Without a commensurate scale for measuring risk, it would be impossible to designate specific times at which specific types of intervention would be appropriate.

The third, and final, problem with embracing regulatory competition as a mechanism to modernize solvency regulation is that doing so would jeopardize a regime that appears to have functioned quite well in the recent financial crisis. Virtually every major insurer has

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²⁶² See Grace, Philips and Klein, Why do Insurance Company Failures Cost so Much, at 23 (2007) (finding that “an order of liquidation is the first formal regulatory action take against over half of the insurers in our sample”). This is true even though risk-based capital rules mimic banking rules in attempting to limit regulatory forbearance by establishing prompt-corrective action rules that mandate regulatory intervention when risk based capital levels fall below pre-specified levels. See generally Theresa Vaghan, The Implications of Prompt Corrective Act for Insurance Firms (2008); Cummins, Harrington and Klein, Insolvency Experience, risk-based capital, and prompt corrective action in property-liability insurance, Journal of banking and insurance (1995). Interestingly, the risks of forbearance are reduced when insurers operate in multiple states. See Willenborg (2000);

²⁶³

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maintained its financial health in the last several years.²⁶⁴ Although AIG imploded, requiring a massive federal bailout, it was actually AIG's Credit Default Swap activities, rather than its insurance operations, that drove AIG to the brink of collapse.²⁶⁵ To be sure, part of the industry's success is attributable to market discipline, which encouraged insurers to maintain conservative portfolios in order to safeguard their ratings.²⁶⁶ But solvency regulation's role in this success also cannot be easily dismissed, given that market discipline seems to have been insufficient to deter firms like AIG from adopting high-risk approaches and that executive compensation arrangements in the insurance industry are quite similar to the arrangements that seem to have induced excessive risk taking in other segments of the economy. Risk aversion, which is a guiding principle of most forms of solvency regulation, suggests that policymakers should be hesitant to radically alter a system that is achieving its basic goals, even if it may be doing so inefficiently.

IV. Regulating the Regulatory Market

Parts II and III suggest that regulatory competition in insurance will create both “demand-side” and “supply-side” forces that promote excessive deregulation and perhaps even a “race to the bottom.” Like all markets, though, regulatory markets can themselves be regulated in order to harness the benefits, but limit the costs, of competition. In some cases, this regulation can operate on regulatory supply, by limiting the ability of competing regulators to deregulate beyond a certain point. For instance, bank regulation removes particularly sensitive regulatory issues – such as

²⁶⁴ See Grace, *supra* note, at 1-2 (“The Insurance sector has, so far, escaped serious financial problems resulting from the financial crisis. Life insurers’ bond and equity portfolios are now valued lower and there have been rating downgrades in the life business... Property-casualty insurers as a group are also relatively immune from the crisis as most p-c contracts are short term in nature and are less likely to become insolvent due to changes in their investment portfolio’s value.”). , at 1-2 (“One can argue that the current state based system did an excellent job of protecting insurers’ consumers and, to some extent, their stockholders, especially when superficially compared to the federal banking regulators.”).

²⁶⁵ Insurance regulators had no jurisdiction over these activities, as federal regulators pressured state insurance regulators to issue an opinion letter in 2000 declaring that CDS’s did not meet the definition of insurance. *Hearing to Review the Role of Credit Derivatives in the US Economy Before the H. Comm. on Agriculture* 111th Cong. (2009) (statement of Eric Dinallo, Superintendent of the New York State Insurance Department). In fact, AIG’s primary strategy in seeking to payback its bailout funds has been to sell off its financially healthy insurance companies. Edmund L. Andrews, *AIG Says Revamping Could Take 3 to 5 Years*, N.Y. TIMES, May 13, 2009, at B4. See Robert O’Harrow Jr. & Brady Dennis, *Credit Rating Downgrade, Real Estate Collapse Crippled AIG*, L.A. TIMES, Jan. 2, 2009. A recent article raises the prospect that AIG’s insurance operations are also on shaky financial ground. See Mary Williams Walsh, *After Rescue, New Weakness Seen at A.I.G.*, N.Y. TIMES, July 31, 2009 at A1. The NAIC has asserted that the Article contained “incomplete and misleading information” and that “the 71 state-regulated insurance entities within AIG are financially sound and are fully able to pay claims.” NAIC, AIG: NAIC FOCUSED ON FIDELITY TO THE FACTS RELEASE (Released, July 31, 2009).

²⁶⁶ See Harrington. -Harrington argues there is a lot of market discipline given that life insurers curtailed asset risks in 90s when problems arose (104) and most insurers have very high rbc ratios (104). Also, guarantees are limited in many states and in all states not more than 300K.

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reserve requirements and regulatory takeovers – from the jurisdiction of competing regulators altogether. Similarly, the proposed Consumer Financial Products Authority (CFPA) would safeguard against the risk of a race to the bottom by setting a regulatory floor for all firms.²⁶⁷ In other cases, “regulation” of regulatory markets is designed to operate on regulatory demand, by inducing firms to choose more effective regulators. This, for instance, is one justification for risk-based deposit insurance in banking or for inducing firms to issue subordinated debt instruments.

This Part considers these, and other, potential avenues for “regulating” regulatory competition in insurance. It demonstrates that many of these approaches would face substantial hurdles, whether they were implemented in an SLS, OLC, or other form of regulatory competition in insurance. Replicating the structure of Part III, Section A addresses regulatory competition with respect to market conduct regulation and other non-solvency based regulation. Attempts to improve regulatory competition in this arena generally operate on regulatory supply by limiting the discretion, or authority, of competing regulators. Part A argues that such safeguards would ultimately enjoy only limited success improving outcomes in regulatory markets. Part B turns to solvency regulation. In this domain, efforts to improve the results of regulatory competition generally operate on the demand side of regulatory markets, seeking to improve insurers’ incentives to select socially desirable regulators. Part B argues that such efforts are not likely to prove effective.

A. Consumer Protection Safeguards

1. Insurance and a Consumer Financial Products Authority

One of the key elements of the Obama Administration’s regulatory reform proposals is to create a CFPA that would set federal floors for different banking products through administrative rulemaking.²⁶⁸ The core rationale of the CFPA is to create a single agency, not subject to the forces of regulatory competition or arbitrage, to set a regulatory floor for consumer protection issues. Although there are good reasons to be optimistic about the CFPA’s prospect for success with respect to the regulation of credit products, extending its jurisdiction to traditional insurance markets would only partially counter-balance the impact of

²⁶⁷ See Bar-Gill & Warren, *supra* note at 170 (explaining that rationale for a CFPA is based on the fact that all existing agencies either do not have the motivation to protect consumers, because they compete to attract banks, or do not have the power to do so).

²⁶⁸ See generally Consumer Financial Protection Agency Act of 2009, *supra* note 71. Although the CFPA would have jurisdiction over credit insurance products, it does not have jurisdiction over traditional insurance markets. See *id.*

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regulatory competition in insurance markets, especially in the property/casualty context.²⁶⁹

a. Discretion and Consumer Protections

In order to prevent a race to the bottom in consumer protection, a super-regulator such as the CFPB must be able to set a regulatory floor that effectively constrains competing regulators' discretion.²⁷⁰ This is not a substantial obstacle when the regulatory floor can be expressed as a clear rule rather than a broad standard.²⁷¹

Whereas standards inherently give lawmakers substantial discretion, rules limit that discretion.²⁷² In fact, various consumer protections in banking are better characterized as rules rather than standards. For instance, minimum product standards could ban the use of mandatory arbitration provisions. Similarly, disclosure requirements could mandate prominently noting the number of weeks required to pay off a loan if minimum payments are made. These types of minimum product standards and disclosure requirements are at the core of the proposed CFPB's role in the Obama plan to overhaul financial regulation.²⁷³

By contrast, a CFPB would face various hurdles in attempting to constrain the discretion of competing insurance regulators because many market conduct consumer protections in insurance are peculiarly dependent on standards. Consider product regulation, which is common in insurance.²⁷⁴ Unlike in most financial markets, the regulation of policy language cannot be fully disentangled from the way that insurers apply that language in individual settings.²⁷⁵ This is because insurance policies

²⁶⁹ This does not mean that the jurisdiction of the CFPB should not be extended to cover traditional insurance markets. Rather, it simply means that any such authority cannot be understood as an effective safeguard against regulatory competition.

²⁷⁰ See Bar-Gill & Warren, *supra* note

²⁷¹ See generally Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 611 (1992).

²⁷² *Id.* at 610.

²⁷³ See generally Consumer Financial Protection Agency Act of 2009, *supra* note 71. See *The Proposed Consumer Financial Protection Agency: Implications for Consumers and the FTC: Hearing Before the H. Comm. on Energy and Commerce 111th Cong. 3* (2009) (testimony of Prentiss Cox, Associate Professor, University of Minnesota) ("Enforcement of consumer protection laws and rule-making for consumer protection are different activities that require different models to be effective. Unified rule-making authority in an agency dedicated to consumer protection goals presents an extraordinary opportunity to reform the consumer finance system to ensure products and sales practices that meet minimum standards of fairness for consumers. Public enforcement, on the other hand, is best accomplished in an open model; a system that allows multiple public entities the opportunity to gauge compliance.").

²⁷⁴ Indeed, the Interstate Insurance Compact already devises rules that apply to the products of all participating insurers. See INTERSTATE INSURANCE PRODUCT REGULATION COMMISSION, *supra* note 80.

²⁷⁵ Jackson, *supra* note 134, at 330 ("Contingent liabilities differ from fixed-return deposits or interests in investment pools in that the value of contingent liabilities cannot be determined without

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themselves often use standards rather than rules in defining insurers' contractual obligations, incorporating concepts such as fault, diligence, and harm.²⁷⁶ Insurers consequently retain substantial discretion about whether to pay many claims, at least in property/casualty markets.²⁷⁷ As such, regulators must inevitably exercise discretion in regulating this process. Thus, they must assess whether the insurer failed to pay claims without conducting a *reasonable* investigation; attempted to make *unreasonably* low settlement offers; failed to approve or deny a claim within a *reasonable* time period after a proof of loss has been submitted; or failed to effectuate *prompt, fair and equitable* settlement of claims submitted in which liability has become *reasonably clear*.²⁷⁸

Claims handling regulations are not the only forms of market conduct regulation in which the distinctive features of property/casualty insurance result in regulators inevitably retaining discretion in the consumer protection arena. Another example involves regulators' operation of complaint services, which are often substantial.²⁷⁹ These services provide consumers with information tailored to their particular situation.²⁸⁰ Even more importantly, they provide consumers with the prospect of a potentially quick and low cost dispute resolution service.²⁸¹ Both of these services obviously involve the use of a tremendous amount of discretion by regulatory employees, who must listen to each consumer's particular circumstances, assess the information they need and whether to initiate a conciliation process with the insurer, and then deliver upon that assessment.²⁸²

A third domain in which insurance regulators inevitably possess discretion involves the regulation of suitability rules.²⁸³ Suitability rules apply to the sale of variable annuity products, and require insurers and producers to use "reasonable efforts" to obtain relevant information about their customers, including information that a "reasonable" policyholder

reference to unrelated events. In other words, the value of contingent liabilities does not depend on the performance of the issuing intermediary's assets or the terms of the investment contract itself. Fire and life insurance policies are classic examples of contingent liabilities.").

²⁷⁶ See Standard Homeowners Insurance Policy & Standard Commercial General Liability Policy, reprinted in TOM BAKER, *INSURANCE LAW AND POLICY* (2nd ed. 2008).

²⁷⁷ See KENNETH S. ABRAHAM, *DISTRIBUTING RISK* 174 (1986) ("[I]nsurance policies often are not specific enough to make the rights and obligations of the parties during the claims process crystal clear."); Abraham, *supra* note 154, at 547-50.

²⁷⁸ See, e.g., OFFICIAL NAIC MODEL UNFAIR CLAIMS SETTLEMENT PRACTICES ACT § 6 (1980). See generally KATHLEEN HEALD ETTLINGER ET. AL., *STATE INSURANCE REGULATION* 103 (1st ed. 1995).

²⁷⁹ See generally Schwarcz, *supra* note 81, at 750-59.

²⁸⁰ See *id.*

²⁸¹ See *id.* Although I argue in *Redesigning Consumer Dispute Resolution* that these services could be vastly improved, they nonetheless provide consumers with a substantial benefit given the relative inaccessibility of other dispute resolution services in the status quo.

²⁸² See *id.*

²⁸³ These three examples are not intended to be exhaustive. Much to the contrary, numerous other examples could be imagined. For instance, regulations governing rescissions and policy cancellations also give insurance regulators a substantial amount of discretion.

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would find helpful.²⁸⁴ Insurers must design and implement a system to supervise recommendations that is “reasonably designed to achieve compliance” with these rules.²⁸⁵ Unlike the above examples, the discretion involved in suitability rules stems from the discretionary nature of determining when a particular product is appropriate for a particular consumer. Although that discretion exists with respect to certain banking products as well, suitability rules do not exist in banking regulation in part because of the partially-discredited idea that banks themselves do not have an incentive to sell customers unsuitable products.²⁸⁶

b. Linkage between Consumer Protection and Solvency Regulation

One of the key assumptions of a CFPA is that traditional consumer protection can be disaggregated from solvency regulation. In fact, many have claimed that the two regulatory functions work against one another in the banking arena, as the “mission to protect the safety and soundness of the banking system ... means protecting banks’ profitability.”²⁸⁷ Yet banks’ profitability may well be due, in part, to their exploitation of consumers.²⁸⁸

This logic is counter-balanced in the insurance context by the fact that consumer protection issues are importantly linked to the process of solvency regulation. This link goes in both directions. First, consumer protections aimed at either pricing or form regulation can substantially impact solvency regulation, particularly in the life insurance sphere. Solvency regulation in life insurance is distinctive from such regulation in property/casualty insurance because payouts typically occur far from the time that the policy is purchased.²⁸⁹ Solvency regulation helps to ensure that, as claims are made, the insurer has sufficient liquid funds to pay those claims.²⁹⁰ The technical details of a life insurer’s products therefore very much influence the substance of the appropriate solvency restrictions.²⁹¹ If, for instance, an insurer has sold products that are likely to produce substantial claims in ten years, then solvency regulation must

²⁸⁴ NAIC MODEL LAWS, REGULATIONS AND GUIDELINES 275-1, § 6 (1990).

²⁸⁵ *See id.*

²⁸⁶ *See* McCoy & Engel, *supra* note 69, at 1286. Although the recent financial crisis does indeed suggest that lenders may well have an incentive to sell unsuitable products to borrowers, there are other plausible routes for dealing with this besides suitability requirements. The Obama Administration’s regulatory overhaul would partially deal with this by limiting the amount of risk that lenders could offload via securitization. *See* Summers & Geithner, *supra* note 2.

²⁸⁷ Adam J. Levitin, *Hydraulic Regulation: Regulating Markets Upstream* (Georgetown Public Law Research Paper No. 1259046, 2008); Bar-Gill & Warren, *supra* note; Heidi Mandanis Schooner, *Consuming Debt: Structuring the Federal Response to Abuses in Consumer Credit*, 18 LOYOLA CONSUMER L. REV. 43, 48 (2005).

²⁸⁸ *Id.*

²⁸⁹ *See* Klein, *supra* note 237, at 10-49.

²⁹⁰ *See id.*

²⁹¹ *See id.*

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ensure that assets sufficient to cover those claims are invested in such a way that they will be available in ten years. In sum, the details of consumer protection regulation can substantially impact solvency regulation, making it sensible to keep these two regulatory functions together.²⁹²

At the same time, the process of solvency regulation can often inform traditional consumer protection issues.²⁹³ Insurers with financial problems often begin to have market conduct problems as well.²⁹⁴ They may delay payments because of liquidity constraints.²⁹⁵ They may deny legitimate claims in an attempt to regain a financial footing. And they may non-renew large numbers of policyholders. Regulators are more likely to observe and proactively respond to these consumer protection issues when they also perform solvency review, and are therefore well attuned to an insurer's financial health.²⁹⁶

2. Judiciary as an External Safeguard

A second important way that a race to the bottom in consumer protection might be avoided is by entrusting a judicial system that is insulated from the pressures of regulatory competition with the ability to protect consumer interests when regulators fail to do so. The extent to which reform proposals rely on this judicial safeguard varies. Some reform proposals do not explicitly address the issue, leaving in place the current choice of law rules for insurance.²⁹⁷ These rules generally provide that the governing law is the law where the underlying contract is entered into, but do not explicitly forbid choice or law of choice of forum clauses.²⁹⁸ By contrast, the SLS proposal explicitly permits choice of law clauses, but also would permit states to over-ride this rule in order to

²⁹² See *Regulatory Restructuring: Enhancing Consumer Protection* (statement of Gary E. Hughes, Executive Vice President and General Counsel, American Council of Life Insurers), *supra* note 93.

²⁹³ From Klein, 41, "It should be noted that while financial regulation and market regulation are often discussed separately, there are necessarily intertwined. The regulation of an insurer's financial condition and risk has implication for its market practices, and vice versa."

²⁹⁴ See Schwarcz, *supra* note 81, at 799-802;

²⁹⁵ see Klein, A regulator's introduction to the insurance industry, at 159 ("An increase in consumer complaints, for example, may reveal that an insurer is delaying the payment of claims because of financial problems.").

²⁹⁶ See *id.* at 161 ("insurance departments have made greater efforts to coordinate information from their market conduct and solvency units").

²⁹⁷ See, e.g., National Insurance Consumer Protection Act. H.R. 1880, 111th Cong. (2009).

²⁹⁸ See generally Jerry, *supra* note 167. Although broad choice of law clauses are uncommon in consumer insurance policies, this could obviously change under a scheme of regulatory competition. Indeed, one explanation for the status quo is that state regulators do not, or would not, permit such broad choice of law clauses under their general authority to regulate forms. See Steven Baker, *Foreign Law Between Domestic Commercial Parties: A Party Autonomy Approach with Particular Emphasis on North Carolina Law*, 30 CAMPBELL L. REV. 437, 456-57 (2008) (discussing choice of law clauses in insurance policies).

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safeguard against a race to the bottom.²⁹⁹ A more direct approach to using the judiciary to safeguard against a race to the bottom could explicitly prevent choice of law and forum clauses in insurance policies.

Although consumer protections in insurance law can be, and are, enforced by the judiciary, these rules are inherently limited in the extent to which they can protect insurance consumers.³⁰⁰ This is particularly true with respect to policyholders' capacity to challenge claims delays, adverse coverage decisions, and the sale of unsuitable products. In each of these cases, any cause of action would only be possible after the insured faced a loss and was not provided with coverage. But purchasers of insurance face numerous unique and intractable obstacles in such situations. Class actions are often unavailable for coverage disputes given their context-specific nature,³⁰¹ claimants have an immediate need for cash and are generally risk averse,³⁰² insurers can (and do) ignore complaints until they mature into credible litigation threats,³⁰³ and insurers enjoy significant strategic advantages from their repeat-player status.³⁰⁴ Moreover, the current Alternative Dispute Resolution options that exist are quite limited in their effectiveness.³⁰⁵

Resort to judicial regulation is also very difficult for numerous other regulatory issues, such as policy non-renewals, cancellations and price increases, which typically involve small dollar amounts. Although these regulatory issues can be aggregated into class actions when they involve changes in an insurer's overarching practice, they often involve disputes over the specific application of a standard to a particular consumers' factual situation.³⁰⁶ These regulatory issues cannot be aggregated into class actions.³⁰⁷ It is therefore not particularly surprising that the empirical evidence finds that the prevalence of insurance class actions in a state is generally unrelated to the magnitude of insurance regulation in that state.³⁰⁸

²⁹⁹ They would require four pre-requisites to such opt out: "(1) any state override must be by the legislature; (2) the override only applies if enacted in a state where policies are sold; (3) the override is effective only as to policies sold after the legislation is enacted; and (4) the insurer has a clear right to exit the state." Butler & Ribstein, *The Single License*, *supra* note 9, at 40.

³⁰⁰ See generally Schwarcz, *supra* note 81, at 746-50.

³⁰¹ Most insurance-related class actions concern non-claims issues, such as the calculation of premiums or the selling of policies. See Eric Helland & Jonathan Klick, *The Tradeoffs Between Regulation and Litigation: Evidence from Insurance Class Actions*, 1 J. TORT L. 17 (2007), (collecting instances of insurance class actions in recent years). There are exceptions, like the non-original equipment manufacturer parts class action. See *id.*

³⁰² See Schwarcz, *supra* note 81.

³⁰³ Hyman, Silver, and Black, *Untitled Draft* (on file with the author).

³⁰⁴ See Schwarcz, *supra* note 81.

³⁰⁵ See *id.*

³⁰⁶ See *supra*.

³⁰⁷ A core requirement for a class action is that common issues predominate. See generally

CHARLES ALAN WRIGHT & ARTHUR RAPHAEL MILLER, *FEDERAL PRACTICE AND PROCEDURE* (2009).

³⁰⁸ See Helland & Klick, *supra* note 301.

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Judicial regulation has also proven to be a problematic strategy for regulating insurers' policy forms. Several doctrines of insurance law, most notably the reasonable expectations doctrine, provide courts with a doctrinal tool to perform this ex post regulation of policy terms.³⁰⁹ But most courts refuse to take advantage of this doctrinal route, and not without reason.³¹⁰ Although the ex post regulation of insurance policy terms could be disciplined by a more specific doctrinal framework, the currently available frameworks give courts too little guidance about when and how to alter policy terms.³¹¹ This leaves courts prone to over-reach in regulating policy terms, especially given the ordinary dynamic of insurance coverage litigation, which involves a sympathetic plaintiff and a deep pocket defendant in the business of paying people who have suffered losses. Most courts have attempted to resolve this problem simply by prohibiting ex post regulation of policy terms, except in specific and narrowly defined contexts.³¹²

B. Solvency Regulation and Guarantee Funds

Guarantee funds represent a central potential mechanism for improving the prospect that regulatory competition will generate enhanced solvency regulation.³¹³ First, well-designed guarantee funds may improve *regulatory supply* by acting as a type of product warranty.³¹⁴ If competing jurisdictions are required to guarantee payment when an insurer that they regulate becomes insolvent, they will have a stronger incentive to supply effective solvency regulation.³¹⁵ Of course, this incentive is hardly perfect, as the political actors who set regulatory policy may not fully internalize that expected cost of such a guarantee. But such actors will at

³⁰⁹ See Schwarcz, *supra* note 70, at 1426.

³¹⁰ See *id.* at 1426-35.

³¹¹ See *id.*

³¹² See *id.*

³¹³ Other potential mechanisms exist to limit the risk of excessive deregulation in a scheme of regulatory competition. For instance, insurers could be required to maintain a minimum market rating from private rating agencies, such as Best's and Moody's. See Butler & Ribstein, *A Single-License*, *supra* note. Of course, the reliability and neutrality of private rating agencies has recently been thrown into doubt in the wake of the financial crisis. Additionally, private entities do not have the same authority that regulators have to gather certain information. Finally, and perhaps most importantly, rating agencies do not have the authority to demand increased safeguards from insurers as they start to become financially vulnerable. Simply setting a minimum financial rating would allow an insurer to conduct its business however it wished until its rating fell below the requisite level. Yet solvency regulation is often most effective when regulators intervene early, before a firm has experienced substantial financial harm. A second option would be simply to rely entirely on market discipline in the solvency arena.

³¹⁴ See Bert Ely, *Optional Federal Charter*,

³¹⁵ Macey and Butler argued that banking regulation can lead to a moral hazard by state regulators because state banks receive federal insurance via the FDIC. See *id.* Ely says this too.

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least face some political pressures from within their jurisdictions to limit this contingent risk.³¹⁶

Second, guarantee funds may also improve *regulatory demand* if the insurers who select a competing regulator are required to contribute to the cost of that regulator's guarantee. Such contributions can be charged *ex ante*, through insurance premiums, if those premiums reflect an accurate estimate of the expected costs of supplying the guarantee. They can also be charged *ex post*, after a covered insurer becomes insolvent. Although it is easier to charge firms for the actual costs of insolvencies in a post-assessment scheme, insurers that embrace a risky strategy may discount this cost based on the prospect that they will be the firm that becomes insolvent.

Unfortunately, guarantee funds are unlikely to supply either of these benefits in either an SLS or OFC scheme of regulatory competition. Unlike approaches to regulate the market conduct outcomes of regulatory competition, the problems with guarantee funds are particular to each scheme of regulatory competition.

1. Guarantee Funds and the OFC

The precise structure of guarantee funds in an OFC has proven controversial even among proponents of an OFC. There are three basic ways that a guarantee fund could be structured in an OFC scheme.³¹⁷ First, all insurers, including insurers that did not opt for federal chartering, could be required to participate in a new federal guarantee fund, with the current state-based guarantee funds being eliminated. This *exclusive federal guarantee system* would replicate the FDIC scheme in banking. Second, all insurers that opted for a federal charter could nonetheless be required to continue their participation in state guarantee funds. This *exclusive state guarantee system* would maintain the status quo approach despite the addition of a federal option. Finally, the OFC could also create a *dual guarantee system*, under which insurers that opted for a federal charter were required to participate in a federal guarantee fund, whereas those that chose to be regulated at the state level could continue their participation in state funds.

Neither of the first two options – an exclusive federal guarantee system or an exclusive state guarantee system – is theoretically attractive. From a regulatory supply perspective, both options would create a moral

³¹⁶ Bert Ely, *The Fate of Insurance Guarantee Funds after the Advent of Federal Insurance Chartering*, in *OPTIONAL FEDERAL CHARTERING AND REGULATION OF INSURANCE COMPANIES*, *supra* note 7, at 135.

³¹⁷ See Grace & Scott, *supra* note 7, at 89-91 (providing an overview of guarantee funds and how they could be adjusted in an OFC scheme so as not to sever the link between regulation and guarantee, which operates as a product warranty).

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hazard for one of the two regulatory schemes. If guarantee funds were lodged exclusively at the federal level, then state regulators' jurisdictions would not bear the costs of inadequate solvency regulation. Commentators have argued that an analogous mismatch in banking regulation -- the FDIC insures even state-chartered banks -- induces excessively lax state safety and soundness regulation.³¹⁸ Yet the problem would be even worse in an exclusive federal guarantee scheme. Whereas the FDIC has various regulatory powers to shut down a bank that falls below certain minimum capital requirements, OFC proposals that lodge the guarantee system at the federal level do not entrust that guarantee scheme with powers analogous to the FDIC's powers in banking. Retaining the exclusive state guarantee fund in an OFC scheme would create a similar moral hazard, wherein federal regulators could impose the costs of insufficient solvency regulation on the state guarantee fund system. However, the extent of this moral hazard would likely be less than in the exclusive federal guarantee system, as the federal government might indeed have a substantial interest in preventing states from funding the costs of insurer insolvencies.

Lodging guarantee funds exclusively at the federal or state level would also create no benefits from a regulatory demand perspective. That is because neither of these options tethers an insurers' responsibility for funding guarantees to the selection that that insurer makes among competing regulators. In theory, these options might nonetheless improve insurer demand if they charged insurers ex ante an appropriate risk-based premium that reflected their regulatory choice.³¹⁹ Such insurance would cause insurers to internalize the costs of their solvency risk, inducing them to weigh the full social costs and benefits of that risk when choosing among competing regulators. But this is unlikely, as government provided insurance does a remarkably poor job at setting premiums at appropriate levels.³²⁰ Simply put, accurate insurance rating and politics do not mix. Even to the extent that the guarantee insurance scheme did incorporate some element of risk-based pricing, this would be unlikely to improve insurer demand for effective regulation. Such a measure would likely be tethered not to the effectiveness of regulation, but rather to some easily identifiable variable, like the insurers level of risk-based capital.

By contrast, the third option, which would establish a dual guarantee fund, is theoretically attractive, but practically unworkable. The theoretical case for a dual guarantee fund is that regulators would be forced to provide a "warranty" for their solvency regulation, while insurers' regulatory demand might improve because insurers would not

³¹⁸ Macey and Butler.

³¹⁹ See Macey and Butler.

³²⁰ See NBER economist and Illinois; See Macey & Butler, *supra* note, at 714. (noting that FDIC does not charge actuarially fair rates, as doing so would harm small banks).

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want to fund the costs of guaranteeing their competitors' risky strategies. But however theoretically attractive such a scheme looks, it would not survive as a practical matter beyond the first substantial wave of insurer insolvencies.

To understand why this is so, it is first necessary to appreciate two details about the mechanics of state guarantee funds in the status quo. First, state guarantee funds are almost universally funded on a post-assessment basis, meaning that insurers only pay into the fund when another insurer becomes insolvent. This practice is generally seen as necessary, as *ex ante* funding of guarantee funds can lead budget-strapped legislatures to siphon off this money for general spending. Indeed, this is exactly what occurred in New York, the one state that uses pre-assessment funding for its insurance guarantee. The key risk of post-assessment funding is that a state cannot be assured of having the financial capacity or political impetus to pay policyholders when insurer insolvencies occur.³²¹ In the status quo, this is not a substantial concern because the state can usually raise the funds to pay a guarantee based on its capacity to levy assessments on the insurers that did not become insolvent. The second key mechanical point to understand is that state guarantees are funded by all insurers that are licensed to do business in a state, and each state's guarantee fund is responsible for policyholders within that state. This ensures that a substantial number of insurers are available to tax in the event of an insolvency, and that the burden will often be split by multiple states.

The post-assessment approach that states use to fund guarantee systems would simply be unworkable in a dual guarantee system, as states could not be relied upon to follow through on their commitments in the event of a substantial insolvency. First, states would face substantial resistance to collecting assessments from state-licensed insurers, as federally-chartered insurers operating in the same state would not be obliged to pay these assessments (as, by hypothesis, such insurers would only participate in the federal guarantee fund). This would leave federal insurers with a substantial competitive advantage over state-licensed insurers. Second, the number of insurers who would be available to tax on a post-assessment basis would be variable, changing as state-licensed insurers shifted their charter to the federal level. A state that insisted on post-assessment funding would thus create additional risk for state-licensed insurers associated with the prospect that other insurers would choose to charter federally. Third, a state might well calculate that the federal guarantee fund would bail it out and pay off the policyholders of a state-licensed insurer that became insolvent.

³²¹ *See id.*

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Additionally, a dual guarantee fund approach in an OFC scheme, wherein state guarantee funds were funded on a post-assessment basis, might well produce a separating equilibrium. Financially strong insurers would indeed be likely to select between federal and state regulation in a way that promoted stringent solvency rules.³²² By contrast, financially marginal insurers that adopted a high-risk, high-reward strategy would still be enticed to seek out a weak solvency regulator, as these insurers would discount the prospect that they would be required to pay for the failure of their fellow insurers, because they might themselves be the insurer that failed. The fact that risks often effect the entire insurance industry at the same time would only enhance this effect, as an insurer might reason that if its fellow insurer failed, it would be likely to fail as well. These dynamics could well result in a federal regulator that responded to insurer demand by providing stringent solvency regulation, but a state regulatory system that responded to a different segment of insurers that demanded lax regulation and severely discounted the prospect of paying post-insolvency assessments.

2. Guarantee Funds, the SLS, and Solvency Bonds

The only sensible way to structure guarantee funds in an SLS scheme of regulatory competition would be to require every state that issues charters to provide a financial guarantee for those insurers, irrespective of where policyholders are located. This approach to guarantee funds would maintain the link between regulation and the guarantee fund that is critical to the notion of a guarantee system as a warranty. But this approach to funding guarantees would be even less reliable than state guarantee funds in an OFC scheme. The key problem is that a single state could be on the hook for all of the losses associated with an insolvency, and it could only look to the insurers that are chartered in its state (as opposed to those who are licensed to do business in the state) to help pay for the costs of that insolvency. In most cases, states will simply be unable or unwilling to raise the funds to pay for such guarantees if they are large.

Recognizing this limitation of state guarantee funds in an SLS scheme, proponents of the SLS have proposed that insurers could be required to issue solvency bonds that default if their state regulator's guaranty fund fails.³²³ This approach would do nothing to improve the bonding mechanism of state guarantee funds. Much to the contrary, it would likely decrease the effectiveness of guarantee funds as warranties by creating a moral hazard for states in following through on their

³²² This is a natural consequence of a post-assessment guarantee scheme. Financially strong insurers in such a scheme will tend to demand stringent and effective regulation so as to reduce the likelihood that they will be taxed for the failure of another insurer.

³²³ Butler & Ribstein, *The Single License*, *supra* note 9.

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guarantee fund obligations. Nonetheless, solvency bonds could theoretically discourage jurisdictions from adopting overly lax solvency regulation because doing so would increase the costs of these bonds to the insurers they regulate.³²⁴ This, in turn, would discourage insurers from choosing that jurisdiction as its regulator.

Unfortunately, this proposal assumes that capital markets have much more of an appetite for taking on insurance risk than recent history suggests. Insurers in recent years have repeatedly attempted to issue catastrophe bonds that seemingly mirror what Butler and Ribstein propose: these bonds pay large returns to investors in the absence of a catastrophic event, but default in the event of a contractually-defined catastrophe, with investors losing their entire investment.³²⁵ Insurers' experiences with such catastrophe bonds have been decidedly underwhelming, with insurers repeatedly finding little demand from investors for such bonds.³²⁶ Investor demand for such bonds has also fluctuated substantially.³²⁷ Requiring *all insurers* to purchase such bonds could prove disastrous in economic climates where capital market investors were not interested in purchasing them. Indeed, if anything, investors would be less likely to purchase the solvency bonds that Butler and Ribstein propose than they are to purchase ordinary catastrophe bonds, given the moral hazard that solvency bonds would inevitably create.

Conclusion

There are good reasons to think that the state-based system of insurance regulation might benefit from reform. But the reforms that are currently at the forefront of the policy debate would ultimately harm consumers, third parties, and insurers themselves by creating a destructive system of regulatory competition. Although regulatory competition may be appropriate in various regulatory domains, insurance is not one of those domains.

³²⁴ *See id.*

³²⁵ *See* Howard Kunreuther & Mark Pauly, *Terrorism Losses and All-Perils Insurance*, 23-4 J. OF INSUR. REG. 3 (2005) (describing catastrophe bonds)

³²⁶ Martin F. Grace, Robert W. Klein, Richard D. Phillips, *Regulating Onshore Special Purpose Reinsurance Vehicles*, 19-4 J. OF INSUR. REG. 551 (2001) (noting that, as of 2001, "almost 60 [cat bond] transactions totaling nearly \$ 7 billion having been completed since 1994.").

³²⁷ *See* Johannes Skylstad Tynes, *Catastrophe Risk Securitization*, 19-1 J. OF INSUR. REG. 3 (2000).