2010

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

Daniel Schwarcz
University of Minnesota Law School, schwarcz@umn.edu

Article

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

Daniel Schwarcz†

† Associate Professor of Law, University of Minnesota Law School. For helpful comments and guidance, I thank Ken Abraham, Prentiss Cox, Mary Lou Fellows, Anna Gelpern, Erik Gerding, Kristin Hickman, Claire Hill, Alex Klass, Brett McDonnell, Geoffrey Miller, Amy Monahan, Saule Omarova, Richard Painter, Larry Ribstein, Steven Schwarcz, Gregory Shaffer, Jeffrey Stempel, and David Zaring as well as panel participants at the 2009 Law and Society Association Annual Meeting, Carlson School of Management, Tobin Project on Financial Regulatory Reform at the University of Pennsylvania Law School, University of Minnesota Law School, and 2010 Annual Association of Law Schools. Christina Alexander, Richard Sarohia, and Tim Sullivan provided excellent research assistance.

For the last two centuries, individual states and U.S. territories have been entrusted with primary responsibility for regulating property, casualty, and life insurance markets.[1] Under this system, each jurisdiction has its own insurance regulator and set of insurance laws. Turf battles among these fifty-six insurance jurisdictions are rare, as they each enjoy exclusive authority over any insurance business that takes place within

1. *See generally* Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13, 20–26 (1993) (outlining the broad scope of state regulation of insurance in the context of the McCarran Ferguson Act's "business of insurance" exception); Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 629–34 (1999) (discussing the development of state regulation of insurance).

their physical boundaries.[2] As a result, their relationship is characterized much more by cooperation than competition.[3]

To its critics, this patchwork approach to insurance regulation is antiquated and inefficient.[4] It requires multistate insurers to conform their practices to different regulatory regimes in different states,[5] inhibits cooperation between American and international insurance regulators,[6] and allows state politics to dictate counterproductive regulatory strategies.[7] Given this nonexhaustive litany of complaints about state insurance regulation, it is hardly surprising that insurance regulatory reform

2. *See* ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 112–13 (3d ed. 2007) ("[E]ach state separately regulates the business of insurance.").

3. *See* Elizabeth F. Brown, *The Development of International Norms for Insurance Regulation*, 34 BROOK. J. INT'L L. 953, 984 (2009) ("Traditionally, states have operated their insurance commissions as regulatory monopolies and have not engaged in regulatory competition, which exists to some degree between state and federal government agencies that issue bank charters, and among states for the incorporation of businesses.").

4. *See* Henry N. Butler & Larry E. Ribstein, *The Single-License Solution*, REG., Winter 2008, at 36, 36–38. *See generally* OPTIONAL FEDERAL CHARTERING AND REGULATION OF INSURANCE COMPANIES (Peter J. Wallison ed., 2000) (documenting the history of insurance regulation and the implications for an optional federal charter); THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES 13–51, 117–43 (Martin F. Grace & Robert W. Klein eds., 2009) (outlining the history of insurance regulation and explaining why reform is necessary).

5. *See* Martin F. Grace & Robert W. Klein, *Efficiency Implications of Alternative Regulatory Structures for Insurance*, *in* OPTIONAL FEDERAL CHARTERING AND REGULATION OF INSURANCE COMPANIES, *supra* note 4, at 79, 109–11. *See generally* Robert W. Klein, *The Insurance Industry and Its Regulation: An Overview*, *in* THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES, *supra* note 4, at 13, 31–42 [hereinafter Klein, *Overview*] (outlining the current framework of state insurance regulation). Not only does this produce costs for the industry, but it also creates inefficiencies in the regulatory process itself, as states free-ride off of each other when it comes to regulating multistate insurers. *See* Martin F. Grace & Richard D. Phillips, *The Allocation of Governmental Regulatory Authority: Federalism and the Case of Insurance Regulation*, 74 J. RISK & INS. 207, 235 (2007).

6. *See* Brown, *supra* note 3, at 972, 987–88 (noting that the lack of insurance uniformity in the United States inhibits adoption of international insurance standards and makes it difficult to conduct negotiations for such standards).

7. *See* Butler & Ribstein, *supra* note 4, at 38 (noting that large, lucrative states can impose inefficiencies into the market); J. David Cummins et al., *Regulation, Political Influence and the Price of Automobile Insurance*, 20 J. INS. REG. 9, 43–44 (2001) (using statistics to show that politics can negatively influence car insurance prices); Martin F. Grace & Hal S. Scott, *An Optional Federal Charter for Insurance: Rationale and Design*, *in* THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES, *supra* note 4, at 55, 59 (noting that states will regulate in a way most salient to their voters).

has received renewed attention in the wake of the global financial panic of 2008 and the federal bailout of American International Group (AIG).[8]

One of the central ideas to emerge out of this public debate is that the relationship among insurance regulators should be inverted, so that different regulators are pitted against one another in competition rather than joined together in cooperation.[9] Two prominent reform proposals would implement such regulatory competition by permitting individual insurers to select a single jurisdiction's regulatory scheme, irrespective of where that insurer sells coverage or conducts its operations. In the first proposal, known as the Optional Federal Charter (OFC), this choice would be binary: insurers would be permitted to opt-out of the current state-based regulatory regime in

8. *See, e.g.*, Mark A. Hofmann, *Trade Groups Applaud Fed Action on AIG*, BUS. INS., Sept. 17, 2008, *available at* http://www.businessinsurance.com/article/20080917/NEWS/200013972 (reporting a statement from Marc Racicot, president of the American Insurance Association, arguing that the AIG situation highlights the need for insurance regulatory reform); Tom Wilson, Op-Ed, *Regulate Me, Please*, N.Y. TIMES, Apr. 16, 2009, at A29 (calling for federal reform of regulation in light of AIG's collapse). Additionally, congressional committees have held numerous hearings in the last year on insurance regulatory reform in light of AIG's collapse. *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 the AIG Bailout: Hearing Before the H. Comm. on Oversight and Government Reform*, 110th Cong. (2008).

9. In the last year, various commentators have advocated for enhanced regulatory competition in insurance. *See, e.g.*, Butler & Ribstein, *supra* note 4, at 39–41; Grace & Scott, *supra* note 7, at 57; Mark E. Ruquet, *Forbes Says Insurers Should Have Their Choice of Regulator*, NAT'L UNDERWRITER, May 25, 2009, at 10, 10 (arguing that insurers and consumers should have the right to choose who regulates them); Scott Harrington, *Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation* 22–23 (Networks Fin. Inst., Policy Brief No. 2006-PB-02, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=923605 (highlighting the benefits of an optional federal charter); Sharon Tennyson, *State Regulation and Consumer Protection in the Insurance Industry* 21 (Networks Fin. Inst., Policy Brief No. 2008-PB-03, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1106172 (arguing that regulatory competition—in the form of the threat of federal preemption—"has spurred efficiency enhancing changes in state market conduct regulation, as economic theory would predict"). Others have strongly resisted such regulatory competition. *See Insurance Industry Regulation: Hearing Before the S. Comm. on Commerce, Science, and Transportation*, 108th Cong. (2003) (statement of J. Robert Hunter, Director of Insurance, Consumer Federation of America) (urging Congress to reject the optional federal charter); Editorial, *Regulator Shopping*, N.Y. TIMES, May 21, 2009, at A34.

favor of a newly created federal scheme.[10] Fundamentally, this proposal would replicate the dual banking system, which permits banks to acquire a charter at either the state or federal level.[11] The second proposal, dubbed the Single-License Solution (SLS), imagines more wide-ranging competition among different insurance regulators, whereby insurers would be empowered to select any state regulator to govern all of their insurance operations across the country.[12] It thus emulates the system of corporate chartering, which permits corporations to incorporate in any of the fifty states irrespective of their principal place of business.[13]

In one sense, this renewed enthusiasm for regulatory competition in insurance is ironic, as many blame similar forms of regulatory competition for contributing to the global financial panic of 2008.[14] 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 widespread predatory lending and overlook the immense risks borne by individual banks.[15] Similarly, regulatory competition in corporate law may arguably have contributed to the executive compensation schemes that incentivized firms to fo-

---

10. *See* Grace & Scott, *supra* note 7, at 57; Harrington, *supra* note 9, at 22. *See generally* OPTIONAL FEDERAL CHARTERING AND REGULATION OF INSURANCE COMPANIES, *supra* note 4 (outlining arguments for and against the OFC).

11. *See* Robert Detlefsen, *Dual Insurance Chartering: Potential Consequences*, *in* THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES, *supra* note 4, at 97, 98.

12. *See* Butler & Ribstein, *supra* note 4, at 39–42 (enumerating the costs and benefits of such a regulatory system); Henry N. Butler & Larry E. Ribstein, *A Single-License Approach to Regulating Insurance* 14–15 (Nw. Univ. Sch. of Law, Law & Econ. Research Paper No. 08-10; Univ. of Ill., Law & Econ. Research Paper No. LE08-015, 2008), *available at* http://ssrn.com/abstract=1134792 [hereinafter Butler & Ribstein, *Regulating Insurance*]; Harrington, *supra* note 9, at 28–29.

13. *See* Harrington, *supra* note 9, at 28–29 (explaining that this approach "has its roots in corporate law, where corporations choose a state in which to be chartered").

14. *See Regulator Shopping*, *supra* note 9.

15. *See, e.g.*, *Consumer Protections in Financial Services: Past Problems, Future Solutions: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 62–63 (2009) (prepared statement of Patricia A. McCoy, Professor, University of Connecticut School of Law). *But see* Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 12 (2009) (arguing that regulations should not "unduly disrupt the market for legitimate subprime loans" because "only a minority of subprime loans could be considered 'predatory'").

cus too much on short-term profits and too little on long-term risks.[16]

At the same time, regulatory competition can indeed generate substantial benefits depending on the context in which it is deployed and the way in which it is structured.[17] In certain situations, regulatory competition may provide an appropriate "safety valve" against excessive regulation, motivate regulators to design efficient and responsive regimes, and provide regulation that matches the legitimate needs of different types of regulated entities.[18] Indeed, many (if not most) corporate law scholars endorse jurisdictional competition, and the dual chartering system in banking is so revered that none of the serious proposals to modernize banking regulation would upset it.[19]

As such, this Article explores the case for promoting competition among regulators of life, property, and casualty insurance markets.[20] It focuses on the key argument for promoting

16. *See* LUCIAN BEBCHUK & JESSE FRIED, PAY WITHOUT PERFORMANCE: THE UNFULFILLED PROMISE OF EXECUTIVE COMPENSATION 184–85 (2004) (arguing that executives with options are incentivized to drive up short-term share value at the expense of long-term value); Claire Hill & Brett McDonnell, Avoiding "Short-Term Capital Management": Can Better Corporate Governance Prevent Future Crises? (unpublished manuscript, on file with author). Of course, this point is quite speculative, and others resist both the notion that executive pay is primarily responsible for creating excessive risk taking and the notion that it is excessive from the standpoint of shareholder value. *See* Stephen M. Bainbridge, *Executive Compensation: Who Decides?*, 83 TEX. L. REV. 1615, 1629–30 (2005) (book review) (criticizing *Pay Without Performance*, noting that strong evidence suggests that executive compensation packages are designed to align managerial and shareholder interests); John E. Core et al., *Is U.S. CEO Compensation Inefficient Pay Without Performance?*, 103 MICH. L. REV. 1142, 1172–77 (2005) (reviewing BEBCHUK & FRIED, *supra*); *cf.* Nathan Knutt, *Executive Compensation Regulation: Corporate America, Heal Thyself*, 47 ARIZ. L. REV. 493, 495, 500–06 (2005) (arguing that government regulation of executive compensation is generally ineffective and that companies should self-regulate in this area).

17. *See generally* Daniel C. Esty & Damien Geradin, *Introduction*, *in* REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES, at xix, xxiii–xxxi (Daniel C. Esty & Damien Geradin eds., 2001) (introducing the concept of regulatory competition and outlining various costs and benefits).

18. *See infra* Part I.

19. *See infra* Part I.B.

20. *See generally* M. Todd Henderson, *Credit Derivatives are Not "Insurance"* (Univ. of Chicago John M. Olin Law & Econ. Working Paper, Paper No. 476, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1440945 (arguing that credit derivatives are not insurance and should not be governed as insurance). With respect to health insurance, regulatory reform is currently proceeding independently of other forms of insurance reform, in

regulatory competition: that it can improve *the substance* of insurance regulation by harnessing the power of markets.[21] This Article concludes that regulatory competition cannot be defended on this basis in the context of property, casualty, and life insurance markets. Rather than promote optimal regulation, regulatory competition would inevitably tend to promote deregulation irrespective of its desirability.[22] Ultimately, such deregulation would prove undesirable, even in the small doses that might be induced by limited regulatory competition such as that imagined in the OFC. It would tend to exacerbate existing problems with the political economy of insurance regulation and impede the development of effective regulatory innovation.[23]

By focusing on regulatory competition's impact on the substance of insurance regulation, this Article deliberately sidesteps several important issues that are relevant to any discussion of reforming insurance regulation.[24] First, and most importantly, it does not address the fact that both the SLS and OFC proposals would eliminate the need for multistate insurers to comply with multiple regulatory regimes.[25] Although this

large part because health insurance is fundamentally intertwined with health care in the United States, and health care is a central policy issue.

21. *See* ERIN A. O'HARA & LARRY E. RIBSTEIN, THE LAW MARKET 16, 26 (2009).

22. *But see id.* (arguing that regulatory competition is desirable because it promotes optimal outcomes, irrespective of whether efficiency requires more or less regulation).

23. Others have also suggested that regulatory competition might promote a race to the bottom in insurance, though they have not analyzed this prospect extensively. *See* Lissa Lamkin Broome, *A Federal Charter Option for Insurance Companies: Lessons from the Bank Experience*, *in* FINANCIAL MODERNIZATION AFTER GRAMM-LEACH-BLILEY 203, 219–23 (Patricia A. McCoy ed., 2002) (highlighting the risk that an OFC might promote a race to the bottom by analogizing the OFC to the banking industry); Elizabeth F. Brown, *The Fatal Flaw of Proposals to Federalize Insurance* 39 (Univ. of St. Thomas Sch. of Law Legal Studies, Research Paper No. 07-25, 2007), *available at* http://ssrn.com/abstract=1008993 (mentioning that regulatory competition in insurance might promote a race to the bottom).

24. This Article also avoids questions concerning whether regulatory competition would hamper effective enforcement by geographically separating policyholders from their regulators. *See, e.g.*, THERESE M. VAUGHAN, CHIEF EXECUTIVE OFFICER, NAT'L ASS'N. OF INS. COMM'RS, PERSPECTIVES ON SYSTEMIC RISK 9–12 (Mar. 5, 2009); Tennyson, *supra* note 9, at 12–13, 21 (focusing on the impact that regulatory competition via an OFC might have on various enforcement issues, such as the effectiveness of consumer complaint handling and market conduct exams).

25. *See* Grace & Klein, *supra* note 5, at 111 ("Insurers under a federal charter would need to prepare reports for and respond to inquiries from only

may be a desirable outcome, various regulatory reforms—including modified versions of the OFC and SLS—could accomplish this goal without promoting regulatory competition.[26] To be sure, each of these alternatives would themselves be imperfect.[27] But the goal of this Article is not to definitively establish the pros and cons of all reform proposals. Rather, it is to demonstrate, in the insurance context, that a reform proposal's embrace of regulatory competition ought to count as a substantial negative in evaluating it. For similar reasons, the Article does not address the impact of enhanced regulatory competition on American insurance regulators' coordination with international regulatory authorities.[28]

Despite these omissions, the Article's conclusion that regulatory competition would degrade the content of insurance regulation has important policy implications. First, it largely undermines the case for the SLS proposal, which is premised on the notion that regulatory competition would promote optimal insurance regulation.[29] Second, this Article raises substantial—though not definitive—concerns about OFC proposals. It also specifically rejects the claims of some that the OFC's limited

one regulator, rather than multiple regulators."); Klein, *Overview*, *supra* note 5, at 40–42.

26. *See infra* text accompanying notes 39–41 (discussing various proposals that would reduce duplicative compliance costs without promoting regulatory competition); *see also* text accompanying notes 356–357 (noting that regulatory competition is not necessary to reduce compliance costs).

27. *See generally* NEIL KOMESAR, IMPERFECT ALTERNATIVES: CHOOSING INSTITUTIONS IN LAW, ECONOMICS, AND PUBLIC POLICY (1994) (emphasizing the importance of comparative institutional analysis, given the fact that all institutions are imperfect but nonetheless enjoy comparative benefits over other institutions).

28. *See generally* Brown, *supra* note 3, at 972, 987–88 (discussing such impacts). In any event, it is likely that enhanced regulatory competition would exacerbate the difficulty of American insurance regulators' coordination with international authorities by eliminating the capacity of any one body or constituency to represent American insurance regulators' interests on the world stage.

29. Butler and Ribstein contend that "[t]he 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 marketplace—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." Butler & Ribstein, *Regulating Insurance*, *supra* note 12, at 9; *see also* Ruquet, *supra* note 9, at 10 (arguing that insurers should have the right to choose who regulates them).

form of regulatory competition would promote improved insurance regulation.[30]

This Article develops a three-part framework for analyzing the impact of regulatory competition on the content of regulation. First, it examines the demand side of regulatory markets, focusing on how insurers—the "buyers" in regulatory markets—would select among competing regulators—the "sellers" in these markets. Second, it assesses the supply side of regulatory markets, or how competing regulators would respond to insurers' demand for regulation. Finally, it looks at the extent to which regulatory competition schemes can employ minimum standards, judicial oversight, risk-based insurance requirements, and other design elements that regulate the regulatory market, producing controlled competition among different regulators. 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—and analyzes how individual insurers would choose among multiple regulators were they empowered to do so. It concludes that insurers offering consumer-oriented coverage would inevitably "demand" deregulation, *irrespective* of the social desirability of this outcome. Market forces would exert only minimal discipline on insurers' regulatory choices, and the legitimate interests of third parties would be entirely excluded from insurers' calculus. In fact, insurers' regulatory demand might actually harm the collective interests of insurers themselves; regulatory choice could destabilize the capacity of regulation to solve prisoner's dilemma problems by allowing individual insurers to "cheat" from the collective optimum. And the prospect that a competing reg-

30. Scott Harrington has argued that "optional federal chartering could promote beneficial regulatory competition," because it could "discipline the potential excesses of either state or federal regulators." Harrington, *supra* note 9, at 22. Martin Grace and Hal Scott have also claimed 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-asset problems of their own." Grace & Scott, *supra* note 7, at 57; *see also* GRACE & KLEIN, *infra* note 139, at 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.").

ulator might offer particularly attractive direct services to insurers—such as policy design, data aggregation, or fraud detection—would be unlikely to alter this result given the entrenched role of industry associations in supplying such services to insurers.

Part III analyzes regulatory supply, including the extent to which regulatory demand would improve the political economy of state insurance regulation. It argues that the deregulatory forces that regulatory competition would produce are not normatively desirable. Insurance regulation is structurally more susceptible to underregulation than overregulation, particularly outside of the solvency domain. Although solvency regulation can be criticized on efficiency grounds, Part III argues that regulatory competition is not the answer. Rather, regulatory competition would actually undermine solvency modernization because it is largely incompatible with *effective* principles-based regulation. Finally, it contends that regulatory competition would not improve regulatory specialization relative to the status quo.

Part IV applies the third part of the analytical framework, evaluating the extent to which effective institutional design could harness the benefits of regulatory competition while limiting its costs. It argues that such regulation of regulatory markets would likely be only partially effective. With respect to market conduct regulation and other forms of nonsolvency regulation, it suggests that minimum standards intended to limit the risk of excessive deregulation would be difficult to enforce. Similarly, allowing individual states to opt-out of a regulatory competition scheme in order to preserve consumer protections would provide only a limited check on these risks. Designing regulatory competition to promote effective solvency regulation is also a challenge, as neither guarantee funds nor market-oriented approaches are likely to prove effective in an OFC or SLS scheme.

This Article concludes by acknowledging the potential need to reform insurance regulation. But rather than embracing regulatory competition, this Article concludes that effective reform should strive to avoid it. Numerous potential reforms do just that, such as proposals to create a single federal insurance regulator, empower a federal agency to coordinate state regulation, or create a federal regulator for all multistate insurers. To be sure, each of these options has its own distinctive flaws. It is for this reason that the Article leaves open the possibility that proposals which mildly increase regulatory competition—such as an OFC option with mandatory consumer safeguards—may ultimately be the least-worst reform options. But before so concluding, policymakers should more carefully scrutinize proposals that avoid enhancing regulatory competition, rather than reflexively importing the regulatory architecture of banking and corporate law into the insurance sphere.

I. AN OVERVIEW OF REGULATORY COMPETITION

In its broadest sense, regulatory competition has two basic ingredients. First, business entities or individuals must have some degree of choice among at least two regulatory systems. In some cases, exercising that choice may be quite costly, requiring, for instance, physically locating oneself in a jurisdiction with the desired regulatory scheme or selling products exclusively within that jurisdiction. In other cases, the targets of regulation may be able to exercise regulatory choice much more easily, simply by filing documents with a particular jurisdiction or writing contracts that reference that jurisdiction.[31] The second necessary component of regulatory competition is that individual jurisdictions must have some incentive to attract regulated parties to their regime.[32] These incentives can include increasing tax revenues, promoting economic growth, or simply expanding regulatory influence.[33]

Section A of this Part provides a brief overview of the regulatory reform debate in insurance and its linkage to regulatory competition. It focuses on the two proposals that would enhance regulatory competition in insurance by empowering insurers to select among competing regulators *without* changing their base of operations or the location of their insurance sales. Section B then examines three key issues that frame the debate in the extant literature about the ways in which regulatory

31. *See* Harrington, *supra* note 9, at 28–29.

32. *See* Esty & Geradin, *supra* note 17, at xxiii.

33. This conception of regulatory competition mirrors that given in Esty & Geradin, *supra* note 17, at xxiii–xxiv. Note that this definition of regulatory competition does not consider preemption threats from the federal government. Such threats may substantially impact regulatory evolution. *See* Mark J. Roe, *Delaware's Competition*, 117 HARV. L. REV. 588, 601–07 (2003) (noting that federal law often limits, or threatens to limit, states' authority to regulate internal affairs). However, they can be distinguished from regulatory competition because the federal government can unilaterally preempt state law in the insurance realm. *But see* Tennyson, *supra* note 9, at 21 (characterizing the threat of federal preemption in insurance *as* regulatory competition).

competition impacts the substance of regulation. These three issues organize the remainder of the Article.

A. REGULATORY COMPETITION AND INSURANCE REFORM

The current scheme of American insurance regulation entrusts individual states and territories to regulate insurance transactions that occur within their boundaries.[34] As with virtually any regulatory scheme, it creates some degree of regulatory competition.[35] In most cases, insurers that disfavor a particular jurisdiction's regulatory regime can shift their sales elsewhere to avoid this regulation.[36] But this mechanism for exercising regulatory choice is costly, as profits can generally be made by selling coverage even in jurisdictions with regulatory regimes that insurers perceive to be excessive.[37] For this reason, insurers almost never exercise this form of regulatory choice, and their occasional threats to do so are rarely credible.[38]

34. *See* Randall, *supra* note 1, at 629. *See generally* Macey & Miller, *supra* note 1, at 20–26.

35. Indeed, regulatory competition is an important topic in fields ranging from tax, labor, and financial services law to environmental regulation. *See generally* Esty & Geradin, *supra* note 17, at ixx–xxxi (discussing the evolution of regulatory competition theory in different substantive literatures).

36. Interestingly, regulators often attempt to prevent insurers from exiting a state. This practice is both controversial and only partially effective. *See generally* Richard A. Epstein, *Exit Rights and Insurance Regulation: From Federalism to Takings*, 7 GEO. MASON L. REV. 293, 300–08 (1999) (describing insurers' exit rights and how states limit these rights).

37. One exception to this point involves captive insurance companies, which effectively only sell insurance to one company and generally need only become licensed in one state to reach a market of purchasers in other states. *See infra* notes 288–89 and accompanying text.

38. *See* KENNETH J. MEIER, THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE 53 (1998). *See generally* Bruce G. Carruthers & Naomi R. Lamoreaux, *Regulatory Races: The Effects of Jurisdictional Competition on Regulatory Standards* (UCLA Ctr. for Econ. History Working Paper, 2009), *available at* http://www.econ.ucla.edu/people/papers/Lamoreaux/Lamoreaux484.pdf (arguing that firms across regulatory contexts rarely exit for regulatory reasons when doing so requires physically relocating or substantially altering their sales practices). The biggest exception to this point is that many property insurers have recently left Florida, thus their threats to leave were certainly credible. *See* Martin F. Grace & Robert W. Klein, *The Perfect Storm: Hurricanes, Insurance, and Regulation*, 12 RISK MGMT. & INS. REV. 81, 85–86 (2009); *see also infra* note 228 and accompanying text. Florida is distinctive, though, as there are obviously nonregulatory factors, like hurricanes, which make it more risky to provide insurance in the state. *See* Grace & Klein, *supra*, at 81–82. There has also been some evidence of increased movement of insurers to states that have relaxed certain elements of their insurance regu-

Although regulating insurers where they sell coverage produces minimal regulatory competition, it generates a host of problems. Foremost among these is that state regulation creates some degree of duplicative compliance costs and inconsistencies for insurers that sell coverage in more than one state.[39] Indeed, multistate insurers must design different products to conform with different states' regulatory standards, acquire licenses from multiple states, and employ differing underwriting models in different states.[40] Although these duplicative costs have decreased substantially in the last decade due to state coordination via the National Association of Insurance Commissioners (NAIC), many assert that there is a natural limit to the effectiveness of these efforts.[41]

---

lation. *See* DEREGULATING PROPERTY-LIABILITY INSURANCE: RESTORING COMPETITION AND INCREASING MARKET EFFICIENCY 131, 256–58 (J. David Cummins ed., 2002) (analyzing automobile insurance rates in Illinois, the only state operating without rate regulatory law).

39. *See* Grace & Scott, *supra* note 7, at 58.

40. *See* SHEILA BLAIR, UNIV. OF MASS. ISENBERG SCH. OF MGMT., CONSUMER RAMIFICATIONS OF AN OPTIONAL FEDERAL CHARTER FOR LIFE INSURERS 32–37 (2004) (attempting to quantify the costs of duplicative regulation in the life insurance industry); Klein, *Overview*, *supra* note 5, at 40–41. Insurers often complain that market conduct exams by different states are duplicative. *See* Robert W. Klein & James W. Schacht, *An Assessment of Insurance Market Conduct Surveillances*, 20 J. INS. REG. 51, 79 (2001). Others, however, suggest that insurance market conduct exams are extraordinarily uncommon in most states. *See* JEFFREY STEMPEL, LITIGATION ROAD: THE STORY OF *CAMPBELL V. STATE FARM INSURANCE* (2008).

41. Among other activities, the NAIC drafts model laws, collects and aggregates state-level data, helps administer solvency regulation by an insurer's state of domicile, and helps coordinate market conduct regulation to reduce duplicative compliance costs. *See* Randall, *supra* note 1, at 636–38, 640–41. The NAIC has also facilitated the development of an interstate compact to provide coordinated review and approval of life insurers' product filings. *See* Interstate Insurance Product Regulation Commission, History, http://www.insurancecompact.org/history.htm (last visited Mar. 5, 2010). Nonetheless, many view these approaches as skirting the fundamental problem that insurance is an interstate, and increasingly an international, business. *See* Klein, *Overview*, *supra* note 5, at 42 (arguing that states have "embark[ed] on 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"); Martin Grace, *A Reexamination of Federal Regulation in the Insurance Industry* 21 (Networks Fin. Inst., Policy Brief No. 2009-PB-02, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1350538. For more on this issue, see *infra* notes 313–16 and accompanying text (describing coordination efforts by the NAIC and contrasting this with the lack of coordination that would result from a single state opting to impose its own set of insurance laws and regulations).

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.[42] A recent working paper by state insurance regulators proposes a similar role for the federal government in facilitating uniformity among state regulators without preempting state regulation.[43] 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.[44] And, of course, some proposals would scrap the state-based system of insurance regulation entirely and replace it with a single federal regulatory scheme.[45]

Other proposed reforms attempt to address the duplicative and overlapping nature of state insurance regulation by allowing insurers to choose a single regulator irrespective of the location of their insurance sales.[46] By permitting insurers to choose a single regulator, this strategy obviously limits the extent to which multistate insurers will be subject to duplicative and overlapping regulatory schemes.[47] At the same time, though, these types of reform fundamentally alter the degree of regulatory competition in insurance regulation. Unlike the status quo, they allow insurers to exercise regulatory choice without incurring any meaningful cost as a result. As evidenced by similar forms of regulatory competition in the financial services

42. *See* Brown, *supra* note 23, at 32–34; Klein, *Overview*, *supra* note 5, at 44–45.

43. *See* NAT'L INS. SUPERVISORY COMM'N, REGULATORY MODERNIZATION: DISCUSSION DRAFT FOR STAKEHOLDER DIALOGUE 1 (2009), *available at* http://www.naic.org/documents/committees_ex_rmsg_nisc_discussion_draft.pdf (describing the basic elements of the proposal).

44. *See* Brown, *supra* note 23, at 37–38. A similar proposal, advanced by Robert Cooper, envisions that "the federal government would be the rulemaker, and the state insurance commissioners would enforce those rules within their states." Robert W. Cooper, *OFC: Is it Really Overkill?*, 26 J. INS. REG. 5, 9 (2008). Unfortunately, this proposal is clearly unconstitutional under Supreme Court case law preventing the federal government from commandeering state governments. *See* Printz v. United States, 521 U.S. 898, 935 (1997).

45. *See, e.g.*, Klein, *Overview*, *supra* note 5, at 49; Brown, *supra* note 23, at 63–75 (outlining various federal regulatory schemes).

46. *See* Butler & Ribstein, *supra* note 4, at 39–42.

47. *See id.* at 38–39.

and corporate law spheres, this dramatically increases the degree of competition among regulators.[48]

Two reforms of this variety have received particular attention in recent months. The first, dubbed the Single-License Solution (SLS), would mimic the structure of jurisdictional competition in corporate law.[49] 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.[50] The SLS would similarly permit insurers to select a single state insurance regulator to govern all of their insurance operations and allow states to tax the sales of the insurers they regulate.[51] In addition to allowing insurers to select their regulator of choice, the SLS proposal would permit insurers to choose the law governing disputes with policyholders.[52]

The proponents of the SLS recognize the possibility that it could produce a race to the bottom, and they propose several safeguards to limit that risk.[53] First, the SLS would permit state legislatures to opt-out and impose their own consumer protection regulations and laws, so long as the legislative opt-out only applied prospectively and insurers maintained a clear right to exit the state.[54] Second, the proposal would potentially require all insurers to issue "solvency bonds."[55] Investors who purchased an insurer's solvency bond would receive a market-determined yield on their investment if the guarantee fund of

48. *See* O'HARA & RIBSTEIN, *supra* note 21, at 28; Carruthers & Lamoreaux, *supra* note 38, at 2 (noting that firms regularly exercise choice among competing regulatory schemes when doing so simply requires changing their corporate identity or source of capital).

49. Butler & Ribstein, *supra* note 4, at 39; *see also* Butler & Ribstein, *Regulating Insurance*, *supra* note 12, at 14–15 (calling the SLS an "analogous proposal for insurance regulation"); Harrington, *supra* note 9, at 28.

50. *See generally* ROBERTA ROMANO, THE GENIUS OF AMERICAN CORPORATE LAW 6–48 (1993). Delaware generally dominates this regulatory competition, with most corporations choosing to incorporate either in the state of their principal place of business or in Delaware. *See id.* at 6; Roe, *supra* note 33, at 594–96.

51. *See* Butler & Ribstein, *supra* note 4, at 39–40.

52. *See id.* at 40 (explaining that such a choice would ultimately lower prices by ensuring certainty).

53. These safeguards are individually addressed *infra* Part IV.

54. *See* Butler & Ribstein, *supra* note 4, at 40. This requirement is important given the historical tendency of states to refuse to allow insurers to withdraw. *See* Epstein, *supra* note 36, at 300. For more on this issue, see *infra* Part IV.A.2.

55. *See* Butler & Ribstein, *supra* note 4, at 40.

the insurer's chosen regulator did not default in the contractually specified time period.[56] By contrast, if the guarantee fund of the insurer's chosen regulator did default, then the purchasers of the bond would lose their investment, which would presumably be used to make up for the state guarantee fund's default.[57] The central idea behind requiring the purchase of these bonds is that their yield will reflect the strength of a state's solvency regulation—and thus the likelihood that its guarantee fund will fail—thereby causing firms to avoid states with excessively lax solvency regulation.[58]

A second prominent reform proposal, known as the Optional Federal Charter (OFC), would introduce a more limited form of regulatory competition into insurance regulation.[59] The OFC proposal is modeled on the dual banking system, which allows banks to acquire a charter at either the state or federal level.[60] Banks that opt for a state charter must select the state in which they have their principal place of business.[61] The OFC would similarly give insurers the option of opting out of the current system of state insurance regulation, in favor of a single federal regulator.[62] As in the banking system, insurers

56. *Id.*

57. *See id.* For further explanation of how these bonds would work and discussion of potential problems, see *infra* Part IV.B.2.

58. *See* Butler & Ribstein, *supra* note 4, at 40.

59. *See* Harrington, *supra* note 9, at 22.

60. *See* Detlefsen, *supra* note 11, at 98.

61. *See* JONATHAN R. MACEY ET AL., BANKING LAW AND REGULATION 95 (3d ed. 2001); Geoffrey P. 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 21, 2009, at A20; Damian Paletta, *Historic Overhaul of Finance Rules*, WALL ST. J., June 18, 2009, at A1; Brian Wingfield, *Bank Regulation Blowout*, NEWSWEEK, June 17, 2009, *available at* http://www.newsweek.com/id/202379.

62. *See* Detlefsen, *supra* note 11, at 98. *See generally* Grace & Scott, *supra* note 7, at 55–91 (explaining how an OFC would function). Under most proposals, the federal insurance regulator would be housed within the Department of the Treasury. *See* Broome, *supra* note 23, at 206. Recent OFC proposals were introduced in the House in April of 2009 by Representatives Melissa Bean and Ed Royce, and in the Senate in May of 2007 by Senators John Sununu and Tim Johnson. *See* Grace, *supra* note 41, at 4–7. Grace criticizes these recent OFC proposals for "merely copy[ing] the structure of the banking system." *Id.* at 8.

would be free to switch back and forth between the state and federal regulator.[63] Various versions of OFC proposals exist, but most do not explicitly permit insurers to include in their policies choice-of-law provisions specifying the state law governing the resolution of insurer-policyholder disputes.[64]

The degree of regulatory competition that the OFC would actually generate is sometimes contested. The OFC would clearly create less regulatory competition than the SLS, as it envisions two competing regulatory systems rather than fifty. But several commentators have suggested that even this choice would be illusory, leading to a "one-way street" where large national insurers would inevitably choose to charter federally in order to avoid the duplicative nature of the state regulatory regime.[65]

While it is possible that a national insurance regulator might, in fact, have a comparative advantage over state regulators in attracting large insurers, the OFC would nonetheless create some nontrivial degree of regulatory competition. First, small and medium-sized insurers that only operated in a few states would not necessarily favor a federal regulator over a state regulator, especially given the potential costs associated with switching. Second, the costs to insurers of complying with multiple state regulators have decreased substantially in recent years.[66] As a result, the potential benefits that insurers would enjoy from dealing with a single regulator are more likely to be outweighed by the prospect of less stringent regulation imposed by multiple state regulators. Finally, both 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.[67] The incentives of a federal insurance regulator to attract

63. *See* Detlefsen, *supra* note 11, at 98.

64. For example, a 2009 bill proposing an OFC does not give insurers unfettered choice. *See* National Insurance Consumer Protection Act, H.R. 1880, 111th Cong. § 312 (2009) (allowing the insurer to choose its principle place of business, main office, or location of its policyholder as its jurisdiction).

65. *See* Broome, *supra* note 23, at 220; Butler & Ribstein, *supra* note 4, at 38 (stating that OFC would merely provide "the mirage of competition").

66. *See infra* text accompanying note 315.

67. 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, *Overview*, *supra* note 5, at 46.

insurers are dependent on the details of different OFC proposals.[68] But most OFC proposals envision that fees imposed on regulated entities would fund the federal insurance regulator, and an insurer's choice to charter federally could also impact the scope of the federal regulators' power and authority.[69] There is substantial evidence that similar fee structures for the Office of the Comptroller of Currency (OCC) and Office of Thrift Supervision (OTS) give them a strong incentive to attract and retain regulated banks.[70]

B. THE DESIRABILITY OF REGULATORY COMPETITION

Although the desirability of regulatory competition has received only minimal sustained scholarly attention in insurance,[71] it has been analyzed exhaustively in corporate law, securities law, and banking law. This section distills a substantial portion of this literature by describing three major issues that determine the impact of enhanced regulatory competition on the substance of regulation. 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 regarding regulatory supply, or the likely responses of regulators to regulatory demand. Third, it reviews several potential mechanisms for "regulating" the process of regulatory competition in order to prevent a race to the bottom. The remainder of this Article applies this framework to the regulation of insurance, analyzing regulatory demand in Part II, regulatory supply in Part III, and the regulation of regulatory markets in Part IV.

1. Regulatory Demand

Not surprisingly, the effects of regulatory competition on substantive law are inextricably linked to the way that regulated entities choose among competing regulators. Thus, one of the most common defenses of regulatory choice is that the interests of regulated entities in selecting among competing regu-

68. *See infra* Part IV.

69. *See* Grace & Scott, *supra* note 7, at 78–79. The scope of the federal regulators' authority might be particularly important to a new federal insurance regulator interested in establishing its authority and stature.

70. *See, e.g.*, Dain C. Donelson & David Zaring, *Charter Switching and the Financial Crisis: Evidence from the Office of Thrift Supervision* 6–8 (Ill. Corp. Law Colloquium Working Paper 2009).

71. *See supra* notes 12–13.

lators match the interests of the intended beneficiaries of regulation. This argument is particularly important in corporate law, which regulates the internal affairs of corporations and is principally intended to benefit shareholders. Proponents of state chartering argue that managers will incorporate in the state that best promotes the interests of shareholders.[72] Although shareholders cannot easily observe managers' everyday decisions, they can monitor and react to managers' selection of a regulatory regime.[73] The efficiency of capital markets consequently means that the price of the corporation's shares will accurately reflect this choice.[74] Because managers seek 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.[75] This, in turn, motivates jurisdictions to compete in generating efficient corporate law.[76]

By contrast, detractors of regulatory competition in corporate law generally dispute the claim that the sole driving force behind managerial decisionmaking is increasing stock prices.[77] Although increases in stock price will generally improve managers' job security and compensation, occasionally choices that decrease share price may best serve managers' personal interests. In particular, corporate laws that directly enhance man-

72. Ralph K. Winter Jr., *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251, 276 (1977); *see also* FRANK H. EASTERBROOK & DANIEL R. FISCHEL, THE ECONOMIC STRUCTURE OF CORPORATE LAW 6–7 (1991); ROMANO, *supra* note 50, at 15; Robert M. Daines, *Does Delaware Law Improve Firm Value?*, 62 J. FIN. ECON. 525, 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).

73. *See* EASTERBROOK & FISCHEL, *supra* note 72, at 1–3 (describing the agency problem of corporate law and how various different mechanisms of corporate law help to address these agency problems).

74. *See id.* at 17–21; Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2366–67 (1998); Winter, *supra* note 72, at 275–76.

75. *See* Winter, *supra* note 72, at 266.

76. *See* Romano, *supra* note 74, at 2366–67; Winter, *supra* note 72, at 275–76. As in all markets, the pace of evolution towards this efficient market outcome may be slow, and punctuated by wrong turns. *See* EASTERBROOK & FISCHEL, *supra* note 72, at 220–22; Michael Abramowicz, *Speeding Up the Crawl to the Top*, 20 YALE J. ON REG. 139, 168–70 (2003).

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

agers' job security and compensation—such as barriers to hostile takeovers—may more than offset the indirect impact of decreased share price on job security and compensation.[78] 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.[79]

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.[80] 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.[81] Similarly, critics of such regulatory choice in securities law argue that the interests of issuers are not, in fact, aligned with regulatory objectives, which include social benefits that go beyond the interests of individual investors.[82]

78. *See* Lucian Arye Bebchuk & Allen Ferrell, *Federalism and Takeover Law: The Race to Protect Managers from Takeovers*, *in* REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES, *supra* note 17, at 68, 73–74; Lucian Bebchuk et al., *Does the Evidence Favor State Competition in Corporate Law?*, 90 CAL. L. REV. 1775, 1800 (2002); Eisenberg, *supra* note 77, at 1510.

79. *See* Bebchuk, *supra* note 77, at 1444–45, 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).

80. *See* Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903, 947–48 (1998); *see also* Stephen J. Choi, *Law, Finance, and Path Dependence: Developing Strong Securities Markets*, 80 TEX. L. REV. 1657, 1702 (2002); Romano, *supra* note 74, at 2367–68, 2383–88 (arguing that jurisdictional competition should govern the registration of securities and continuous disclosure requirements). Others have advocated for extending such regulatory competition to the regulation of securities exchanges as well. *See* Jonathan R. Macey, *Regulatory Competition in the US Federal System: Banking and Financial Services*, *in* REGULATORY COMPETITION AND ECONOMIC INTEGRATION: COMPARATIVE PERSPECTIVES *supra* note 17, at 95, 105–09.

81. *See, e.g.*, Choi, *supra* note 80, 1704–05; Rafael La Porta et al., *What Works in Securities Laws?*, 61 J. FIN. 1, 23–25 (2006) (concluding that issuers tend to raise capital in countries where there are strong disclosure regimes, suggesting that it is in the interest of issuers to find strong regulation); Macey, *supra* note 80, at 106; Romano, *supra* note 74, at 2414.

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

Unlike in corporate and securities law, the banking law literature does not generally defend regulatory competition based primarily on claims that banks would demand efficient regulation.[83] In part, this is because a core goal of banking law is to promote the safety and soundness of banks.[84] As such, its principal purpose is to limit the externalities associated with failed banks, including systemic risk.[85] There is little reason to expect that banks would fully consider this risk in selecting a regulator, as these costs (by definition) fall on unrelated third parties.[86]

Perhaps even more importantly, banking law is partially designed to protect ordinary consumers. By contrast, regulatory competition in corporate law applies only to the internal affairs of corporations and does not extend to the regulation of corporate behavior in the consumer markets where they sell their products.[87] Many banking law scholars have argued that banks offering consumer services—particularly credit cards—generally exploit regulatory competition to select regimes that harm their customers. Regulatory competition in this domain expands beyond the dual federal/state choice normally associated with banking regulation, as the state in which a national bank is located has historically determined many of the consumer protection laws applicable to that bank's operations.[88] As

83. *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) ("As 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.").

84. Kathleen J. Woody, *The International Economic Implications of Deregulating the U.S. Banking Industry*, 31 AM. U. L. REV. 25, 77 (1981).

85. *See* MACEY ET AL., *supra* note 61, at 251.

86. *See* O'HARA & RIBSTEIN, *supra* note 21, at 33. Consistent with this reasoning, recent evidence suggests that bank charter switching may have promoted deregulation, which helped cause the recent financial crisis. *See* Donelson & Zaring, *supra* note 70, at 18–19. The role of externalities is also important in the securities and corporate law contexts. Much of the debate about regulatory competition in securities law turns on the potential third-party effects of securities regulation. *Compare* Fox, *supra* note 82, at 1342–63, *with* Romano, *supra* note 74, at 2380–81. In corporate law, proponents of jurisdictional competition generally dismiss the claim that corporate law should promote the interests of nonshareholder stakeholders. *See, e.g.*, Larry E. Ribstein, *Accountability and Responsibility in Corporate Governance*, 81 NOTRE DAME L. REV. 1431, 1445 (2006).

87. *See* EASTERBROOK & FISCHEL, *supra* note 72.

88. *See* Marquette Nat'l Bank of Minneapolis v. First of Omaha Serv. Corp., 439 U.S. 299, 310 (1978) (holding that usury laws applicable to a na-

a result, national banks have been free to "export" the consumer protection laws of the state in which they are located to consumers across the country.[89] It is abundantly clear that this exportation doctrine has resulted in national banks choosing to locate in states that pursue deregulation (particularly South Dakota).[90] And most commentators argue that, in doing so, national banks purposely exploit their least-informed consumers.[91] Others, however, suggest that banks have selected deregulatory regimes precisely because doing so advances the rational self-interest of their customers.[92]

2. Regulatory Supply

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. 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 are usually responsive to considerations other than attracting regulated entities. These considerations are numerous, and include faithfully pursuing regulatory objectives, currying favor from political groups, avoiding negative media scrutiny, generating fundraising sources, and expanding regulatory power and

---

tional bank's operations are determined by the state in which that bank is located). Subsequent cases expanded this doctrine to encompass various other consumer protection laws in the credit context. *See* Elizabeth R. Schiltz, *The Amazing, Elastic, Ever-Expanding Exportation Doctrine and Its Effect on Predatory Lending Regulation*, 88 MINN. L. REV. 518, 520–22 (2004). Recent federal reforms of the laws governing credit cards substantially reduce the capacity of a jurisdiction to export lax laws to other states. *See generally* Credit Card Accountability Responsibility and Disclosure (CARD) Act of 2009, 123 Stat. 1734 (2009).

89. *See* Schiltz, *supra* note 88, at 520–22.

90. *Id.* at 552 (noting South Dakota and Delaware in particular).

91. *See generally* Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1, 86–95 (2008); Prentiss Cox, *The Importance of Deceptive Practice Enforcement in Financial Institution Regulation*, 30 PACE L. REV. 279, 297 (2009); Adam J. Levitan, *Hydraulic Regulation: Regulating Credit Markets Upstream*, YALE J. ON REG. 143, 159 (2009); Art E. Wilmarth Jr., *The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis*, 41 CONN. L. REV. 963, 1002–25 (2009).

92. *See generally* Todd J. Zwycki, *Economics of Credit Cards* (George Mason Univ. Sch. of Law, Working Paper No. 00-22, 2000), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=229356 (arguing that *Marquette*'s holding, which acquiesced to the selection of deregulated regimes, inevitably led to a "market more responsive to consumer demand").

prestige.[93] Many of these considerations will often weigh against simply dismantling regulatory restrictions in response to regulatory demand.[94]

Firms' demand for laxity in a scheme of regulatory competition is particularly unlikely to dominate other regulatory inputs to the extent that regulatory choice is limited to only a few competing regulators, as in the case of the dual banking system or OFC proposals.[95] As the number of competing regulators decreases, the importance of regulatory demand, as compared to more traditional inputs into regulators' decision-making calculus, decreases as well. This is no different than ordinary markets, where decreased competition is often thought to decrease firms' incentives to respond to consumer preferences.[96]

To the extent that regulatory demand simply supplements, but does not overwhelm, other factors that impact regulators' decisions, it may ultimately improve the political economy of regulation. This is because competing regulators may improve efficiency without sacrificing effectiveness in their efforts to balance wooing regulated entities with their competing regulatory interests. For instance, they may eliminate ineffective regulatory hurdles, develop innovative but effective new rules, or develop specialized expertise.[97]

Scholars often employ these arguments to defend the dual banking system. First, proponents of dual banking often claim that bank regulators are prone to excessive regulation due to

93. *See, e.g.*, MEIER, *supra* note 38, at 167 (describing the complex and multifaceted nature of political economy of regulation).

94. *See* Daniel R. Fischel et al., *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 335 (1987); Wilmarth, *supra* note 83, at 1242 ("[T]he 'competition in laxity' argument overlooks the strong incentive of both elected public officials and appointed 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 Proposal*, 53 BROOK. L. REV. 53, 60 (1987).

95. *See supra* text accompanying notes 58–94.

96. *See* Bebchuk, *supra* note 77, at 1438.

97. Of course, these arguments are consistent with the notion that banks demand inefficiently lax regulations: "specialization" and "innovation" may simply refer to excessively lax standards in the relevant area. *See* Elizabeth F. Brown, *E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency*, 14 U. MIAMI BUS. L. REV. 1, 52–57 (2005); Melanie L. Fein, *The Fragmented Depository Institutions System: A Case for Unification*, 29 AM. U. L. REV. 633, 675–700 (1980) (arguing that a dual banking system promotes a race in laxity with respect to safety and soundness regulation).

"ordinary" political economy factors such as the fear of negative media attention.[98] Regulatory demand for lax regulation may provide a limited, but socially desirable, counterweight.[99] It also provides banks with at least one "escape valve" against the most oppressive instances of excessive regulation.[100] Second, defenders of dual banking argue that it promotes innovation. Critics of regulation often claim that regulators have little reason to proactively embrace innovation, because doing so takes time and effort.[101] Limited regulatory competition may encourage regulators to experiment with innovative regulations in order to attract regulated entities.[102] Indeed, proponents of dual banking have linked limited regulatory competition to such innovations as "checking accounts, branch banking, real estate lending, [and] trust services."[103] Third, limited regulatory competition may cause regulators to specialize in the regulation of particular types of banks. In particular, defenders of the dual banking system often note that local banks tend to charter at the state level, which may be more sensitive to local issues, whereas national banks tend to adopt national charters.[104]

98. *See* MACEY ET AL., *supra* note 61, at 76–77 (quoting the Federal Reserve stating that ordinarily, 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 also* Henry N. Butler & Jonathan R. Macey, *The Myth of Competition in the Dual Banking System*, 73 CORNELL L. REV. 677, 716 (1988); Kenneth E. Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 36 (1977).

99. *See* Scott, *supra* note 98, at 36 (noting that regulatory competition in banking generally results in "broader operating authority" of banks and "fewer constraints on profitability," and noting arguments that this may be desirable because it offsets the tendency towards excessive regulation).

100. *See* GEORGE J. BENSTON ET AL., PERSPECTIVES ON SAFE AND SOUND BANKING: PAST, PRESENT, AND FUTURE 274 (1986); WILLIAM J. BROWN, THE DUAL BANKING SYSTEM IN THE UNITED STATES 64–65 (1968); MACEY ET AL., *supra* note 61, at 111–22; Scott, *supra* note 98, at 36.

101. *See* Bar-Gill & Warren, *supra* note 91, at 84–94.

102. *See* Wilmarth, *supra* note 83, at 1156.

103. *See id.*

104. *See, e.g.*, SUSAN HOFFMANN, POLITICS AND BANKING: IDEAS, PUBLIC POLICY, AND THE CREATION OF FINANCIAL INSTITUTIONS 70–83 (2001) (noting that theorists have argued that state regulation of local banks is preferable because regulators are closer to customers); PETER J. WALLISON, STATE BANKING REGULATION AND DEREGULATION 6–9 (1985); Elizabeth R. Schiltz, *Damming Watters: Channeling the Power of Federal Preemption of State Consumer Banking Laws*, 35 FLA. ST. U. L. REV. 893, 907 (2008) (describing this argument by the Office of the Comptroller of Currency (OCC) to justify broad preemption).

Others have extended this argument to defend horizontal regulatory competition among competing federal bank regulators.[105]

The securities regulation literature offers similar political economy arguments in favor of regulatory competition. For instance, proponents of regulatory competition in securities law argue that ordinary monopolistic regulation has resulted in the Securities and Exchange Commission's (SEC) regulatory ineptness, such as its historical refusal to permit firms to disclose projected earnings.[106] 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.[107] It also could allow different regulators to specialize in different types of issuers.[108]

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.[109] In some cases, however, structural elements of regulatory markets offset this risk. Such design features of regulatory markets effectively "regulate" the market for regulatory competition.[110] Consider several examples.

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

105. One study, for instance, found that banks that specialize in consumer loans tend to shift to the OCC, banks that specialize in commercial loans shift to the Federal Reserve, and banks that specialize in real estate construction loans tend to switch to the Federal Deposit Insurance Corporation (FDIC) and state charters. Richard J. Rosen, *Is Three a Crowd? Competition Among Regulators in Banking*, 35 J. MONEY, CREDIT & BANKING 967, 990 (2003).

106. Romano, *supra* note 74, at 2378–79.

107. *See id.* at 2395–401.

108. *See* Choi, *supra* note 80, at 1705.

109. Bebchuk, *supra* note 77, at 1438.

110. *Cf.* O'HARA & RIBSTEIN, *supra* note 21, at 15 (noting that law markets convert ordinary mandatory rules in contract law into default rules, but noting that it is possible that "the law market would create a new category [of] supermandatory laws" wherein judges refuse to accept choice of law provisions on some issues).

regulation attempts to prevent regulatory competition from inducing excessive deregulation of safety and soundness.[111] For example, the Federal Reserve sets reserve requirements for all depository institutions, irrespective of their chosen regulator.[112] 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.[113] 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.[114]

Recently, and especially in light of the global financial meltdown of 2008, 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. The most notable such safeguard would create a new federal consumer protection agency with broad rule-making authority to protect banking consumers.[115] The agency would have authority to set a regulatory floor for all banks on a variety of consumer protection issues, but would permit competing regulators to go beyond that floor in their own domains.[116] A different proposal would create suit-

111. 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 33, at 592 (describing how federal securities law restricts the competition in which states can practically and legally engage); Brett McDonnell, *The Ambiguous Virtues of Federalism in Corporate Law* 1 (Univ. of Minn. Law Sch. Pub. Law & Legal Research Paper Series, Working Paper No. 03-10, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=424681.

112. *See* Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 461 (2006).

113. *See* Butler & Macey, *supra* note 98, at 689.

114. *See* MACEY ET AL., *supra* note 61, at 147 (describing restrictions that the FDIC imposes on state banks with deposit insurance).

115. Bar-Gill & Warren, *supra* note 91, at 98–100 (proposing that financial products should be treated as ordinary consumer products, which must be approved as safe by the Consumer Products Safety Commission); *cf*. Daniel Schwarcz, *A Products Liability Theory for the Judicial Regulation of Insurance Policies*, 48 WM. & MARY L. REV. 1389, 1397–98 (2007) (proposing that insurance policies should be envisioned as products and that products liability law can usefully serve as a model for the role of judicial regulation of those products).

116. *See* Consumer Financial Protection Agency Act of 2009, H.R. 1880, 111th Cong. (2009).

ability standards for the sale of mortgages.[117] 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.[118]

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.[119] This is particularly true with respect to solvency regulation, where potential 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.[120] Such deposit insurance, if priced accurately to reflect expected payouts, should increase banks' willingness to choose an effective safety and soundness regulator.[121] That is because such a scheme forces banks to internalize ex ante the expected social costs of their insolvency risk.

II. REGULATORY DEMAND AND INSURANCE

Regulatory competition transforms regulated business entities into "customers" by empowering them to shop in a market comprised of different regulators.[122] As with any market, these customers' preferences are central to predicting the market's outputs.[123] If regulators' customers prefer regulators that efficiently promote regulatory objectives, then a race—or at least a

117. *See* Kathleen C. Engel & Pat A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1318–67 (2002); Jonathan Macey et al., *Helping Law Catch Up to Markets: Applying Broker-Dealer Law to Subprime Markets*, 34 J. CORP. L. 789, 814–31 (2009).

118. *See* Engel & McCoy, *supra* note 117, at 1337, 1357.

119. Yet another approach is to limit the consequences of insufficient regulation by enhancing market discipline. Whether this counts as "regulating the regulatory" market is questionable, though, as this approach essentially attempts to limit the need for regulation rather than to ensure that regulatory competition produces desirable regulation.

120. *See* Butler & Macey, *supra* note 98, at 699.

121. *See id.* at 712–16. Of course, setting accurate risk-based premiums is exceedingly difficult for the government due to political factors. *See* MACEY ET AL., *supra* note 61, at 279–88 .

122. *See* O'HARA & RIBSTEIN, *supra* note 21, at 14 ("The law market fundamentally alters the political process to the extent that it makes people 'consumers' or 'buyers' of laws rather than simply voters.").

123. *See* Fox, *supra* note 82, 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 U.S. issuer would select if given the choice.").

crawl—to the top is virtually inevitable. By contrast, if these customers view regulation as an unnecessary obstacle and cost, then regulatory choice will promote deregulation irrespective of its desirability.[124]

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. 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 increases as well.[125] So too does the competitive pressure on regulators to satisfy regulatory demand. A large number of competing regulators can consequently produce a powerful "race to the top" when firm demand for regulation is aligned with regulatory objectives. For similar reasons, though, a substantial number of competing regulators also increases the risk of a race to the bottom when firms demand minimal regulation irrespective of regulatory goals.

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. Section A focuses on consumer-policyholders, the primary intended beneficiaries of insurance regulation. It contends that life insurers and property/casualty insurers that provide personal lines of coverage could be expected to "demand" lax consumer protections in a scheme of regulatory competition. This is so irrespective of whether such demand would actually benefit policyholders. 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 third party interests, such as limiting social insurance payments and compensating tort victims. It also suggests that insurer demand would do little to directly advance the interests of insurers themselves, at least aside from reducing regulatory restrictions. Importantly, for purposes of analytical clarity, the analysis in this Part proceeds on the assumption that regulation of regulatory markets—such as guarantee funds and mar-

124. If regulators' customers endorse some forms of efficient regulations but not others, then regulatory choice is likely to promote a regime that mimics these preferences. *See* Bebchuk, *supra* note 77, at 1458–68.

125. *See supra* text accompanying notes 94–97.

ket-based bonding mechanisms—are not present. These issues are addressed separately in Part IV.

A. REGULATORY DEMAND AND CONSUMER PROTECTION IN INSURANCE MARKETS

Consumer protection is the central objective of insurance regulation.[126] Indeed, most of the core functions of insurance regulators are directed primarily toward this goal, and regulation of commercial lines of coverage (where policyholders tend to be much more sophisticated) is limited.[127] For instance, form and price regulations attempt to ensure that policyholders receive reasonable policy terms at fair prices that are not unduly discriminatory.[128] Claims handling regulations are intended to protect insureds by limiting insurers' ability to deny or delay claim payments.[129] Licensing is designed to ensure that market actors have sufficient expertise and resources to advise and in-

126. See Donald Cleasby & Nancy M. Schroeder, *Regulatory Reform: The Consequences of "Baby Steps"*, 18 J. INS. REG. 288, 292–93 (2000).

127. *See id.* at 292 (distinguishing between regulation of personal and commercial lines of insurance). The primary role of regulation in commercial lines of insurance is solvency regulation. *Regulatory Restructuring: Enhancing Consumer Financial Products Regulation: Hearing Before the Subcomm. on Capital Markets, Insurance and Government Sponsored Entities of the H. Comm. on Financial Services*, 111th Cong. 5 (2009) [hereinafter *Regulatory Restructuring*] (statement of Gary E. Hughes, Exec. Vice President & General Counsel, American Council of Life Insurers). This role for insurance regulation can be justified as a credible commitment device for insurers. *See infra* text accompanying notes 145–46, 187–90.

128. Many states review and preapprove 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* Schwarcz, *supra* note 115, at 1424. 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, though the degree and intrusiveness of this regulation differs dramatically among states. *See infra* text accompanying notes 223–31.

129. Daniel Schwarcz, *Redesigning Consumer Dispute Resolution: A Case Study of the British and American Approaches to Insurance Claims Conflict*, 83 TUL. L. REV. 735, 745 (2009) (discussing the law's role in preventing improper practices of insurers). 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. *Id.* at 750 & n.65. 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. KATHLEEN HEALD ETTINGER ET AL., STATE INSURANCE REGULATION 90–97 (1995).

sure policyholders.[130] And even solvency regulation is primarily defended on the grounds that it protects policyholders from the risk that insurers will not have the financial strength to pay future claims.[131] This stands in stark contrast with prudential regulation in banking (known as "safety and soundness" regulation), which is primarily justified not by consumer protection rationales, but by the need to limit bank runs and other forms of systemic risk.[132]

This section analyzes whether insurers operating in consumer-oriented markets would choose among competing regulators in a way that promoted the interests of policyholders. It first shows that this depends largely on the extent to which insurance consumers would know, and rationally respond to, insurers' choices among competing regulators. It then shows that most insurance consumers in a scheme of regulatory competition would be unlikely to be sophisticated about insurers' regulatory choices. Additionally, this section also raises the possibility that allowing insurers to choose among different regulators may itself undermine the commitment function of consumer protections, even if insurers' consumers were fully informed and rational about the selection of a regulatory regime.

In sum, this section therefore suggests that insurers would choose among competing regulators in much the same way that many claim banks have chosen among competing regulators in credit card markets: by selecting the least intrusive regime available.[133] In large part, this is because the intended beneficiaries of insurance regulation are ordinary consumers rather than the relatively sophisticated intended beneficiaries of corporate and securities law.

130. ETTINGER ET AL., *supra* note 129, at 174–89 (explaining the licensing process and requirements).

131. *See Regulatory Restructuring*, *supra* note 127 ("The primary objective of insurance regulation is solvency, which is the most important consumer protection of all."). *But see infra* Part II.B.2. Solvency regulation establishes guarantee funds and limits the investments that insurers can make, the capital they can deploy, and the accounting methods they can use. *See* Steven W. Pottier & David W. Sommer, *The Effectiveness of Public and Private Sector Summary Risk Measures in Predicting Insurer Insolvencies*, 21 J. FIN. SERV. RES. 101, 103–04 (2000) (listing these goals as factors in measuring risk of insolvency).

132. *See* MACEY ET AL., *supra* note 61, at 112–14 (providing background on this type of regulation).

133. *See* text accompanying notes 86–90.

1. The Character of Insurers' Regulatory Demand

a. *Policyholder Sophistication About Insurers' Regulatory Choices*

Insurers' demand for competing regulators would be driven largely by policyholders' demand for competing insurers. In particular, insurers' regulatory choices would depend largely on how sophisticated their policyholders were *about those regulatory choices*.[134] If policyholders were "unsophisticated" about insurers' regulatory choices—either because they were unaware of these choices or failed to appreciate their implications—then insurers would demand regulatory regimes with minimalist consumer protections. Such a regime would decrease insurers' regulatory compliance costs and maximize their choices of business strategies without any substantial offsetting cost in policyholder demand. To be sure, it is possible that consumers would also benefit from the selection of a deregulatory regime, as their premiums would likely decrease.[135] But the key point here is that insurers with policyholders who were unsophisticated about regulatory choice would favor deregulatory regimes *irrespective* of consumers' interests.[136]

At least two objections can be levied against the prediction that insurers would inevitably choose the least restrictive regulatory regime if their consumers were unsophisticated about their regulatory choices. First, although consumer protections limit individual insurers' range of permissible actions, they can nonetheless promote industry interests by solving collective action and coordination problems.[137] 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.[138] Similarly,

134. *Cf.* Grace & Scott, *supra* note 7, at 74 (rejecting the single license proposal of Butler and Ribstein because "a key reason for insurance regulation is consumers' asymmetric and imperfect information").

135. *See* Harrington, *supra* note 9, at 22–30.

136. *Cf.* O'HARA & RIBSTEIN, *supra* note 21, at 16 (noting that regulatory competition is a "procedural mechanism that will tend to contribute to more efficient regulations" by harnessing the power of the markets).

137. The related argument that other forms of regulation *aside from consumer protections* may benefit insurers is addressed *infra* Part II.B.1.

138. *See* TOM BAKER, INSURANCE LAW AND POLICY 7 (2d 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, *Differential Compensation and the "Race to the Bottom" in Consumer Insurance Markets*, 15 CONN. INS. L.J. 723, 742–45 (2009) (arguing that a similar

consumer protections may increase overall demand for insurance by warranting that all available coverage meets certain minimum standards, thereby reducing consumer search costs.[139] If consumer protections benefit insurers, then insurers might select robust regulatory regimes irrespective of their consumers' knowledge.

Interestingly, though, the fact that consumer protections might benefit insurers' collective interests does not undermine the prediction that insurers competing in a market comprised of policyholders who were unsophisticated about regulatory choice would demand minimalist regulation.[140] This is because insurers who were choosing among competing regulatory regimes would ignore, or at least largely discount, these potential industry-wide benefits of consumer protection in choosing among competing regulators. These industry-wide benefits from consumer protections arise from the capacity of consumer protections to solve collective action problems by limiting the permissible range of choices available to individual insurers. But regulatory choice—at least when it is not tethered to firms' geographic sales or operations[141]—eliminates these collective action benefits from regulation. It does so because it is unable to prevent individual firms from "cheating" from the collective optimum by defecting to (i.e., choosing) a competing regulator. In other words, regulatory choice is a fundamentally unstable solution to prisoner's dilemma games, because it cannot prevent cheating by individual players.

The second objection is that insurers might choose a relatively robust regulatory regime to improve the coverage they offer to consumers. Even if consumers were not *directly* aware

race to the bottom may characterize insurers' claims handling practices in the current market). Even policyholders who were unsophisticated about specific insurers' regulatory choices might be influenced by media reports or other stories about insurers' bad practices. *See id.* at 740.

139. MARTIN F. GRACE & ROBERT W. KLEIN, THE EFFECTS OF AN OPTIONAL FEDERAL CHARTER ON COMPETITION IN THE LIFE INSURANCE INDUSTRY 26–29 (2007) (considering consumer benefits of regulation and stating that many insurers have expressed a desire for increased regulation).

140. As is true of all the analysis in Parts II and III, this 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.

141. *See supra* text accompanying notes 34–38.

of their insurer's regulatory choice, they might nonetheless be *indirectly* responsive to the improvements that resulted from that choice. The key problem with this objection, though, is that it inverts the usual logic of regulatory competition—that principals can monitor and discipline regulatory choices even when they cannot monitor the behavior that is subject to that regulation.[142] This inversion ultimately supports the absence of any consumer protection regulation whatsoever, rather than regulatory competition.[143]

Although insurers would inevitably pursue weak consumer protections if their consumers were uninformed about their regulatory choices, the converse is not necessarily true. In fact, insurers might pursue inefficiently lax consumer protection regimes *even if* their consumers were sophisticated about insurers' regulatory choices.[144] For informed and sophisticated policyholders, a key benefit of consumer protections is that they enhance the credibility of insurers' commitments.[145] The sequential and contingent nature of insurance means that even insurers that want to commit to paying claims in the future may have difficulty doing so, especially in markets (such as life insurance) where commitments are long term.[146] Most potential

142. *See* Romano, *supra* note 74, at 2367 ("[A] theoretical need for government regulation to prevent market failure is not equivalent to a need for a monopolist regulator."). Even if market forces are insufficient to protect insureds against risks such as unfair claims handling and exploitive policy forms, Schwarcz, *supra* note 115, at 1403–12, it does not necessarily follow that they are insufficient to effectively constrain insurers' choices among competing regulators.

143. As I have argued at length elsewhere, there are good reasons for consumer protections in insurance. Schwarcz, *supra* note 138, at 726–27. Indeed, defenders of regulatory competition in its most robust forms argue that it offers a procedural mechanism that increases the chances of reaching the efficient substantive outcome whatever the nature of that outcome. *See* O'HARA & RIBSTEIN, *supra* note 21, at 199–215.

144. *But see* GRACE & KLEIN, *supra* note 139, at 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."); Butler & Ribstein, *supra* note 4, at 40.

145. Other explanations for consumer protections do not substantially benefit informed consumers who do not need regulatory protections to locate an insurer that offers the coverage they desire. *See* Schwarcz, *supra* note 138, at 725–26 (contrasting sophisticated and ordinary consumers).

146. 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"*

options for making credible commitments—such as investing heavily in a brand or acquiring ratings from private entities—are imperfect. Regulation can supplement these commitment devices with the prospect of legal sanctions in the event of broken commitments.

Regulatory competition of the type envisioned in OFC and SLS schemes could undermine this commitment device by allowing insurers to switch regulators in the future. For instance, an insurer looking to make a credible long-term commitment to policyholders by selecting a stringent financial regulator would be unable to do so, because it would always have the option of changing its selection in the future. This problem could likely be remedied by allowing firms to commit to a particular regulatory regime. But doing so might undermine some of the ostensible benefits of regulatory competition in the first place and raise a host of practical issues.

b. The Requisite Degree of Policyholder Sophistication About Insurers' Regulatory Choices

Predicting the nature of insurers' choices among competing regulatory regimes is complicated by the fact that potential policyholders are neither completely informed nor completely uninformed about those choices. In reality, some insurance purchasers in a scheme of regulatory competition would be "sophisticated" about insurers' regulatory choices, and others would not be. Assessing 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.[147] Ironically,

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).

147. The "informed minority" argument is important in contract law. R. Ted Cruz & Jeffrey J. Hinck, *Not My Brother's Keeper: The Inability of the Informed Minority to Correct for Imperfect Information*, 47 HASTINGS L.J. 635, 646–48 (1998); *see also* 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). 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. As such, it is hardly surprising that defenders of regulatory competition invoke the informed minority argument to argue that firms will make choices

this is partially due to the intense price competition that characterizes most consumer insurance markets.[148] Insurers that select a less intrusive regulatory regime will 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. 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.

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 marketplace, 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 until states adopted a mandatory fire insurance policy.[149] 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.[150] Such ruinous competition allegedly 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,

that are consonant with their consumers' preferences. *See, e.g.*, O'HARA & RIBSTEIN, *supra* note 21, at 35.

148. *See* Jeffrey R. Brown & Austan Goolsbee, *Does the Internet Make Markets More Competitive? Evidence from the Life Insurance Industry*, 110 J. POL. ECON. 481, 482–83 (2002) (term life); J. David Cummins, *Property-Liability Insurance Price Deregulation: The Last Bastion?*, *in* DEREGULATING PROPERTY-LIABILITY INSURANCE 2–3 (J. David Cummins ed., 2002) (property-liability); Paul T. Joskow, *Cartels, Competition and Regulation in the Property-Liability Insurance Industry*, 4 BELL J. ECON. & MGMT. SCI. 375, 391 (1973) (property-liability).

149. *See* BAKER, *supra* note 138, at 7 (explaining the relationship in the market between limited coverage, or "lemon," and comprehensive coverage, or "peach," fire insurance policies).

150. *See* MEIER, *supra* note 38, at 60–73 (chronicling the historical development of insurance regulation).

gravitated to the cheapest coverage available.[151] Although insurers have used this argument to justify collusive pricing, the underlying concern is legitimate.[152]

In sum, whether market forces would effectively discipline insurers' choices among competing regulators depends largely on the extent to which insurance consumers would know, and rationally respond to, insurers' choices among competing regulators. Regulatory competition may degrade consumer protections even if policyholders are generally informed about regulatory choices. But regulatory competition is sure to produce weaker consumer protections to the extent that most consumers are ill-informed about their insurers' regulatory choices.

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 personal property/casualty lines 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 consumers armed with this information would have a limited capacity to use it to make informed purchasing decisions. This section considers each reason in turn.

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.[153] 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 charac-

151. *See id.* at 59–60 (describing the former).

152. *See* MEIER, *supra* note 38, at 59–60; Macey & Miller, *supra* note 1, at 54–57.

153. Any scheme of regulatory competition would presumably be accompanied by a requirement that insurers disclose their chosen regulator. *See, e.g.*, Romano, *supra* note 74, at 2413 (proposing that firms would need to disclose which regulator they selected).

ter 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 family and friends are their primary source of information about competing insurers.[154] Other common sources of information, including insurance company literature, advertisements, television, and the yellow pages, similarly require minimal research and effort from consumers.[155] Recently, more consumers also report using internet platforms such as einsurance.com in selecting among competing insurers.[156] By contrast, a very small percentage of insurance consumers report conducting more extensive independent research of competing insurers: only three percent report consulting state government hotlines and only seven percent report using consumer-oriented magazines.[157] Perhaps even more notably, such consumers generally found these sources of information

154. *See* Jeffrey E. Thomas, *An Interdisciplinary Critique of the Reasonable Expectations Doctrine*, 5 CONN. INS. L.J. 295, 311 (1998) (citing INS. RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 1995 at 15 fig.2-7, 31 fig.2-27 and giving data that fifty-one percent of homeowner insureds and fifty-four percent of auto insureds relied on word of mouth to learn about insurance, more than all other sources of information). A similar 2001 study found that, for auto insurance, fifty-six percent of recent consumers relied on the recommendations of someone they knew, and ninety-eight percent of them stated that this information was somewhat or very valuable. *See* Schwarcz, *supra* note 115, at 1413 (citing INS. RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 2001, Issue 2, at 6 fig.2-5). As in 1995, insureds did not cite any other source of information as frequently as a basis for their decision. *Id.* 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. *Cf.* Schwarcz, *supra* note 138, at 737–38 (discussing consumer behaviors). For that reason, it is hardly surprising that *virtually all* consumers report being satisfied with their auto and homeowners insurance. *See* Schwarcz, *supra* note 115, at 1413.

155. *See* Thomas, *supra* note 154, at 313.

156. *See* Randy E. Dumm & Robert E. Hoyt, *Insurance Distribution Channels: Markets in Transition*, 22 J. INS. REG. 27, 28 (2003) (noting that the internet channel "was growing at an explosive rate").

157. *See* Thomas, *supra* note 154, at 312–14 (providing 1995 data).

less useful than more accessible sources of information, such as advice from friends and family.[158]

When consumers do conduct independent research, they focus principally on price. One recent study found that only ten percent of automobile insurance customers reported selecting a carrier that did not offer the lowest price.[159] Price distinctions are obviously easy for consumers to understand and compare. Consumers who choose among competing carriers for reasons other than price do not generally do so because their independent research has revealed relevant nonprice information. Rather, they do so because they personally received poor service or experienced a claims problem.[160]

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. In one study of 194 respondents, none reported reviewing independent financial strength ratings in purchasing their coverage, two reported consulting popular press like *Consumer Reports*, and one reported contacting the state insurance commissioner.[161] The overwhelming majority of survey respondents chose a life insurer based on the recommendations of others.[162] More recent research finds a significant amount of comparison shopping based on price in the term life insurance market, which has helped to lower premiums substantially. However, it finds limited evidence of such comparison shopping in the whole life insurance markets, where products are much more complicated and heterogeneous.[163]

158. *See* Schwarcz, *supra* note 115, at 1413, 1416 (citing INS. RESEARCH COUNCIL, PUBLIC ATTITUDE MONITOR 2001, Issue 2, at 6 fig.2-5 that ninety-eight percent found useful information from family and friends compared to only ninety percent for that from insurance agents).

159. *See* J.D. POWER & ASSOCS., 2009 INSURANCE SHOPPING STUDY, http://www.jdpower.com/insurance/articles/2009-Insurance-Shopping-Study; *see also* Dumm & Hoyt, *supra* note 156, at 35 fig.1 (citing 2001 survey by J.D. Power and Associates indicating that cost savings may not greatly influence decision making).

160. *See* Dumm & Hoyt, *supra* note 156, at 36 fig.2 (noting thirty-four percent were "event-driven").

161. *See* Roger A. Formisano et al., *Choice Strategies in Difficult Task Environments*, 8 J. CONSUMER RES. 474, 476 (1982).

162. *See id.* at 477.

163. *See* Brown & Goolsbee, *supra* note 148, at 503.

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. Nonprice distinctions among competing insurers are complex, contingent, and difficult to interpret.[164] Yet first-time decisions among competing insurers are generally made during eventful and stressful times in peoples' lives.[165] In the property/casualty context, consumers first select a carrier when they buy a home or automobile, or move.[166] First-time life insurance decisions are often made when people take a new job or have a sudden change in family structure. And once consumers select an insurer, they tend not to switch unless they can save a substantial amount of money from doing so.[167]

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 life insurance markets and about half in property/casualty lines 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 passed on to consumers, but it eliminates expert advice about choosing among competing carriers.[168] Even consumers who do purchase insurance through independent agents often receive slanted advice about competing insurers.[169] Most independent insurance agents receive con-

164. RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE 77 (2008) ("The benefits from holding insurance are delayed, the probability of having a claim is hard to analyze, consumers do not get useful feedback on 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.").

165. Consumers making decisions under these circumstances rationally "adopt simple choice strategies" that balance "the desire to achieve accuracy with the desire to minimize effort." Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, 70 U. CHI. L. REV. 1203, 1223–34 (2003).

166. *See* Dumm & Hoyt, *supra* note 156, at 36 fig.2 (noting thirty-four percent were "event-driven").

167. *See id.* at 34.

168. *See* Laureen Regan & Sharon Tennyson, *Insurance Distribution Systems*, *in* HANDBOOK OF INSURANCE 709, 712–17 tbls.1 & 3 (Georges Dionne ed., 2000) (16.4% and 49.7%, respectively).

169. *See* Daniel Schwarcz, *Beyond Disclosure: The Case for Banning Contingent Commissions*, 25 YALE L. & POL'Y REV. 289, 296–303 (2007) (discussing these agents "inefficient steering" to suboptimal plans).

tingent commission payments or other forms of differential compensation from insurers based on the amount of business they direct to the insurer.[170] 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.[171] They consequently 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.[172] 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.[173] But in contrast to financial ratings, where there is substantial agreement at least with respect to the basics,[174] any rating of a jurisdiction's regulatory "quality" could be immensely subjective, depending in large part on the political philosophy of the entity doing the rating.[175] As a result, different ratings organi-

170. *See* Schwarcz, *supra* note 138, at 727–32 (elaborating on these compensation schemes).

171. *Id.*

172. *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.").

173. *Cf.* Tom Baker & David Moss, *Government as Risk Manager*, *in* NEW PRINCIPLES ON REGULATION 99 (David Moss & John Cisternino eds., 2009), (discussing government standards and private marketing slogans that convey complex messages simply).

174. 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." A.M. Best, Best's Credit Rating Methodology, http://www.ambest.com/ratings/methodology.asp (last visited Mar. 7, 2010).

175. Some have tried to rate the enforcement of different countries' corporate and securities law. *See* Rafael La Porta et al., *Law and Finance*, 106 J. POL. ECON. 1113, 1115 (1998). But rating the content of the laws themselves is an entirely different matter from rating enforcement efforts, where factors such as the number of enforcement actions can be used to generate quantitative metrics. *Id.* at 1140. Moreover, these ratings have themselves been sharply criticized by many scholars. *See, e.g.*, Stephen J. Choi & Kon Sik Kim, *Es-*

zations could easily have largely inconsistent ratings of different regulators, and challenging the accuracy of these different ratings would be costly and difficult.

Ultimately, of course, the percentage of consumer-policyholders who would be familiar with their insurer's regulatory selection would depend on numerous factors. These include the specific insurance market at issue, the number of competing regulators, and the extent to which any of these regulators invested in developing a particular reputation with consumers and/or insurers. But this section gives good reason to be skeptical that a substantial percentage of policyholders would be so informed, given the manner in which consumers shop for insurance and the complex and subjective nature of the underlying information.

b. Consumer Decisionmaking and Regulatory Choice

Even if consumers were reasonably well-informed about the relative quality of insurers' choices of regulatory regimes, they would have substantial difficulties in assessing the implications of those choices for their own purchasing decisions. Consumers only care about an insurers' regulatory regime insofar as it provides them with better coverage or lower costs. But the relationship between insurance regulation and these two variables—particularly the former—is complicated and contestable.[176] It requires an appreciation of the risks involved in insurance transactions, and the extent to which regulation effectively mitigates those risks.[177] Simply put, many consumers do not have this appreciation of insurance regulation.

Not only would consumers have difficulty mapping insurers' regulatory choices into substantive outcomes, but they would be prone to underestimating the benefits that enhanced regulation could produce in terms of better coverage.[178] Beha-

tablishing a New Stock Market for Shareholder Value Oriented Firms in Korea, 3 CHI. J. INT'L L. 277, 281–82 (2002).

176. *See* THALER & SUNSTEIN, *supra* note 164, at 75–76 (describing this as mapping from choices to outcomes).

177. It is for precisely this reason that regulators still regulate insurers' solvency and organize guarantee funds even though it is relatively easy for consumers to get objective measures of different insurers' financial strength. *See supra* note 174.

178. 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 Univ., Working Paper 2004); *see also* Howard Kunreuther & Mark V. Pauly, *Rules Rather Than Discretion:*

vioral research reveals that individuals systematically underestimate the likelihood that they will suffer an insurable loss. Studies have repeatedly shown that people are ordinarily overly optimistic that they will not be injured in an earthquake,[179] be involved in a car accident,[180] suffer from health problems,[181] or die young.[182] Such over-optimism "is a pervasive feature of human life" in general.[183] Of course, competing factors—such as recent events that make bad outcomes particularly available—can push probability estimates in the other direction. But over-optimism tends to be a robust phenomenon that has been repeatedly documented in insurance decisions in particular. Such over-optimism produces an artificially depressed assessment of the value of regulatory protections, which only matter when, and if, consumers suffer a loss.

Lessons from Hurricane Katrina (Nat'l Bureau of Econ. Research, Working Paper No. W12503, 2006), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=927387. Much of this literature is of limited applicability 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 decision making, such as underestimation of risks, many behavioral anomalies are not so easily described as errors, rather than preferences. *See* Daniel Schwarcz, *Regulating Consumer Demand in Insurance*, ERASMUS L. REV. (forthcoming 2010), *available at* http://ssrn.com/abstract=1572908 (arguing that consumer deviations from expected utility theory in the insurance realm are often the results of mistakes, but that these deviations can also frequently be explained as sophisticated behavior). Second, many behavioral anomalies would have an ambiguous impact on how consumers would evaluate insurers' regulatory choices in a system of regulatory competition.

179. 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, 40–41 (1992).

180. David Dunning et al., *Ambiguity and Self-Evaluation: The Role of Idiosyncratic Trait Definitions in Self-Serving Assessments of Ability*, 57 J. PERSONALITY & SOC. PSYCHOL. 1082, 1082 (2006); Ola Svenson, *Are We All Less Risky and More Skillful Than Our Fellow Drivers?*, 47 ACTA PSYCHOLOGICA 143, 147 (1981).

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

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

183. *See* THALER & SUNSTEIN, *supra* note 164, at 31–33 (noting that such "unrealistic optimism . . . characterizes most people in most social categories").

B. Regulatory Demand and Other Beneficiaries of Insurance Regulation

Although consumers are the primary intended beneficiaries of insurance regulation, they are not the only such beneficiaries. At least two other potential groups of beneficiaries exist: insurers themselves and third parties outside of the insurer/policyholder relationship.[184] This section examines these potential beneficiaries, looking at the extent to which "insurer demand" among competing regulators would promote these interests. It first argues that insurer demand would do little to promote industry objectives other than reducing regulatory costs. It 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.[185] Frequently, such claims are premised on the idea that consumer protections benefit financial firms by solving collective action or commitment problems.[186] Section A showed why individual insurers' preferences among competing regulatory regimes could not be expected to promote these goals.[187] In short, regulatory solutions to collective action problems typically require that those solutions are mandatory. By giving insurers choice as to their regulatory scheme, regulatory competition allows individual insurers to cheat from the collective optimum.[188] Regulatory competition would also be unlikely to solve

184. *See generally* Howell E. Jackson, *Regulation in a Multisectored Financial Services Industry: An Exploratory Essay*, 77 WASH. U. L.Q. 319, 333–34 (1999) (identifying financial regulation as primarily concerned with regulating risk and protecting consumers/investors and third parties).

185. *See* Timothy Geithner & Lawrence Summers, *A New Financial Foundation*, WASH. POST, June 15, 2009, at A15 (describing the 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).

186. *See, e.g.*, Schwarcz, *supra* note 129, at 810 (promoting an independent dispute resolution entity for consumer insurance lines, and arguing that it would enhance the insurance industry's reputation among consumers by restricting the capacity of insurers to unfairly limit or delay claim payments).

187. *See supra* Part II.A.

188. *See supra* text accompanying notes 137–43.

commitment problems given the prospect that an insurer could change regulatory regimes in the future.[189]

However, regulation can also promote the interests of regulated entities in more obvious ways. 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 scale and avoid coordination problems associated with certain services.[190] Consider the banking sphere, where these considerations prompt the Federal Reserve to provide private banks with check-clearing, wire-transfer, and automated clearinghouse transaction services.[191] 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.[192] 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.[193]

Although insurers' regulatory demand might promote regulators' provision of direct services to insurers,[194] this is not an important element of insurance regulation. The reason is that

189. *See supra* text accompanying notes 143–46.

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

191. *See generally* Adam J. Levitin, *Public-Private Competition in Payments: The Role of the Federal Reserve* (Georgetown Univ. Law Ctr., Working Paper No. 1420061, 2009), *available at* http://ssrn.com/abstract=1420061 (arguing that the Federal Reserve serves industry interests by introducing competition into the marketplace where none would exist).

192. *See* Wilmarth, *supra* note 83, at 1156.

193. *See* Claire A. Hill & Brett H. McDonnell, Disney*, Good Faith, and Structural Bias*, 32 J. CORP. L. 833, 848 (2007); 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 a public company 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. 15 U.S.C. §§ 7264–7265 (2006).

194. 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 & Damien Geradin, *Regulatory Co-Opetition*, *in* REGULATORY COMPETITION AND ECONOMIC INTEGRATION, *supra* note 17, at 30, 36–37.

industry associations already do an excellent job of providing these services.[195] The most important example is the Insurance Services Office (ISO), which facilitates the drafting of standard insurance policies and the collection of aggregate loss data.[196] Other examples include the Coalition Against Insurance Fraud, which serves as a national clearinghouse for information about insurance fraud,[197] and the Insurance Marketplace Standards Association, which develops best practices for life insurers.[198]

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. The insurance industry has been largely exempt from federal antitrust laws since the McCarran Ferguson Act was passed in 1945.[199] This has allowed private industry associations to play a large role in identifying common issues and coordinating activities without facing significant antitrust scrutiny.[200] At the same time, insurance regulators have historically been poorly situated to facilitate industry coordination because those regulators have themselves been uncoordi-

195. Coordination in securities is also significantly facilitated by private associations. First, the Financial Accounting Standards Board, a private association, sets accounting rules for public disclosures that are adhered to in most states. *See* Romano, *supra* note 74, at 2394. Second, exchanges set various trading rules that are forms of regulation. *See* Roberta S. Karmel, *Should Securities Industry Self-Regulatory Organizations Be Considered Government Agencies?*, 14 STAN. J.L. BUS. & FIN. 151, 153 (2008).

196. *See* KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 34 (4th ed. 2005). 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.* at 33–34; *see also* Helping Insurers Price Their Products, http://www.iso.com/About-ISO/ISO-Services-for-Property-Casualty-Insurance/Helping-Insurers-Price-Their-Products.html (last visited Mar. 3, 2010).

197. About the Coalition Against Insurance Fraud, http://www.insurancefraud.org/aboutus.htm (last visited Mar. 19, 2010).

198. Insurance Marketplace Standards, Association Frequently Asked Questions, http://www.imsaethics.org/Content/FAQs_47.aspx (last visited Jan. 15, 2010).

199. *See* Macey & Miller, *supra* note 1, at 14–27.

200. *Id.* at 47–48. 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. *Id.* at 64–65.

nated.[201] State regulators' historical lack of coordination helped induce the industry to develop strong and active industry associations to allow individual insurers to navigate this patchwork regulatory system.[202] This, in turn, has allowed industry associations to take on roles that might otherwise not be efficiently provided in markets without regulatory competition.

2. Externalities and Third-Party Beneficiaries of Insurance Regulation

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.[203] These positive externalities of regulation are costly to regulated entities and, unlike consumer protections, provide them with virtually no potential benefit.

Insurance regulation is at least partially intended to benefit third parties to the insurance transaction as well as consumers and insurers.[204] For instance, regulations promoting the payment of liability insurance claims protect accident victims as well as policyholders.[205] Regulations in the property insurance sphere shield neighborhoods and families from the consequences of destroyed homes and businesses.[206] And the regulation of virtually all forms of insurance helps to keep individuals from relying on publicly funded social insurance programs, such as bankruptcy, social security, and unemployment insurance.[207]

201. *Cf. id.* at 72–74 (describing different state regulatory schemes).

202. *See* Brown, *supra* note 23, at 4–6 (describing the lack of coordination in state regulation); *see also* Helping Insurers Comply with Legal and Regulatory Requirements, http://www.iso.com/About-ISO/ISO-Services-for-Property-Casualty-Insurance/Helping-Insurers-Comply-with-Legal-and-Regulatory-Requirements.html (last visited Mar. 3, 2010).

203. *See supra* Part I.B.1.

204. *See generally* Jeffrey W. Stempel, *The Insurance Policy as Social Instrument and Social Institution*, 51 WM. & MARY L. REV. 1489, 1489 (2010) (arguing that "insurance policies are not merely contracts but also are designed to perform particular risk management deterrence, and compensation functions important to economic and social ordering").

205. *See* BAKER, *supra* note 138, at 8, 642.

206. *See id.*

207. *See* Kenneth S. Abraham & Lance Liebman, *Private Insurance, Social Insurance, and Tort Reform: Towards a New Vision of Compensation for Illness and Injury*, 93 COLUM. L. REV. 75, 94–96 (1993) (describing the interactions between public and private insurance programs).

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. For instance, regulations may forbid the use of certain underwriting classifications, such as gender, race, and genetics.[208] 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 suicides[209]—at least partially for similar reasons.

Although insurance regulation is indeed partially designed to protect the interests of third parties to the insurance relationship, this is not a central goal of insurance regulation, as it is in the banking context. The reason is that insurance—defined to exclude "insurance" against losses to credit risks[210]—generally does not create substantial systemic risks.[211] First, and most importantly, insurance failures are not particularly contagious because policyholders usually only have a right to demand payment on the occurrence of a contractually specified event.[212] This minimizes the risk of a "run" on an insurer.[213]

208. *See* KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 92–93 (1986); *cf.* Regina Austin, *The Insurance Classification Controversy*, 131 U. PA. L. REV. 517, 538–46 (1983) (describing the utility of age, sex, and marital data to insurance companies' calculation of risk).

209. *See generally* BAKER, *supra* note 138, at 25.

210. *See* Henderson, *supra* note 20, at 2–4.

211. *See* Richard Herring & Til Schuermann, *Capital Regulation for Position Risk in Banks, Securities Firms, and Insurance Companies*, *in* CAPITAL ADEQUACY BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE 23–24 (Hal S. Scott ed., 2005); Klein, *Overview*, *supra* note 5, at 28 ("With the exception of the problems suffered by the American International 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."); VAUGHAN, *supra* note 24, at 3 ("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.").

212. Life insurers are more susceptible to contagion because life insurance products often include savings vehicles from which policyholders can withdraw funds. *See* JERRY, *supra* note 2, at 31. Even for life insurance products, contagious risks are limited because the most common forms of life insurance—term life insurance and basic annuities—do not permit policyholders to withdraw funds. *Id.* at 30. Perhaps more importantly, policyholders conceptualize life insurance products differently than they conceptualize demand deposits in banks. 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. *See* Scott E. Harrington, *Policyholder Runs, Life Insurance Company Failures, and Insurance Solvency Regulation*, 15 REG. 27, 30 (1992); *cf.*

Second, unlike credit, the availability and proper functioning of insurance is not a prerequisite to most systemically important economic activities.[214] To the extent that 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.[215] Finally, the inability of an insurer to pay claims is unlikely to be systemically significant as insurers naturally avoid concentrated and correlated risks. While insurance regulation may be *less* concerned with protecting third parties than banking regulation, such protection is nonetheless an important goal of insurance regulation. Yet, it is a goal that insurers' demand for competing regulators would ignore.

Regulatory Modernization: Perspectives on Insurance Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong. 5 (2009) (statement of Martin F. Grace). Even the near collapse of insurance giant AIG has not triggered an "insurance run" from AIG itself or from other insurers. *See* Editorial, *The Never-Ending Bailout*, N.Y. TIMES, Mar. 3, 2009, at A26.

213. 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. It can also promote contagion, as depositors at other banks seek to withdraw funds for fear that their own bank is financially weak. *See* DAVID A. MOSS, WHEN ALL ELSE FAILS: GOVERNMENT AS THE ULTIMATE RISK MANAGER 91 (2002). Banking regulation limits this risk by providing deposit insurance, which limits the incentives of wary depositors to withdraw their funds. *Id.* at 118.

214. *See* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors' & Officers' Liability Insurer*, 95 GEO. L.J. 1795, 1834, 1841 (2007) (suggesting that the purchase of traditional forms of insurance by these companies is somewhat of a mystery, at least when they are publicly owned); Victor P. Goldberg, *The Devil Made Me Do It: The Corporate Purchase of Insurance* 2 (Columbia Law Sch., Working Paper No. 346, 2009), *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 L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1522 (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. *See id.* at 1526.

215. There is ample precedent for such measures, most notably the Terrorism Risk Insurance Act of 2002, Pub. L. No. 107-297, § 103, 116 Stat. 2327 (codified as amended at 15 U.S.C. § 6701 (2006 & Supp. 2007)). 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. Insurance markets routinely cycle between "hard" markets, where coverage is limited and more expensive, and "soft markets," where it is comparatively available and inexpensive.

III. REGULATORY SUPPLY AND INSURANCE

Part II argued that insurers in a scheme of regulatory competition would demand minimalist regulatory regimes that imposed as few costs and constraints on them as possible. But competing regulators would not necessarily supply such a regime. Simply put, competing regulators would have various incentives other than attracting insurers 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 degree to which "ordinary" political economy factors would temper insurers' demand for deregulation depends crucially on the number of competing regulators. As the number of competing regulators increases, so too will the prospect that regulatory demand will dominate other regulatory incentives.[216] Consequently, while regulatory demand would largely determine outcomes in an SLS scheme with fifty competing regulators, it would simply supplement other regulatory incentives in an OFC scheme that contained only two competing regulators.

This distinction is crucial, as a *limited* incentive for regulators to attract competing firms may, in certain contexts, offset some of the inefficiencies of regulation without jeopardizing its core objectives. This argument is often deployed by defenders of the dual banking system.[217] In particular, they have argued that the dual banking system causes regulators to reduce regulatory costs, embrace innovation, and specialize in different types of banks.[218] At the same time, the dual banking system does not undermine the effectiveness of regulation, according to its defenders, because regulators must balance their desire to attract banks with the political consequences of allowing banks to fail.[219]

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 content of insurance regulation. It focuses on three ways in which regulatory demand for decreased regulatory costs may theoretically do so. First, section A considers the argument that

216. *See supra* text accompanying note 125.
217. *See* Fischel et al., *supra* note 94, at 335.
218. *See* Miller, *supra* note 61, at 14–15.
219. *See supra* Part I.B.3.

the political economy of insurance regulation means that it is naturally prone to excessive intervention in the markets. If so, limited regulatory competition may provide a desirable counterweight to this tendency. Focusing on nonsolvency consumer protections—the domain most frequently criticized on these grounds[220]—it argues that insurance regulation is structurally more susceptible to the opposite problem: insufficient regulation. Regulatory competition would exacerbate this problem rather than offset it.

Section B turns to a second regulatory supply argument: that regulatory demand can promote more efficient regulation without jeopardizing regulatory effectiveness. Here, the primary target of critics is typically state solvency regulation, at least once one sets aside complaints about the duplicative and overlapping nature of nonsolvency regulation for multistate insurers.[221] While acknowledging that insurance solvency regulation is indeed antiquated, section B argues that regulatory competition is not a good solution to this problem. Rather, it would undermine the most promising approach to modernizing solvency regulation and jeopardize a scheme that worked reasonably well in the recent financial crisis.

Finally, section C considers the argument that regulatory competition can promote specialization among different regulators. It argues that the status quo already achieves such regulatory specialization through cooperation rather than competition. It also observes that, at least in the property/casualty context, the most important form of specialization for regulators—familiarity with local perils and the state tort system—is embedded in the status quo.

A. REGULATORY COMPETITION AND OFFSETTING EXCESSIVE REGULATION

Regulatory competition is often defended on supply-side grounds based on the claim that monopolistic regulatory schemes tend to be excessive. Regulatory competition, from this

220. Few commentators argue that state solvency regulation is excessive, as most seem to accept the premise that such regulation is sensible, even if it could be more efficiently conducted.

221. Efficiency complaints about nonsolvency regulations usually involve the difficulty of complying with multiple regulatory regimes rather than the substantive inefficiencies associated with any particular regulatory approach. As noted at the outset, this Article explicitly excludes this issue from analysis on the grounds that regulatory competition is not necessary to address this problem.

perspective, can offset this natural tendency of regulation. At the very least, it can give regulated entities a safety valve against the worst regulatory excesses. Moreover, regulators' natural inclination to overregulate mitigates the prospect that a small number of competing regulators would go too far in promoting deregulation to attract regulated entities.[222]

Such supply-side arguments are common among proponents of insurance regulatory reform, who often cite price regulation in homeowners and automobile insurance markets to argue that political forces promote excessive state regulation of insurers' market behavior.[223] And a fair reading of the evidence supports these claims. Both automobile and homeowners insurance premiums are highly salient political issues in certain states.[224] This political pressure has often generated regulatory efforts to prohibit or limit price increases in insurance markets.[225] 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.[226] The reason is that automobile and homeowners insurance markets are naturally quite price competitive,[227] meaning that artificially low prices must be off-

222. *See supra* Part I.B.2 (discussing these arguments in the banking context).

223. *See, e.g.*, Grace & Scott, *supra* note 7, at 74; Klein, *Overview*, *supra* note 5, at 31; Robert E. Litan & Phil O'Connor, *Consumer Benefits of an Optional Federal Charter: The Case of Auto Insurance*, *in* THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES, *supra* note 4, at 145–46; *cf.* Butler & Ribstein, *supra* note 4, at 38 ("[S]tates . . . [have] the ability and incentive to impose inefficient regulation at the behest of local interest groups.").

224. *See generally* Cummins, *supra* note 148, at 10–11 ("[A]uto insurance prices have been a potent political issue in legislative and gubernatorial elections for decades in states such as New Jersey and Massachusetts."); Grace & Klein, *supra* note 38, at 105 ("The cost and availability of property insurance has been a potent issue in many coastal areas, none more so than Florida.").

225. *See* Cummins, *supra* note 148, at 13; Grace & Klein, *supra* note 38, at 105. This is hardly surprising, as state insurance commissioners are either elected or appointed by the state governor, and thus operate in a highly politicized environment. *See* Martin F. Grace & Richard D. Phillips, *Regulator Performance, Regulatory Environment and Outcomes: An Examination of Insurance Regulator Career Incentives on State Insurance Markets*, 32 J. BANKING & FIN. 116, 121 (2008).

226. *See* Stephen D'Arcy, *Insurance Price Deregulation: The Illinois Experience*, *in* DEREGULATING PROPERTY-LIABILITY INSURANCE, *supra* note 38, at 248, 265–66; Scott E. Harrington, *Effects of Prior Approval Rate Regulation of Auto Insurance*, *in* DEREGULATING PROPERTY-LIABILITY INSURANCE *supra* note 38, at 285, 309.

227. *See* Harrington, *supra* note 226, at 309–10.

set by artificially high prices or else insurers will simply refuse to write coverage in the state.[228] 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.[229]

Although some states' price regulations are indeed excessive, state market conduct regulation—defined here to include price and form regulation[230]—is actually dominated by problems of precisely the opposite character. In part, this is because the character of price regulation has changed across the country in the last decade. Only fifteen states currently require insurers' pricing schemes to be approved before they are offered in the marketplace and no state unilaterally sets insurance rates.[231] With a few notable exceptions (such as Florida), these states are increasingly abandoning efforts to use price regulation as a tool to keep premiums below market rates.[232] Rather,

228. 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 38, at 90. Recently, State Farm threatened to leave the Florida market, and agreed to stay only after the state regulator allowed it to nonrenew up to fifteen percent of its residential property policies and to raise its insurance rates on approximately fifteen percent on all homeowners and condominium unit owners policies. *See* Lavonne Kuykendall, *Insurer State Farm Drops Plan to Leave Florida*, WALL ST. J., Dec. 16, 2009, http://online.wsj.com/article/BT-CO-20091216-712292.html.

229. *See* Harrington, *supra* note 226, at 310; Sharon Tennyson, *Efficiency Consequences of Rate Regulation in Insurance Markets* 18 (Networks Fin. Inst., Policy Brief No. 2007-PB-03, 2007), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=985578 (suggesting attempts to regulate insurance prices may be "self-defeating in the long run").

230. Market conduct regulation is sometimes distinguished from the regulation of insurance policy forms and rates. The former is envisioned to encompass only issues such as insurers' advertising, selling, and claims handling. This Article collapses this distinction for expositional ease.

231. *See* J. ROBERT HUNTER, CONSUMER FED'N OF AM., STATE AUTOMOBILE INSURANCE REGULATION: A NATIONAL QUALITY ASSESSMENT AND IN-DEPTH REVIEW OF CALIFORNIA'S UNIQUELY EFFECTIVE REGULATORY SYSTEM 2–3 (2008), http://www.consumerfed.org/elements/www.consumerfed.org/file/finance/state_auto_insurance_report.pdf (reporting that fifteen states use prior approval, twenty-three states employ file and use, eight states employ use and file, and four have limited regulatory oversight). In contrast, in January 2001, thirty-one states required prior approval of automobile insurance rates. Cummins, *supra* note 148, at 3.

232. *See, e.g.*, Phil Gusman, *Mass. AG, Insurers Spar Over State's Auto Insurance System*, NAT'L UNDERWRITER PROP. & CASUALTY, Dec. 28, 2009, http://www.property-casualty.com/News/2009/12/Pages/Mass-AG-Insurers-Spar-Over-States-Auto-Insurance-System.aspx (describing Massachusetts' abandonment

they are tending to focus their scrutiny on the more defensible goal of ensuring that rates do not discriminate among policyholders based on illegitimate criteria.[233]

Even more importantly, insurance market conduct regulation outside of price regulation is generally subject to political forces that lead to underregulation rather than overregulation. In contrast to price regulation, most forms of market conduct regulation only matter to consumers who actually *use* their insurance. Examples include regulations governing the qualifications and duties of insurance agents, the accuracy and effectiveness of disclosures, the substance of insurance policies, and the willingness of insurers to settle claims promptly and fairly.[234] Because most policyholders never suffer substantial losses, they generally have no first-hand experience with these regulatory issues.[235] And when consumers do experience losses, and potentially encounter market conduct regulatory issues, those experiences are normally discrete and non-correlated.[236] Not only are most forms of market conduct regulation unfamiliar to consumers, they are also quite complex. Unlike with premiums, an appreciation of the contractual and regulatory rules governing insurers and their sales force is generally necessary to understand these issues.

Because the vast majority of market conduct regulations are complex and nonsalient, they are more prone to regulatory capture and underregulation than the excesses that have characterized price regulation in the recent past. The leading study of the political economy of insurance regulation concluded that

of the system of setting insurance "rates that would be used by all auto insurers").

233. *See infra* text accompanying notes 244–57.

234. *See generally* ROBERT W. KLEIN, A REGULATOR'S INTRODUCTION TO THE INSURANCE INDUSTRY 107–13, 140–67 (2d ed. 2005) (providing an overview of the elements of market conduct regulation).

235. *See* Schwarcz, *supra* note 115, 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.").

236. This is not an accident. Insurance is specifically designed to aggregate an individual's risks of loss so that the risks occur in predictable and steady fashion. *See* BAKER, *supra* note 138, at 2. The obvious exception involves mass catastrophes, where insurance regulatory issues can become quite politically salient precisely because numerous policyholders simultaneously experience a sizeable and publicly accessible loss. Insurance regulators may tend to be less captured by industry interests in such scenarios. Elizabeth Baker Murrill, *Mass Disaster Mediation: Innovative ADR, or a Lion's Den?*, 7 PEPP. DISP. RESOL. L.J. 401, 403–07 (2007).

industry interests historically dominated debates about regulatory issues at the state level when those issues were complex and not politically salient.[237] Perhaps the most notorious example is the institutionalization of semiprivate rate-making organizations that facilitated price fixing among competing property/casualty insurers.[238] When insurance issues are not politically salient, political forces are relatively weak but industry interests can be quite strong, especially when the industry is relatively unified in its position. This is hardly surprising, as state insurance regulators interact constantly with industry representatives.[239] Even more importantly, there is also a sig-

237. Randall, *supra* note 1, at 679; *see also* MEIER, *supra* note 38 ("The political economy of insurance regulation results from a complex interaction of insurance groups, consumer interests, regulatory bureaucrats, and political elites.").

238. Meier's excellent book reviews a number of examples of this phenomenon in depth. *See generally* MEIER, *supra* note 38. Consider two of the most important examples. 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. *Id.* at 58–59. 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. *Id.* at 59–61. Unlike the Armstrong Committee, insurers were able to control the agenda of the Merritt Committee in order to develop a scheme of collaborative ratemaking that ultimately created a state-run system for fixing fire insurance premiums. *See id.* 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 politically salient event, "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.

239. *See* Randall, *supra* note 1, at 677–82 (discussing interactions between industry representatives and regulators at NAIC meetings).

nificant amount of cross-fertilization between the industry and top state regulators, with seventeen percent of state insurance commissioners employed in the insurance industry before becoming commissioners, and fifty percent of commissioners going directly to insurance industry positions after their tenure as commissioners.[240]

This trend is evident in some of the most important market conduct 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 sued, and how often policies were canceled or nonrenewed.[241] Such information, while absolutely necessary to assess the relative quality of different insurance options, is almost entirely absent from the public domain.[242] In 2008, under the leadership of a pro-consumer state insurance commissioner, the Market Conduct and Consumer Affairs Committee of the NAIC proposed 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.[243]

Second, industry interests have generally prevailed with respect to the use of credit scoring in insurance, which consumer groups have consistently attacked over the last decade.[244] The vast majority of automobile and homeowners insurers use

240. Grace & Phillips, *supra* note 225, at 122 tbl.1.

241. *See* James Connolly, *NAIC Insurer Conduct Data Scheme Riles Insurers*, NAT'L UNDERWRITER PROP. & CASUALTY, Sept. 25, 2008, http://www.property-casualty.com/News/2008/9/Pages/NAIC-Insurer-Conduct-Data-Scheme-Riles-Insurers.aspx; Letter from Lawrence Mirel to Sandy Praeger, President of the Nat'l Assoc. of Ins. Comm'rs (Apr. 16, 2008) (on file with author). Unfortunately, insurers have bitterly resisted the proposal under the guise of confidentiality and trade secrets. *See infra* text accompanying notes 307–09.

242. *See* Schwarcz, *supra* note 138, at 734.

243. *See supra* note 241.

244. *See, e.g.*, CHI CHI WU, NAT'L CONSUMER LAW CTR. & BIRNY BIRNBAUM, CTR. FOR ECON. JUSTICE, CREDIT SCORING AND INSURANCE: COSTING CONSUMERS BILLIONS AND PERPETUATING THE ECONOMIC RACIAL DIVIDE 1, 18 (2007), *available at* http://www.consumerlaw.org/reports/content/InsuranceScoring.pdf (calling for a ban on the use of credit scoring in insurance, but noting that many states permit it).

policyholders' credit scores to price their policies.[245] This is not surprising, given that there is substantial evidence that individuals' credit scores correspond to their losses.[246] 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 likelihood of suffering an insurance loss.[247] 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.[248] Yet credit scores serve as strong proxies for these characteristics.[249]

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.[250] 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.[251] No state has passed any substantive regulations of agents' commission arrangements, and the disclosure regulations that do exist are extremely limited.[252] New York's recent efforts to develop more extensive disclosure requirements prompted extensive industry outcry, causing New York to limit the scope of the required disclosures.[253]

245. *See id.* at 4.

246. *See* FED. TRADE COMM'N, CREDIT-BASED INSURANCE SCORES: IMPACTS ON CONSUMERS OF AUTOMOBILE INSURANCE 3 (2007), *available at* http://www.ftc.gov/os/2007/07/P044804FACTA_Report_Credit-Based_Insurance_Scores.pdf.

247. *See id.* (reporting that "there is not sufficient evidence to judge" why the correlation exists).

248. *See id.* at 61 ("The risk models that companies build do not include information about race, ethnicity, or income. If there are large differences in average risk based on [those factors], then models may attribute some of those differences in risk to other variables included in the model . . . ."). *See generally* Austin, *supra* note 208, at 528 (discussing legislative restrictions on factors insurers may consider).

249. *See* FED. TRADE COMM'N, *supra* note 246, at 72–73 (finding a "proxy effect" between credit scores and race).

250. Schwarcz, *supra* note 169, at 290.

251. *See id.* at 291; *see also* Robert W. Cooper, *Spitzer's Allegations of the Anticompetitive Effects of Contingent Commissions: A Shot Truly Heard Around the World*, J. INS. REG., Fall 2007, at 83, 100 (detailing American regulatory responses to industry problems with conflicts of interest).

252. *See* Schwarcz, *supra* note 169, at 292.

253. *See* Phil Gusman, *IIABNY Threatens Suit Over N.Y. Producer Comp Rule*,

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 quite aggressive, particularly when it comes to rate regulations. Moreover, strong consumer advocates do occasionally come into power in particular states and implement more far-reaching consumer protection programs.[254] But in the aggregate, ordinary "monopolistic" insurance regulation is more frequently subject to substantial regulatory capture that produces underregulation as opposed to excessive regulation. Trying to address this problem by embracing even a limited form of regulatory competition, such as that embodied in the OFC, would exacerbate this problem rather than solve it.

B. Regulatory Competition and Improving Regulatory Efficiency

A second key supply-side argument for regulatory competition is that it can promote more efficient regulation that reduces compliance costs for insurers but does not sacrifice effectiveness. In the insurance context, this argument is primarily directed at solvency regulation.[255] Indeed, the two key elements of state solvency regulation—capital and reserve requirements[256]—have remained relatively static over the last two

NAT'L UNDERWRITER PROP. & CASUALTY, Dec. 3, 2009, http://www.property-casualty.com/News/2009/12/Pages/IIABNY-Threatens-Suit-Over-NY-Producer-Comp-Rule.aspx; Mark E. Ruquet, *N.Y. Compensation Rules Would Burden Them, Some Agents Say*, NAT'L UNDERWRITER PROP. & CASUALTY, Sept. 11, 2009, http://www.property-casualty.com/News/2009/9/Pages/NY-Compensation-Rules-Would-Burden-Them-Some-Agents-Say.aspx.

254. Recent examples include J. Robert Hunter in Texas and John Garamendi in California. *See, e.g.*, Linda Tuma, *Hunter Refocuses Texas Ins. Dept.*, NAT'L UNDERWRITER, Mar. 21, 1994; Joseph B. Treaster, *States Increase Their Scrutiny of Insurance Brokers*, N.Y. TIMES, Oct. 21, 2004, http://www.nytimes.com/2004/10/21/business/21broker.htm (discussing Garamendi's efforts as the California Insurance Commissioner).

255. Once again, the primary efficiency argument with respect to market conduct regulation is based on the need for multistate insurers to comply with multiple regulatory schemes and is not addressed for that reason. *See supra* note 221.

256. *See generally* KLEIN, *supra* note 234, at 140–64 (discussing capital standards and reserve requirements and their use in solvency regulation). Of course, solvency regulation encompasses various additional elements. For instance, solvency regulations impose limits on the types of assets that insurers can hold. *See id.* at 146. Additionally, they include less quantitative review of insurer activity, such as scrutiny of insurers' management. *See id.* at 161–62. All solvency rules are enforced via quarterly and annual reports that insurers must file with state regulators, as well as by regular examinations of insurers'

decades, even though their shortcomings have become increasingly apparent during that time.[257]

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.[258] Various remedial measures are required when insurers fall below the requisite capital measures dictated by the risk-based formula.[259] 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.[260]

records to ensure the accuracy of more regular reports. *See id.* at 149–50. Insurers' annual statements to regulators are completed according to statutory accounting principles (SAP). *Id.* at 150. These are designed to be more conservative than generally accepted accounting principles (GAAP). *See id.* at 150–51. In particular, both assets and liabilities are valued on a liquidation basis, rather than a going-concern basis. *Id.* For an example of how SAP calculations work, see SEAN MOONEY & LARRY COHEN, BASIC CONCEPTS OF ACCOUNTING & TAXATION OF PROPERTY/CASUALTY INSURANCE COMPANIES 22–26 (1991).

257. 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, *supra* note 41, at 10 ("[S]olvency 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.").

258. There are actually three different models: one for life insurers, one for property/casualty, and one for health. *See* Martin Eling & Ines Holzmüller, *An Overview and Comparison of Risk-Based Capital Standards*, J. INS. REG., Summer 2008, at 31, 34. In order to be accredited by the NAIC, states are required to adopt the Risk-Based Capital for Insurers Model Act (RBC Model Act), MODEL LAWS, REGULATIONS AND GUIDELINES: RISK-BASED CAPITAL (RBC) FOR INSURERS MODEL ACT 312-1 (Nat'l Ass'n of Ins. Comm'rs. 2010), or substantially similar provisions. NAT'L ASS'N OF INS. COMM'RS., FINANCIAL REGULATION STANDARDS AND ACCREDITATION PROGRAM 7 (2009), *available at* http://www.naic.org/documents/committees_f_FRSA_pamphlet.pdf. 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 & Sommer, *supra* note 131, at 104.

259. For instance, while insurers who fall below the first threshold must file a remedial plan with regulators, insurers who fall below the last threshold must be seized by insurance regulators. *See* Klein, *supra* note 258, at 31 tbl.IV.1.

260. *See* Eling & Holzmüller, *supra* note 258, at 55–56. 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.

Second, it assigns crude ratings to different assets and liabilities that only partially reflect the actual associated risks.[261] Third, it does a poor job accounting for insurers' diversification and risk mitigation measures, employing a simple covariance formula that does not credit standard hedging techniques, much less sophisticated portfolio design.[262]

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.[263] In the life insurance industry, regulators strictly specify the criteria that insurers must use to predict those losses.[264] 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.[265] Regulators' formulaic rules for establishing reserves do not come close to keeping up with this rapid pace of product development.[266] Regulations governing reserves can

See Simon Ashby et al., *Lessons About Risk: Analysing the Causal Chain of Insurance Company Failure*, J. INS. RES. & PRAC., July 2003, at 1, 4–13.

261. *See* J. David Cummins et al., *Insolvency Experience, Risk-Based Capital, and Prompt Corrective Action in Property-Liability Insurance*, 19 J. BANKING & FIN. 511 *passim* (1995) (finding that the predictive accuracy of the RBC formula for property-casualty companies is low, and proposing several modifications that could improve its accuracy); Scott Harrington, *Capital Adequacy in Insurance and Reinsurance, in* BEYOND BASEL: BANKING, SECURITIES, AND INSURANCE, *supra* note 211, at 104–05 (noting that NAIC's risk-based capital standards are crude measures of real risk).

262. *See* Herring & Schuermann, *supra* note 211, 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 the NAIC RBC approach does, and does not, take into account diversification).

263. *See* Larry Bruning, *Principles-Based Reserving: A Regulator's Perspective*, J. INS. REG., Spring 2006, at 3, 3–4.

264. *See id.* at 4.

265. *See* Brown, *supra* note 23, at 8 ("Both consumers and regulators find it increasingly difficult to discern meaningful differences among insurance, banking and securities products."); Peter J. Wallison, *Convergence in Financial Services Markets: Effects on Insurance Regulation*, *in* THE FUTURE OF INSURANCE REGULATION IN THE UNITED STATES, *supra* note 4, at 167, 179 ("Insurers have developed tools and products that are increasingly substitutes for capital market instruments.").

266. *See* Bruning, *supra* note 263, at 4 (noting regulators' concern that "the current system does not adequately account for the new risks"); Wallison, *supra* note 265, at 172–73 (discussing institutional resistance to regulatory change).

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.[267]

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.[268] 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. Similarly, it might prompt competing federal and state regulators to develop more sophisticated tools for setting capital requirements that take into account the diversification of insurers' portfolios and their exposure to catastrophe and operational risk.

Enhanced regulatory competition nonetheless does not represent an attractive option for improving state solvency regulation. The key reason is that it is incompatible with the most promising *substantive* approach to improving solvency regulation: shifting towards a more principles-based solvency paradigm.[269] Principles-based solvency regulation deemphasizes,

267. *See* Bruning, *supra* note 263, at 4 (contrasting regulators' fears of excessive risk with insurers' desire to compete with other financial services providers on the basis of their own risk management processes); Wallison, *supra* note 265, at 183 (describing the difficulty of striking the right balance of regulatory oversight and vigorous industry competition).

268. *See supra* text accompanying notes 216–19.

269. Lawrence Cunningham takes issue with the notion that regulatory schemes can be, or ought to be, designated principles-based or rules-based. Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-based Systems" in Corporate Law, Securities Regulation, and Accounting*, 60 VAND. L. REV. 1411 *passim* (2007). Cunningham's basic argument is that regulatory systems usually use both rules and standards, meaning that it is not desirable to cabin regulatory schemes in one category or the other. *See id.* This Article does not necessarily take issue with this claim, arguing only that insurance regulation can be substantially improved by incorporating *more* standards than exist in the status quo, and then carefully working to hold insurers accountable for pursuing those standards. *See, e.g.*, Kenneth Bamberger, Regulation as Delegation, 56 DUKE L. J. 377 (2006) (discussing costs and benefits of this form of regulation). Increased usage of standards does not mean, and should not mean, that rules-based approaches should not also be employed when they would prove effective. *See* Therese M. Vaughan, *The Implications of Solvency II for U.S. Insurance Regulation*, *passim* (Networks Fin. Inst., Pol'y Brief No. 2009-PB-03, 2009), *available at* http://www.naic.org/Releases/2009_

but does not eliminate, reliance on prescribed formulas and requirements designed to measure firms' financial health, such as capital requirements and mandatory reserves.[270] It supplements such bright-line rules with more flexible and firm-specific risk-management strategies, often attempting to enlist firms in developing these approaches.

Increased usage of principles-based regulation has numerous potential benefits: it harnesses the experience and sophistication of firms; it allows regulation to more easily keep up with innovation; it is sufficiently flexible to encourage, and account for, risk diversification; and it may promote internal forces within insurers to manage risk more effectively.[271] In recognition of these benefits, state insurance regulation has gradually been moving towards a principles-based approach to solvency regulation over the last several years.[272] Moreover, enhanced principle-based regulation is an important element of international efforts to modernize solvency regulation, including Solvency II (European Union) and the Insurance Core Principles

docs/090305_vaughan_presentation.pdf (advocating for a principles-based approach that is backstopped by a more rules-based approach).

270. *See* Vaughan, *supra* note 269, at 11–12 (contrasting American regulations with proposed European reforms). 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. *See id.* at 2.

271. *See* Herring & Schuermann, *supra* note 211, at 30, 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"); Vaughan, *supra* note 269, at 4–6.

272. First, the NAIC has just recently sought input from the NAIC membership on criteria for a statistical agent to collect firms' principles-based reserve data, and has promulgated a corporate governance guide for firms utilizing principle-based reserves. *See* NAT'L ASS'N OF INS. COMM'RS, PRINCIPLES-BASED RESERVING WORKING GROUP, CORPORATE GOVERNANCE GUIDANCE FOR PRINCIPLES-BASED RESERVES (2009), *available at* http://www.naic.org/documents/committees_ex_isftf_pbr_wg_corporate_governance_guide_pbr.pdf; Principles-Based Reserving (EX) Working Group, http://www.naic.org/committees_ex_isftf_pbr_wg.htm (last visited Mar. 19, 2010). Among its goals for 2010, the NAIC intends to evaluate necessary changes to state laws to effectuate a principles-based regulatory framework. *See* Principle-Based Reserving (EX) Working Group, *supra*. 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 269, at 7.

(International Association of Insurance Supervisors).[273] 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 in that context than in insurance given the major systemic risks associated with banking.[274]

The key role of regulators in a principles-based solvency scheme is to hold insurers accountable for effectively implementing regulatory principles.[275] In order to realize the benefits of principles-based regulation, regulators must effectively "regulate the exercise of [insurers'] judgment."[276] There is no

273. *See* Brown, *supra* note 3, at 963–72 (discussing in detail the Insurance Core Principles and Solvency II).

274. *See id.* at 964–65. Basel II has been subject to extensive criticism, especially in the wake of the financial crisis. *See* Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127, 133–41 (2009) (discussing criticisms against Basel II's operational risk provisions); *Marketplace: Banks Brace for Basel II* (American Public Media radio broadcast July 2, 2008), *available at* http://marketplace.publicradio.org/display/web/2008/07/02/basel_ii/. But 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 supra* text accompanying notes 85–86, 132. Moreover, it is possible that insurance regulators would have an easier time assessing the adequacy of internal models than banking regulators as many of the most important elements, such as underwriting risk, are within the core competencies of insurance regulators. *See* KLEIN, *supra* note 234, at 119 (describing risk governance as one of the basic responsibilities of insurance regulators).

275. A second, related, drawback of a principles-oriented regulatory scheme is that it creates an increased risk of regulatory forbearance. As firms find themselves in financial trouble, regulators may have strong incentives to defer aggressive intervention in the hopes that the firm's prospects will turn around. Such forbearance can substantially exacerbate the ultimate costs of financial failure. *See* Martin F. Grace et al., *Insurance Company Failures: Why Do They Cost So Much?* 23 (Ctr. for Risk Mgmt. & Ins. Research, Ga. State Univ., Working Paper No. 03-1, 2003), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=463103 (finding evidence of regulatory forbearance in insurance); Therese M. Vaughan, *The Implications of Prompt Corrective Action for Insurance Firms* 4–6 (Networks Fin. Inst., Pol'y Brief No. 2008-PB-02, 2008), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1099426 (discussing reasons for and consequences of regulatory forbearance).

276. Bamberger, *supra* note 269, at 381; Saule Omarova, *Rethinking the Future of Self-Regulation in the Financial Industry*, BROOK. J. INT'L L. (forthcoming). By contrast, the rules-based regulations of capital and reserve requirements are largely formulaic, mitigating the need for regulators to rely on the judgment of individual insurers and thus the risk that they will be misled by the wrong-headed or disingenuous exercise of that judgment. *See* Bruning, *supra* note 263, at 4 (noting that a 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); El-

doubt that this is a difficult task, as firms have substantially more expertise, knowledge, and resources than regulators, potentially allowing them to successfully defend patently insufficient risk-management safeguards.[277] However, a burgeoning field of academic literature explores various mechanisms through which regulators can improve the accountability of firms to meaningfully exercise their judgment as to the best way to accomplish regulatory ends.[278] A particularly important way in which regulators can accomplish this is by cultivating their capacity to participate in the development of firms' internal efforts at regulatory compliance.[279] Although firms will clearly have substantially greater expertise regarding their own risks, regulators can bring to the table a different type of expertise developed from interacting with multiple firms over time.[280] They also can bring a different orientation that is not embedded within the firm's assumptions and culture.[281]

ing & Holzmüller, *supra* note 258, at 54 ("The U.S. 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); Vaughan, *supra* note 269, at 16 (regulators must "understand how . . . risks are modeled and . . . make judgments as to whether they are modeled adequately" to effectively implement principles-based regulation).

277. *See* Vaughan, *supra* note 269, at 16 n.22 ("[R]egulatory 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." (internal quotation marks omitted)).

278. For a very good review of these mechanisms, see Bamberger, *supra* note 269, at 436–68. *See generally* Saule Omarova, Wall Street as "Community of Fate:" Toward Financial Industry Self-Regulation (unpublished manuscript, on file with author) (arguing that industry self-regulation, properly incentivized, can effectively minimize systemic risk in the market).

279. *See generally* Michael C. Dorf & Charles F. Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267, 297–388 (1998) (describing the team-oriented makeup of the modern American firm and the ways in which government can effectively interact with it); Bradley C. Karkkainen, *"New Governance" in Legal Thought and in the World: Some Splitting as Antidote to Overzealous Lumping*, 89 MINN. L. REV. 471, 473–75 (2004) (discussing a "new model of collaborative, multi-party, multi-level, adaptive, problem-solving New Governance").

280. *See* Bamberger, *supra* note 269, at 464.

281. *See id.* at 444–45 (discussing the ability of external interactions to promote sound internal decision making in the firm).

Regulatory competition undermines the capacity of regulators to hold firms accountable in these ways.[282] First, regulatory competition cripples regulators' ability "to leverage enforcement threats as a means to bargain for cooperative engagement" in the development of firm-specific risk-management strategies.[283] Simply put, regulators operating in a scheme of regulatory competition would always need to worry that enforcement threats would trigger a regulatory switch. This would diminish their ability to insist that they be treated as real partners in the development of risk-mitigation measures. Second, regulatory competition would undermine the role of regulators as long-term partners of insurers by rendering that relationship temporally unstable. Because firms could, at any time, choose to switch regulators, regulators would have less reason to invest in developing firm-specific knowledge and cultivating relationships with "double agents" within insurers who could be counted upon to safeguard regulatory objectives. Firms would be less likely to fully treat individual regulators as partners in this process for similar reasons: doing so in any meaningful way would be costly and time-consuming, and if the regulator insisted on such treatment the insurer would always have the option to switch regulators.

For these reasons, if regulatory competition did promote principles-based regulation, it would promote a version of it that would inevitably resemble deregulation, as its critics often assert. This prospect is particularly unattractive as, notwithstanding its obsolescence, the present system of solvency regulation appears to have been effective in the recent financial crisis. Virtually every major insurer has maintained its financial health in the last several years.[284] Although AIG imploded, re-

282. Regulatory competition might also increase the already-heightened risk of regulatory forbearance, *see supra* note 275, if it increased regulators' willingness to permit risky bet-the-company strategies. This seems likely, as taking an aggressive approach to shutting down insurers on the brink of insolvency would decrease insurer demand for those regulators. 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. Despite such efforts, regulatory forbearance with respect to small banks seems to have played an important role in the recent financial crisis. *See* Eric Dash, *Pathology of a Crisis: At Failed Banks, Fatal Levels of Untreated Risk-Taking*, N.Y. TIMES, Nov. 19, 2009, at B1.

283. Bamberger, *supra* note 269, at 465.

284. *See* Grace, *supra* note 41, at 1–2.

quiring 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.[285] 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.[286] 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.

> The insurance sector has, so far, escaped serious 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 (p-c) 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. . . . 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.

Id.

285. Insurance regulators had no jurisdiction over these activities, as federal regulators pressured state insurance regulators to issue an opinion letter in 2000 declaring that CDSs did not meet the definition of insurance. *Hearing to Review the Role of Credit Derivatives in the U.S. Economy: Hearing Before the H. Comm. on Agriculture*, 110th Cong. 81 (2009) (statement of Eric Dinallo, Superintendent, New York State Insurance Department). In fact, AIG's primary strategy in seeking to pay back its bailout funds has been to sell off its financially healthy insurance companies. Edmund L. Andrews, *A.I.G. Says Revamping Could Take 3 to 5 Years,* N.Y. TIMES, May 14, 2009, at B4; *see also* Robert O'Harrow Jr. & Brady Dennis, *Credit Rating Woes Sent AIG Spiraling*, L.A. TIMES, Jan. 2, 2009, at C1. 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." Press Release, Nat'l Ass'n of Ins. Comm'rs., AIG: NAIC Focused on Fidelity to the Facts (July 31, 2009) (internal quotation marks omitted), *available at* http://www.naic.org/Releases/2009_docs/aig_naic_focus_on_fidelity.htm.

286. *See* Harrington, *supra* note 261, at 104 (arguing that substantial market discipline exists, given that life insurers curtailed asset risks in the 1990's when problems arose, most insurers have very high RBC rations, and guarantees are limited in many states and in all states are not more than $300,000).

C. REGULATORY COMPETITION AND SPECIALIZATION

Another potential supply-side defense of regulatory competition is that it allows different regulators to specialize in different types of regulated entities. Regulators may develop particular expertise when dealing with similar types of regulated entities. Alternatively, regulatory competition may cause competing jurisdictions to invest their limited resources and energy into developing substantive rules that are particularly relevant to a subset of regulated entities.[287] One particularly good example of regulatory specialization comes from the current insurance sphere, where Vermont has developed a sophisticated and elaborate body of law to govern captive insurers.[288] Because captive insurers (by definition) only provide coverage to one entity, they can easily arrange to "sell" their coverage in Vermont.[289]

This regulatory supply argument in favor of limited regulatory competition is plausible. For instance, it is possible that federal regulators in an OFC scheme might specialize in working with large national insurers because they have particularized expertise relevant to the typical investment portfolios of large insurers. Similarly, state regulators might specialize in working on the particularized issues that face small insurers, such as their potentially limited access to capital markets or

287. *See supra* Part I.B.2.

288. *See generally* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-536, RISK RETENTION GROUPS: COMMON REGULATORY STANDARDS AND GREATER MEMBER PROTECTIONS ARE NEEDED 2–3 (2005), *available at* http://www.gao.gov/new.items/d05536.pdf. Captive insurers are subject to regulation only in their state of domicile and are more loosely regulated than traditional insurers. *Id.* Vermont dominates the market for captive insurers because its regulation of captive insurers is liberal and well developed. *See id.* at 4–6; Kelly Cruz-Brown et al., *Recent Developments in Insurance Regulation*, 44 TORT TRIAL & INS. PRAC. L.J. 591, 620 (2009); Gordon A. Schaller & Scott A. Harshman, *Use of Captive Insurance Companies in Estate Planning*, 33 ACTEC J. 252, 252–54 (2008) (providing background information on captive insurance companies, and noting that the captive insurance market is worldwide and that most U.S. corporations choose a domicile for the corporation with modern captive insurance statutes, including Vermont).

289. As firms can purchase insurance coverage in a state for property or events in other states, firms can purchase insurance through captives in any jurisdiction. *See* INT'L ASS'N OF INS. SUPERVISORS, ISSUES PAPER ON THE REGULATION AND SUPERVISION OF CAPTIVE INSURANCE COMPANIES 6–7 (2006), *available at* http://www.iaisweb.org/__temp/Issues_paper_on_regulation_and_supervision_of_captive_insurance_companies.pdf (recounting the propagation of captive insurance companies in legally attractive jurisdictions separate from the headquarters of the insured firm).

the difficulties they may face in developing exclusive distribution schemes.

At least relative to the status quo, however, this benefit of regulatory competition is minimal. First, the status quo system of insurance regulation already does a good job of marshalling regulatory resources from across the different states to meet the particularized needs of different insurers. For instance, through the NAIC and National Conference of Insurance Legislatures (NCOIL), state regulators and legislatures, respectively, organize their collective experience and expertise to develop specialized model laws and best practices.[290] Individual states are then free to incorporate the results of this resource-intensive process into their own laws and regulations. In many ways, this cooperative system for developing substantive law works better than a scheme of regulatory competition in enhancing specialization, because it allows regulatory experts within different jurisdictions to collaborate in crafting appropriately narrowly tailored laws.[291] Similarly, regulators from different states are often able to develop expertise by relying on a national web of resources, training materials, and guidance.[292] This allows even small state departments to have individual staff members develop the specific expertise that they need to handle the regulatory issues they face on a daily basis.

Second, at least in the property/casualty context, the most important specialized expertise that regulators can possess concerns the particularized risks that insurers face when operating in a specific state. That is because the business of property/casualty insurance is in many ways inherently local. Different geographic regions present different types of property hazards and different states have vastly different tort systems. The state-based system of insurance regulation naturally promotes this form of regulatory specialization.

IV. REGULATING REGULATORY MARKETS IN INSURANCE

Part II suggests that regulatory competition in insurance will create demand-side forces that promote inevitable deregulation. Part III argues that such deregulation, even in the po-

290. *See, e.g.*, Randall, *supra* note 1, at 629–39; *infra* Part IV (discussing the efforts of the NAIC to coordinate regulation among different states).

291. *Cf.* Esty & Geradin, *supra* note 17, at 40–46 (discussing the benefits of cooperation among regulators).

292. *See* Vaughan, *supra* note 269, at 9–10.

tentially mild form associated with OFC proposals, is neither normatively desirable nor likely to enhance regulatory efficiency. 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, limiting the ability of competing regulators to deregulate beyond a certain point. For instance, bank regulation removes particularly sensitive regulatory issues—such as reserve requirements—from the domain of competition altogether. In other cases, regulation of regulatory markets can operate on regulatory demand, inducing firms to choose effective regulators. This, for instance, is one justification for requiring firms to fund the costs of a guarantee fund. If firms must pay for the costs of failed firms, then they will have reason to demand effective regulators that prevent firms from failing and that intervene quickly, before the costs of those failures can be compounded.

This Part considers these and other potential avenues for "regulating" regulatory competition in insurance. Section A begins by focusing on two potential safeguards against the prospect that regulatory competition would promote excessive deregulation of insurers' market conduct. First, it considers proposals that would set minimum standards for all competing regulators, effectively limiting the domain over which competition may legitimately occur. While acknowledging the possibility that such safeguards might limit the risk of unbridled deregulation, it questions how reliably these minimum standards would be enforced. Second, it examines a proposal that would allow individual jurisdictions to opt-out of regulatory competition through legislative action. Finding that such an opt-out would be largely illusory, section A argues that it would do little to constrain regulatory competition.

Section 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. Section B argues that such efforts are not likely to prove effective. It shows that *sustainable* guarantee funds that would counterbalance the risk of excessive solvency deregulation are difficult to construct. It also explores a central problem with proposals to require insurers to issue risk-linked securities as a means of supplementing guarantee funds.

A. MARKET CONDUCT SAFEGUARDS

1. Mandatory Minimum Standards

One potential approach to preventing regulatory competition from producing excessively lax laws is to create minimum standards for all regulated firms, irrespective of their chosen regulator. This strategy attempts to directly prevent regulatory competition from devolving beyond a certain point. Congress is currently considering this type of reform in the form of a new Consumer Financial Products Agency (CFPA). The agency would be empowered to set minimum standards for various consumer financial products (excluding insurance), irrespective of the companies involved in marketing and selling those products.[293] It would thus set a regulatory floor that was relatively immune to the deregulatory forces of regulatory competition in the banking sphere.[294]

The key drawback of relying on minimum standards to constrain regulatory competition is that those standards may not be enforced.[295] Because minimum standards are specifically designed to constrain competing regulators' discretion, they are unlikely to prove effective in influencing those regulators' actions unless they are backed up by some enforcement mechanism. In some contexts, this role is served by the prospect of preemption: competing jurisdictions that fail to adhere to federally imposed regulatory safeguards run the risk of having their power stripped from them by Congress.[296]

Although federally imposed minimum standards overlaid on top of a scheme of regulatory competition would certainly decrease the risk of deregulation, it is unclear how effectively such minimum standards would be enforced in the insurance

293. *See generally* Consumer Financial Protection Agency Act of 2009, H.R. 1880, 111th Cong. (2009).

294. *See* Bar-Gill & Warren, *supra* note 91, at 98–101.

295. Another potential problem with minimum market conduct standards is that they may interfere with effective solvency regulation by individual competing regulators. The design of life insurance products influences the substance of appropriate solvency restrictions. *See Regulatory Restructuring: Enhancing Consumer Protection: Hearing Before H. Comm. on Financial Services*, 111th Cong. 5 (2009) (Statement of Gary E. Hughes, Executive Vice President & General Counsel, American Council of Life Insurers). A seemingly benign market conduct standard might consequently interfere with effective solvency regulation.

296. *See* Roe, *supra* note 33, at 624 (arguing that the threat of federal preemption exerts a disciplining effect on competition among states with respect to corporate law); McDonnell, *supra* note 111, at 48.

context. This is because many, if not most, consumer protections in insurance take the form of broad standards that leave substantial discretion to those charged with their enforcement.[297] Examples abound.[298] Regulators must assess whether the insurer refused 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.[299] They must determine whether premiums are "unfairly discriminatory" and whether policy forms are "unreasonably surprising or unfair."[300] And they must assess whether advertising or sales tactics are misleading or unsuitable.[301]

There are numerous reasons for the prominence of standards in insurance consumer protections. First, property/casualty insurance contracts are themselves riddled with ambiguities and uncertainties.[302] Not only does this leave a substantial amount of discretion and indeterminacy to insurers in applying the language, but it also leaves a substantial amount of discretion to regulators in regulating that relationship.[303] Second, insurance contracts are unique among financial contracts in that their value is explicitly contingent on individual and specific circumstances of the purchaser.[304] This makes

297. In other words, they tend to be standards more than rules. *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 611 (1992).

298. To be sure, there are some counterexamples. For instance, some states prohibit pre-dispute arbitration agreements, which is a pretty clear rule. *See* Schwarcz, *supra* note 129, at 762–63. Similarly, there are some clear disclosure requirements. *See* Schwarcz, *supra* note 169, at 313.

299. NAIC MODEL LAWS, REGULATIONS & GUIDELINES, VOL. VI, 900-1 UNFAIR CLAIMS SETTLEMENT PRACTICES ACT (2008).

300. *See, e.g.*, CAL. INS. CODE § 12401 (West 2009); 215 ILL. COMP. STAT. 5/143 (2009) (prohibiting unfair policy forms); MINN. STAT. § 70A.04 (2009) (prohibiting "excessive" premiums).

301. *See, e.g.,* NAIC MODEL LAWS, REGULATIONS & GUIDELINES, VOL. V, § 710-1 MASS MARKETING OF PROPERTY AND LIABILITY INSURANCE MODEL REGULATION (2008).

302. *See* ABRAHAM, *supra* note 208, at 174 ("[I]nsurance policies often are not specific enough to make the rights and obligations of the parties during the claims process crystal clear."). *See generally* Clark C. Havighurst, *Consumers Versus Managed Care: The New Class Actions*, 20 HEALTH AFFAIRS 8 (2001) (noting that health insurance policy language is broad and malleable).

303. *Cf.* KATHLEEN HEALD ETTLINGER ET AL., STATE INSURANCE REGULATION 103 (1995).

304. Jackson, *supra* note 184, at 330.

setting formulaic rules more difficult. Third, insurance regulation relies much less heavily than other forms of regulation on disclosure for a variety of reasons.[305] Although standardized disclosures are relatively easy to set formulaically, other types of regulations—such as those prohibiting false statements, unsuitable sales, misleading advertising, discriminatory pricing, and the like—are much harder to set precisely ex ante.

Even if competing regulators refuse to strictly enforce minimum standards, it is possible that other entities would do so.[306] But no other enforcement mechanism could reasonably substitute for the enforcement efforts of insurance regulators. First, enforcing most nonsolvency related insurance standards requires expertise and knowledge. For instance, identifying unfair claims practices requires reviewing a tremendous amount of data.[307] Similarly, determining whether a policy form contains an unfair or surprising term requires experience reviewing similar such forms. Second, market conduct violations are frequently—though certainly not always—case-specific, involv-

> Contingent liabilities differ from fixed-return deposits or interests in investment pools in that the value of contingent liabilities cannot be determined without 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.

Id.

305. *See id.*

306. *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 Law School).

> 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.

Id.

307. *See* Letter from Birny Birnbaum, Executive Dir., Ctr. For Econ. Justice, to Timothy B. Mullen (July 1, 2008), *available at* http://www.naic.org/documents/committees_d_saswg_CEJ_080701_comments.pdf ("[T]he foundation for market analysis is data. Without meaningful data to analyze, market analysis is, at best, a limited exercise. . . ."). This data includes extensive self-reporting from insurers themselves, complaint data from consumers, and self-generated data from market conduct exams. *See generally* NAIC, MARKET REGULATION HANDBOOK (2009).

ing an individual instance where a claim was adjusted unreasonably, a policy was impermissibly cancelled or nonrenewed, or an investigation was unreasonably delayed.[308] Public entities other than insurance regulators, such as attorneys general, often have little incentive to involve themselves in such cases.[309]

Finally, the judicial system would also be ill-equipped to enforce minimum standards when competing regulators failed to do so. Policyholders face various intractable obstacles to bringing suit after they are denied coverage. Claimants have an immediate need for cash and are generally risk averse, insurers can (and do) ignore complaints until they mature into credible litigation threats, and insurers enjoy significant strategic advantages from their repeat-player status.[310] Moreover, the current alternative dispute resolution options are quite limited in their effectiveness.[311] Resort to judicial regulation is also very difficult for regulatory issues that might arise outside of the context of a claim denial, as these issues typically involve small dollar amounts. Although class actions are sometimes available, often regulatory infractions are too case-specific to allow for aggregated litigation.[312]

2. Legislative Opt-Out

Another potential approach to regulating a regulatory market is to permit individual jurisdictions to opt out of the scheme if they determine that it is producing excessively lax regulation. Proponents of the SLS approach have suggested that permitting such an opt-out would safeguard against the risk that regulatory competition would produce excessive deregu-

308. Unlike other financial products, insurance payments are contingent on idiosyncratic facts that are external to the contract itself. *See* Jackson, *supra* note 184, at 330.

309. This pattern does not hold when illegal practices are widespread, as in the contingent-commission controversy. *See* Schwarcz, *supra* note 169, at 290.

310. *See* Marc Galanter, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Change*, 9 L. & SOC'Y REV. 95 (1974) (providing the seminal analysis of why repeat players tend to have an advantage in judicial proceedings); *see also* Schwarcz, *supra* note 129, at 741–50 (applying this analysis in the insurance context).

311. *See* Schwarcz, *supra* note 129, at 788–99.

312. Most insurance-related class actions concern nonclaims 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. 2 tbl.3 (2007) (collecting instances of insurance class actions in recent years). There are exceptions, like the nonoriginal equipment manufacturer parts class action. *See id.*

lation.[313] Under their proposal, a jurisdiction's legislature would need to opt out, the opt-out would only apply prospectively, and insurers would be permitted to exit any jurisdiction that selected this option.[314] Although fashioned as a specific component of the SLS proposal, an opt-out could be extended to an OFC scheme simply by permitting individual states to require that federally chartered insurers comply with all state insurance regulations.

Permitting jurisdictions to opt out of a scheme of regulatory competition would be unlikely to substantially reduce the risk of excessive deregulation. The basic problem with this approach is that jurisdictions would be extremely unlikely to opt-out of a scheme of regulatory competition, as doing so would disproportionately increase premiums in that jurisdiction. Opting-out would saddle a jurisdiction's constituents not just with the costs of enhanced regulation, but also with the costs of requiring all insurers to comply with a particular set of rules for doing business in that state. Given the salience of insurance prices,[315] state legislatures would be unlikely to invoke this option even if they were displeased with the state of insurance regulation.

Importantly, there is a key difference between the non-uniformity that characterizes the status quo and the non-uniformity that a state exercising a regulatory competition opt-out would create. In the status quo, regulators have gradually developed (and continue to develop) numerous mechanisms for reducing the costs to multistate insurers of complying with multiple regulatory regimes.[316] These mechanisms are designed

313. *See* Butler & Ribstein, *supra* note 4, at 40.

314. *See* O'HARA & RIBSTEIN, *supra* note 21, at 10; Butler & Ribstein, *supra* note 4, at 40; *see generally* Epstein, *supra* note 36.

315. *See supra* text accompanying notes 158–60.

316. State regulators have pursued an aggressive agenda in the last decade to limit the structural problems created by a state regulatory system. For instance, they have formed an Interstate Insurance Compact through which life insurers can seek product approval relatively quickly. *See* Interstate Ins. Prod. Reg. Comm'n, http://www.insurancecompact.org/index.htm (last visited Mar. 19, 2010). They have automated the document submission process to regulators by developing a single electronic filing system used by all of the states. *See* NAIC, System for Electronic Rate and Form Filing, http://www.serff.com/index.htm (last visited Mar. 16, 2010). They have coordinated the analysis of market conduct data as well as certain targeted multistate investigations. *See generally* Robert W. Klein & James Schacht, *An Assessment of Insurance Market Conduct Surveillance*, 20 J. INS. REG. 51 (2001). Currently, they are developing a process for accrediting different states' market conduct regulations, which should further decrease the costs to insurers of complying with multiple

and operated by the state regulatory system as a whole, through the NAIC.[317] By contrast, any individual jurisdiction that exercised a regulatory competition opt-out would not have in place the infrastructure or developed procedures for reducing the costs to multistate insurers of complying with a separate regulatory regime for that state.

An additional and more straightforward problem with relying on a legislative opt-out to discipline regulatory competition is that passing legislation is costly and difficult. Just as it is no defense of the status quo system of insurance regulation that state legislatures allow it to persist, so too would it be no defense of regulatory competition that state legislatures chose not to opt out. Although the possibility of an opt-out might generate some pressure for competing regulators to avoid large or salient regulatory failures, regulatory competition might well produce deregulatory costs that do not reach these thresholds.

B. SOLVENCY REGULATION, GUARANTEE FUNDS, AND MARKET-BASED SAFEGUARDS

Guarantee funds are state-provided assurances that policyholders who are entitled to insurance proceeds will receive payment up to a prespecified amount, even if their insurer is financially unable to pay.[318] In the status quo, every insurance jurisdiction maintains a guarantee fund, which covers policyholders in that jurisdiction and which is funded by all insurers licensed to do business in that jurisdiction.[319] With one exception, these funds are funded on a postassessment basis, meaning that insurers only pay into the fund when, and if, a fellow insurer is unable to fully pay policyholders.[320] This funding scheme may create some risk that a state will be unable to raise sufficient revenue from insurers to fully pay large guarantee fund obligations.[321] New York, by contrast, relies on ex ante funding of its guarantee fund, meaning that it accumu-

regulatory regimes. *See* NAIC, Market Reg. and Consumer Aff. (D) Comm., http://www.naic.org/committees_d.htm (last visited Mar. 19, 2010). These are only a small sampling of some of the most important efforts of the NAIC in the last decade to coordinate the regulatory process. As noted earlier, the effectiveness of these programs can nonetheless legitimately be challenged. *See supra* note 41.

317. *See* Randall, *supra* note 1, at 634–40.

318. *See generally* BAKER, *supra* note 138, at 683–93.

319. *See* KLEIN, *supra* note 234, at 164–66.

320. *See* Grace & Scott, *supra* note 7, at 90.

321. *See id.*

lates a pool of money from insurers before any guarantee fund payments must be made.[322] The central risk of such ex ante funding is that it allows budget-strapped legislatures to siphon off this money for general spending, as recently occurred in New York.[323]

If properly incorporated into a scheme of regulatory competition, guarantee funds may improve the prospect that such competition will produce reliable solvency regulation. First, a guarantee fund can improve *regulatory supply* by acting as a type of product warranty.[324] If competing jurisdictions are required to guarantee policyholder payment when an insurer that they regulate becomes insolvent, then those jurisdictions may supply effective solvency regulation so as to avoid making payments from the guarantee fund.[325] Of course, this incentive is hardly perfect, as the political actors who set regulatory policy will not fully internalize that expected cost of paying a guarantee. But these actors will at least face some political pressures from within their jurisdictions to limit this contingent risk.[326]

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 payments. In that event, insurers may demand a strong solvency regulator so as to reduce expected payouts to fund guarantee payments stemming from other insurers' insolvencies. This would be especially likely if the fund were funded through ex post assessments, as the size of that assessment would directly correlate to the actual losses produced by an insurer's insolvency.[327] However, an ex ante funding approach can also improve insurer demand so long as the premiums that insurers pay into the fund reflect a fair assessment of the expected cost of future insolvencies. Historically, though, states have done a poor job

322. *See id.*

323. *See id.*

324. *See* Bert Ely, *The Fate of the State Guaranty Funds After the Advent of Federal Insurance Chartering*, *in* OPTIONAL FEDERAL CHARTERING AND REGULATION OF INSURANCE COMPANIES, *supra* note 4, at 135, 137–38.

325. *See id.*

326. *See id.*

327. 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.

setting appropriate ex ante premiums in such circumstances.[328] One alternative is to require insurers to issue bonds that essentially mimic state guarantee funds. Because the price of these bonds would reflect market estimates of the expected costs of guarantee fund payments, they would do a better job of setting prices correctly than a state-set premium.

Unfortunately, neither guarantee funds nor market-based substitutes are likely to improve regulatory competition. In both an OFC and an SLS scheme, the key problem is that guarantee funds would either be unstable or would be poorly designed. Moreover, market-based substitutes for guarantee funds would be practically unworkable.

1. Guarantee Funds and the OFC

There are three basic ways that such guarantee funds could be structured in an OFC scheme.[329] First, an *exclusive federal guarantee system* would require all insurers, irrespective of whether they opted for state or federal regulation, to participate in a new federal guarantee fund. This approach would replicate the FDIC scheme in banking.[330] Second, an *exclusive state guarantee system* would retain the current scheme of state-provided guarantee funds and require that all insurers opting for a federal charter continue their participation in these state guarantee funds. This would maintain the status quo approach despite the addition of a federal option. Finally, a *dual guarantee system* would require insurers that opted for a federal charter to participate in a new federal guarantee fund, but mandate that insurers regulated at the state level continue their participation in state funds.

Neither of the first two options—an exclusive federal guarantee system or an exclusive state guarantee system—would effectively discipline regulatory competition. First, neither of

328. *See* David Cutler & Richard Zeckhauser, *Extending the Theory to Meet the Practice*, *in* PAPERS ON FINANCIAL SERVICES 1, 34 (Robert E. Litan & Richard Herring eds., 2004) ("A common but troubling phenomenon is severe underpricing of risk coverage by the public sector, often because premiums are insufficiently responsive to risk differentials. . . . When politics and political pressures intrude, it is often impossible to impose significant differential rates for insurance.").

329. *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). *See generally* Ely, *supra* note 324.

330. *See* MACEY ET AL., *supra* note 61, at 310–15, 326.

these schemes would improve regulatory supply by acting as an effective product warranty. The basic problem with both schemes is that they would require one of the two suppliers of regulation to provide a warranty not just for its own regulation, but also for the solvency regulation of the other scheme. This would accomplish precisely the opposite goal of the guarantee fund as a product warranty, creating a moral hazard for whichever regulatory scheme did not supply the guarantee fund.[331] Indeed, commentators have argued that an analogous mismatch between deposit insurance and banking regulation (the FDIC insures even state-chartered banks) induces excessively lax safety and soundness regulation at the state level.[332] Second, neither an exclusive state or federal guarantee scheme would improve regulatory demand. Both approaches would sever the link between an insurer's responsibility for funding guarantees and its selection among competing regulators. As a result, insurers would disregard their expected contributions to guarantee funds in choosing among competing regulators.

By contrast, while the third option of a dual guarantee system is theoretically attractive, it is practically unworkable. In theory, a dual guarantee system could promote effective regulatory competition with respect to solvency regulation: it might force regulators to provide a "warranty" for their solvency regulation and it would attempt to tether insurers' regulatory choices to their responsibility to pay guarantee fund costs. Unfortunately, the state guarantee funds in a dual guarantee scheme would be unreliable. First, the separate existence of a federal guarantee scheme would inherently raise the prospect that the federal government would bail out state guarantee funds that were unable to pay their claims. Indeed, this is exactly what happened historically in the banking context, with state deposit

331. *See* Ely, *supra* note 324, at 137–38. In an exclusive federal guarantee scheme, state jurisdictions would not bear the costs of inadequate solvency regulation, whereas in an exclusive state guarantee scheme, federal regulators would not bear the costs of insufficient federal solvency regulation. It is likely that the moral hazard generated by an exclusive state guarantee system would be less than that generated by an exclusive federal guarantee scheme, as federal regulators might have a strong interest in preventing states from funding the costs of insurer insolvencies.

332. *See* Butler & Macey, *supra* note 98, at 712–17. In fact, the problem would be even worse in an OFC, as 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.

insurance funds consistently failing and requiring federal bailouts.[333] Second, state-licensed insurers would inevitably resist paying postassessment fees to fund guarantee fund payments. The key problem, from the perspective of state-licensed insurers, would be that they would not be able to pass these costs on to consumers (as in the status quo) because federally chartered insurers operating in the state, against whom they compete, would not be obliged to pay these assessments. Third, the number of insurers that 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 postassessment funding would thus have substantially less certainty than in the status quo about how much it would need to assess insurers in order to fund guaranteed payments.

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 it 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 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, especially 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,” which are a specific type of risk-linked security.[334] Solvency bonds would be sold to investors in capital markets.[335] In the event that the guarantee fund of the insurer’s selected state regulator failed, the investors’ principal would be used to make up for the state

333. *See* DAVID A. MOSS, WHEN ALL ELSE FAILS 117, 119–20 (2002).
334. *See* Butler & Ribstein, *supra* note 4, at 40.
335. *Id.*

guarantee fund's default.[336] If, on the other hand, the guarantee fund of the insurer's chosen regulator did not default within the bond's time period, then investors' principal would be returned.[337] In exchange for taking on the risk of losing their principal, investors would be compensated by market-determined rates of return.[338] The key idea behind this proposal is that the rate of return that investors demanded would reflect the risk that a state's guarantee fund would fail.[339] This, in turn, would lead insurers to seek out state regulators whose guarantee funds were unlikely to fail because they maintain effective solvency regulation.[340] Doing so would reduce the rate that insurers would need to pay on these bonds.[341]

Unfortunately, it is highly unlikely that capital markets would have anywhere near a sufficient appetite for purchasing these solvency bonds at a reasonable rate of return. The most natural comparison to a solvency bond is a catastrophe bond, which is also a risk-linked bond. A catastrophe bond is a reinsurance substitute for insurers.[342] Catastrophe bonds are virtually identical to solvency bonds, except that the triggering event for payout of investors' principal is based on some measure of the size of insured losses from a single event.[343] Catastrophe bonds were first introduced into the marketplace in the mid-1990s. Since then, insurers have often had difficulty finding investors willing to purchase these bonds.[344] Prior to 2004, no more than nine catastrophe bonds have been issued in a given year. In recent years, these numbers have increased substantially. Yet even in 2007, which saw a record number of new issuances of catastrophe bonds, only twenty-nine bonds were

336. *See id.*

337. *Id.*

338. *Id.*

339. *Id.*

340. *See id.*

341. *See id.*

342. *See generally* Howard Kunreuther & Mark Pauly, *Terrorism Losses and All Perils Insurance*, 23 J. INS. REG. 3 (2005).

343. There are three actual triggers—one based entirely on size of sponsoring entity's losses, one based on an index (usually of industry losses), and one that blends these two triggers. *See* J. David Cummins, *Cat Bonds and Other Risk-Linked Securities: State of the Market and Recent Developments*, 11 RISK MGMT. & INS. REV. 23, 27 (2008).

344. *See* Martin F. Grace et al., *Regulating Onshore Special Purpose Reinsurance Vehicles*, 19 J. INS. REG. 551, 557 (2001) (noting that, as of 2001, "almost 60 [cat bond] transactions totaling nearly $7 billion hav[e] been completed since 1994").

issued.[345] In 2008, the number of new issues fell dramatically to only eleven, though it appears that that number rebounded in 2009.[346] In sum, the catastrophe bond market evolved slowly, over more than a decade, and remains cyclical.[347] The reason, most agree, is due to uneven investor interest in these instruments.

This slowly evolving interest in catastrophe bonds may, at first glance, signal that a robust market for solvency bonds could emerge over time, as investors familiarized themselves with these bonds and their components became relatively standardized. But this would be a mistake. Solvency bonds are, in fact, likely to prove much less enticing to investors than catastrophe bonds. First, and most importantly, the key selling point of catastrophe bonds for investors is that the triggering event is not linked to market risk: whether a hurricane hits Florida has nothing to do with the performance of the Dow in the present year.[348] This makes catastrophe bonds a good diversification mechanism, which is important given that these bonds (like solvency bonds) place the investors' entire principal at risk for a contractually specified period of time.[349]

By contrast, investor risk in solvency bonds would manifestly not be independent of market conditions. Market conditions correlate very well with the risk of insurer insolvency, as insurers make a large percentage of their money from investing the floats on their premiums.[350] Insurer insolvencies are consequently much more likely when the market is performing poorly.[351] And this means that the failure of a state's guarantee fund, which would need to pay policyholders of a failed insurer, would also be clearly linked to overall market conditions. Completing the reasoning, the payout on solvency bonds would also be correlated to market risk. As a result, solvency bonds are likely to be much less attractive to investors than catastrophe bonds.

345. *See* Cummins, *supra* note 343, at 32.

346. *See* Guy Carpenter, *Cat Bonds Persevere in Tumultuous Market*, CAPITALIDEAS.COM, Feb. 4, 2009, http://www.gccapitalideas.com/2009/02/04/cat-bonds-persevere-in-tumultuous-market/.

347. *Id.*

348. *See* Cummins, *supra* note 343, at 24–27.

349. *See id.*

350. *See* Jeffrey Stempel, *Assessing the Coverage Carnage: Asbestos Liability and Insurance After Three Decades of Dispute*, 12 CONN. INS. L.J. 349, 357 (2006).

351. *Id.*

An additional reason that investors are unlikely to have much interest in solvency bonds is that they present a substantial amount of moral hazard. A key component of catastrophe bonds is that the triggering event and the requisite payout cannot be influenced by the actions of the issuer. Thus, most catastrophe bonds base payouts on indices that are not generally impacted by the particular issuer's payouts in the event of a catastrophe.[352] By contrast, solvency bonds would undoubtedly involve a great degree of moral hazard that could not be contracted away. The key problem is that states would be more inclined to default on their guarantee fund obligations—especially in the event of a large loss—if they knew that investors in solvency bonds would pick up the tab. Although this might limit their capacity to compete in the market to attract insurers in the future, that may appear to be a small price to pay in exchange for allowing anonymous investors, rather than state taxpayers, to pay out-of-state policyholders of failed insurers.

There are over ten thousand insurers in the United States.[353] After a decade, the catastrophe bond market—which enjoys massive advantages over solvency bonds from an investor demand standpoint—has managed to produce about thirty bond issuances a year.[354] These issuances have been from only the largest national and international insurers.[355] As these numbers suggest, requiring all insurers to issue solvency bonds is simply unworkable.

CONCLUSION

Any fair evaluation of the present state-based system of insurance regulation must acknowledge that there continue to be substantial inefficiencies in the regulatory process. Appropriate reform could substantially improve this regulatory system, and thus enhance the efficiency and fairness of insurance markets. But this Article has raised substantial doubts about whether reforms that enhance regulatory competition would achieve this outcome. In particular, it has argued that regulatory competition would ultimately undermine the content of insurance

352. *See* Cummins, *supra* note 343, at 27–28.
353. *See generally* INS. INFO. INST., THE INSURANCE FACT BOOK 2009 (2009).
354. *See* Cummins, *supra* note 343, at 32.
355. *See id.* at 39–40.

law and regulation, harming consumers, third parties, and insurers themselves.

To be sure, this Article's scope is limited, and it does not analyze several important issues that are relevant to the broader insurance regulatory reform debate. In particular, it does not consider the duplicative and overlapping nature of state insurance regulation. Although the extent of this problem is debatable,[356] those inclined to believe it is large may conclude that the benefits of a scheme such as the OFC, which allow insurers to select a single regulator and only creates limited regulatory competition, outweigh the costs identified herein.

However, this framing presents a false choice. Various reforms would limit the duplicative nature of state insurance regulation while avoiding enhanced regulatory competition. These include proposals to create a single federal insurance regulator, to empower a federal agency to coordinate state regulation, or to require that all multistate insurers be subject to national regulation.[357] Reform-minded scholars and advocates should focus their efforts on these options rather than embracing regulatory competition in insurance.

356. *See supra* text accompanying notes 312–16 (describing state efforts to reduce the costs of complying with multiple state regulatory schemes).

357. *See infra* Part I.A.