A report to the Federal Insurance Office

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03. August 2011

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AT

INDIANA STATE UNIVERSITY

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AUGUST 2011

Executive Summary: Principal Findings and Comments

Our country has been through economic Hell the past three years. (See the report of the Financial Crisis Inquiry Commission, www.fcic.gov.) The turmoil that began in 2008 with the collapse of Bear Stearns and Lehman Brothers and continued with the failure of American International Group (**AIG**) leading to implementation of the Troubled Assets Relief Program (**TARP**) set the stage for massive scrutiny, study and ultimately overhaul of federal regulation throughout the financial services sector. President Obama's signing of the Dodd-Frank Act (**DFA**) on July 21, 2010 brought the most sweeping financial services legislation since the 1930s. While the majority of the focus has been placed squarely on banks, where the primary problems were believed to be, interest has also extended to the insurance sector.

Banks and insurance companies have historically been two of the most regulated sectors in the U.S. economy. However, it is the banking community that has endured the brunt of frequent regulatory overhauls. Since the 1930s, banks have been subjected to significant regulatory changes every six to seven years, whereas the insurance sector has largely operated within the governing confines of the McCarran-Ferguson Act for more than seven decades. This changed with the failure of AIG and the economic crisis. As a result, the Dodd-Frank Act will have repercussions that will be felt throughout the financial services sector, including by the insurance industry. At the center of these insurance repercussions will be the Federal Insurance Office (**FIO**), created by Title V of the Dodd-Frank Act, within the U.S. Treasury Department,. For the first time, a federal office will be charged with the responsibility of knowing all things insurance and leading the country's examination of how and by whom insurance should be regulated in the 21st century global marketplace. It will be the federal government's eyes and ears in the insurance sector.

Title V of the DFA requires that, by the end of January 2012, the FIO Director is to submit a report to Congress recommending changes to modernize and improve insurance regulation in the United States. This document focuses on the report the FIO is to make on the system of state-based insurance regulation. The FIO Director's report, and any subsequent Congressional legislation based on the report, will have far-reaching implications for the insurance industry and insurance consumers. Networks Financial Institute (**NFI**) at Indiana State University (**ISU**) wants to be a resource for the FIO as it discharges its critically important mission. It is in this spirit that NFI presents its research and recommendations to the FIO.

Summary of Recommendations

In **Section 2** of this paper, NFI provides analysis and recommendations on the issues that Congress has mandated for discussion in the FIO report, highlighting academic work that touches on these discrete issues. Here is a summary of the topics and key recommendations.

2.1	How to modernize and improve the system of insurance regulation in the United States considering: systemic risk regulation with respect to insurance. • The FIO should focus squarely on the insurance industry and not become unnecessarily burdened with financial services issues that are not relevant or do not make sense in the insurance sector, particularly with respect to systemic risk. • The FIO should have a targeted and narrow set of initial issues focused on longstanding regulatory issues facing the insurance sector.

2.2	How to modernize and improve the system of insurance regulation in the United States considering: capital standards and the relationship between capital allocation and liabilities, including standards relating to liquidity and duration risk. • FIO should take the lead in developing solvency standards and liquidity requirements for the insurance sector in the United States. • FIO should ensure that any new regulations and requirements related to capital requirements make sense for (and do not hamper) the insurance sector and effective financial risk management.
2.3	How to modernize and improve the system of insurance regulation in the United States considering: consumer protection for insurance products and practices, including gaps in state regulation. • FIO should examine state-based market conduct regulation with an eye on balancing the attendant costs and inefficiencies for the insurance industry against effective consumer protection.
2.4	How to modernize and improve the system of insurance regulation in the United States considering: the degree of national uniformity of state insurance regulation. • FIO should consider a variety of regulatory alternatives that would promote uniformity of insurance regulation, including regulatory proposals that would utilize and leverage the existing strengths and structure of state-based regulation.
2.5	How to modernize and improve the system of insurance regulation in the United States considering: the regulation of insurance companies and affiliates on a consolidated basis. • The FIO must seek to strengthen the appropriate regulators' ability to monitor large insurance enterprises across both international and domestic borders.
2.6	How to modernize and improve the system of insurance regulation in the United States considering: international coordination of insurance regulation. • The FIO must set as a key goal enhancing and strengthening U.S. participation and leadership in cross-border regulatory collaboration. • The FIO Director must seek to protect the United States insurance industry from regulatory-induced disadvantages at home or abroad.
2.7	Additional Factors: the costs and benefits of potential federal regulation of insurance across various lines of insurance (except health insurance). • In addition to focusing on lines of insurance, FIO should consider the differential impact of federal regulation on varying sizes of insurers.
2.8	Additional Factors: the feasibility of regulating only certain lines of insurance at the federal level, while leaving other lines of insurance to be regulated at the state level. • FIO should examine the characteristics of the various products under each line of business and consider the relative importance of maintaining state consumer protection.
2.9	Additional Factors: the ability of any potential federal regulation or federal regulators to eliminate or minimize regulatory arbitrage. • FIO should not assume that regulatory arbitrage is a negative result in all instances, but should weigh the potential benefits produced by a dual regulatory system.
2.10	Additional Factors: the impact that developments in the regulation of insurance in foreign jurisdictions might have on the potential federal regulation of insurance. • FIO must have as a central goal enhancing the U.S. insurance industry's ability to compete on the international stage, in part by eliminating damaging discriminatory or retaliatory regulatory practices.

2.11	Additional Factors: the ability of any potential federal regulation or federal regulator to provide robust consumer protection for policyholders. • FIO should critically examine the widespread belief that state regulators are better able to provide consumer protection services, being mindful of the fact that insurance consumers fared quite well through the financial crisis and for decades before.
2.12	Additional Factors: The potential consequences of subjecting insurance companies to a federal resolution authority, including the effects of any Federal resolution authority. • FIO must recognize (and publicize) the differences between the obligations secured by the banking safety net (immediate demand deposit accounts) and by the insurance guaranty associations/funds (longer term insurance policies with varying maturation). • The current state-based guaranty system is not inextricably linked to state regulation but could (and should) continue to protect policyholders under a federal or dual regulatory scheme.
2.13	Additional Factors: clarifying the role of the NAIC in relation to the FIO. • FIO should consider whether the existing structure of the NAIC can be used to unify the state-based regulatory system to achieve minimum federal standards.

In addition to these recommendations, NFI offers the following 9 pieces of advice for the new FIO Director, gleaned from extensive conversations with industry experts at the National Association of Insurance Commissioners (**NAIC**) meeting in March 2011 (Appendix 1):

- Interpret for leaders in Washington the meaning and lessons of the Great Recession for the insurance industry, especially that insurance firms are not banks;
- Focus on the role as international spokesperson for the U.S. insurance industry;
- Educate federal regulators and lawmakers about insurance;
- Act as an arbitrator among the NAIC, the NCOIL and others;
- Act like the Congressional Budget Office in evaluating costs of regulation to the industry;
- Establish strong and meaningful boundaries around the FIO's scope and authority;
- Understand that there is not unanimous support for the FIO in the industry;
- Understand that the FIO *cannot* speak for all the states; and
- Provide strong educational leadership on the role and functionality of the state regulatory system.

Since 2003, NFI has conducted an extensive research program on insurance regulatory reform, much of which has been featured at its annual Insurance Reform Summits in Washington, D.C. .

1. Introduction

Perhaps the most important report that the FIO will ever make is the report on the system of state-based insurance regulation. By the end of January 2012, the FIO Director is to submit a report to Congress recommending changes to modernize and improve insurance regulation in the United States. This essentially means the FIO is being asked to propose its own mission and scope of operations and to lay out a road map to guide public policy decision-making moving forward in a major part of the financial services sector. Our focus here is on that report, but the discussion will also be useful in preparing other reports to the Congress mandated by DFA. This paper provides analysis and recommendations of NFI on the issues that the Congress has mandated for discussion in the FIO report to Congress early next year. The specific details required in the FIO report to Congress, according to DFA Title V, are listed in Table 1 below.

Table 1:

Dodd-Frank Act (Title V) Mandated Contents for FIO's Report to the President and Congress

In determining how to modernize and improve the system of insurance regulation in the United States, the FIO shall consider:

- Systemic risk regulation with respect to insurance
- Capital standards and the relationship between capital allocation and liabilities, including standards relating to liquidity and duration risk
- Consumer protection for insurance products and practices, including gaps in state regulation
- The degree of national uniformity of state insurance regulation
- The regulation of insurance companies and affiliates on a consolidated basis
- International coordination of insurance regulation.

Additional factors that may be considered include:

- The costs and benefits of potential federal regulation of insurance across various lines of insurance (except health insurance)
- The feasibility of regulating only certain lines of insurance at the federal level, while leaving other lines of insurance regulated at the state level
- The ability of any potential federal regulation or federal regulators to eliminate or minimize regulatory arbitrage
- The impact that developments in the regulation of insurance in foreign jurisdictions might have on the potential federal regulation of insurance
- The ability of any potential federal regulation or federal regulator to provide robust consumer protection for policyholders
- The potential consequences of subjecting insurance companies to a federal resolution authority, including the effects of any federal resolution authority -
    - on the operation of state insurance guaranty fund systems, including the loss of guaranty fund coverage if an insurance company is subject to a federal resolution authority
    - on policyholder protection, including the loss of the priority status of policyholder claims over other unsecured general creditor claims
    - in the case of life insurance companies, the loss of the special status of separate account assets and separate account liabilities
    - on the international competitiveness of insurance companies
- Such other factors as the Director determines necessary or appropriate.

Source: Title V of the DFA

2. The Specific Issues To Be Addressed in the January 2012 FIO Report to Congress

The specific aspects required for the FIO report to Congress on insurance regulation and reform are indicated in Table 1. The thirteen subsections below follow the content areas specified by the DFA.

2.1 How to modernize and improve the system of insurance regulation in the United States considering: systemic risk regulation with respect to insurance

Key Recommendations:

- The FIO should focus squarely on the insurance industry and not become unnecessarily burdened with financial services issues that are not relevant or do not make sense in the insurance sector, particularly with respect to systemic risk.

- The FIO should have a targeted and narrow set of initial issues focused on longstanding regulatory challenges facing the insurance sector.

Discussion:

The creation of the FIO is a step in establishing a central clearinghouse for state-of-the art insurance practices, appropriate and effective supervision and regulatory oversight, and responsible federal authority in international regulatory and trade negotiations. However, the DFA's creation of the Financial Stability Oversight Council (**FSOC**) will force the FIO, as an FSOC member and expert on the best practices of the business of insurance and its regulation, to be more focused on clarifying the nature of the business of insurance when inaccurate comparisons to other financial institutions would lead to undue burdens and competitive distortions for the insurance industry. While meeting this considerable and immediate challenge, the FIO is advised by the insurance industry to narrow its agenda and focus on longstanding regulatory issues facing the insurance sector. The FIO should not be unnecessarily burdened by the broader discussion of systemic risk in the financial services industry generally, especially commercial banking, since there is no evidence that there is systemic risk in the business of insurance.

Grace (2010) provides strong empirical evidence that there is no systemic risk in the insurance industry. Harrington (2011) provides arguments to that effect as well. The FSOC has established six criteria for a firm to exhibit potential systemic risk. Only one of these criteria – size – has any application to insurance, and that one is ad hoc and time dependent, with no support from more fundamental factors that could give rise to systemic risk.

Industry leaders have expressed concern that some insurance firms will be inaccurately and unnecessarily classified as systemically important financial institutions (**SIFI**s), with all that this entails. Size was the first criteria put forward in the historical policy discussion of systemic risk that began in the crisis in fall 2008. The size criterion was set in the DFA for some purposes at $50 billion in total assets; a few insurance companies were caught in that net by dint of historical growth. There is nothing magical about this number – firms with $49.9 billion and $50 billion are not fundamentally different because of their size difference. The size criteria does not account for inflation, economic growth, or the size or composition of financial markets. No provision is made to recognize the ad hoc nature of the initial limit or to provide some rationale for what is the appropriate setting today. Size alone also does not recognize operating risk, balance sheet risk, or off-balance-sheet risk.

More recently, the FSOC has put interconnectedness and availability of substitutes on its list of the most important criteria for systemic risk. It has added three subsidiary criteria as well: leverage, the degree of maturity transformation, and the extent of existing regulation. Since insurance firms are not banks, they are typically not interconnected except to the extent of reinsurance. Even in this instance, future cash flows and policy liabilities are longer term and subject to more precise anticipation than bank deposits. Until the fall 2008 financial crisis, the original case for systemic risk and interconnectedness was about bank runs. Insurance firms are usually not subject to runs, nor can unanticipated demands to pay insured losses lead to large and immediate cash calls on reinsurers. Unlike banks, large unanticipated cash drains at insurance firms do not lead to immediate payouts even by reinsurers, they do not lead to contagion on runs at other insurance firms or financial institutions, and they do not lead to fire sales of assets and to asset depreciation. In fact, capital typically flows to reinsurers following catastrophic loss episodes. Moreover, there are ample substitute financial products for insurance, both domestically and abroad. There are also other financial product providers, especially competing annuity providers, self-insurance and other risk transfer arrangements.

As for the subsidiary systemic risk criteria, insurers are not leveraged to the extent that banks and investment banks are, and their liabilities are longer term and not subject to large unanticipated demands for payment in the same way as are banks. Insurers do not engage in extensive maturity transformation. They have longer term liabilities, and they have longer term assets. There can be large cash outflows in concentrated disasters, but insurance cash flow planning anticipates and compensates for such events. Finally, insurers are subject already to substantially more regulation than other financial institutions because of the multiplicity of overlapping state and other regulators. The insurance industry has been little affected by the sweeping deregulation that other financial institutions have experienced over the past 40 years. As a result, the greater regulatory problem for the insurance sector is the continued and growing inefficiencies that excessive, or at least duplicative, regulation has created.

2.2 How to modernize and improve the system of insurance regulation in the United States considering: capital standards and the relationship between capital allocation and liabilities, including standards relating to liquidity and duration risk

Key Recommendations:

- FIO should take the lead in developing solvency standards and liquidity requirements for the insurance sector in the United States.

- FIO should ensure that any new regulations and requirements related to capital requirements make sense for (and do not hamper) the insurance sector and effective financial risk management.

Discussion:

Capital standards are not a critical problem for insurers, as demonstrated during the recent financial crisis and recession. The drive to introduce Solvency II in Europe, along with domestic and international regulatory pressures to standardize supervision, increases international competitive pressure. This issue will be central to the new role of the FIO.

By the late 1990s, most state insurance regulators moved to adopt the risk-based capital (**RBC**) standards developed and advocated by the NAIC in late 1992. These standards have served regulators and the industry well for over a decade, as set forth by Vaughan (2006) as she traces the history of capital standard regulation and the adoption of risk-based capital requirements in insurance. The move to Basel III standards in the banking industry and the adoption of Solvency II in Europe, with policy pressures in the United States and Europe to harmonize the regulation of financial institutions, may provide an incentive to revisit RBC requirements for insurers, if for no other reason than international competitiveness.

The NAIC has created a Solvency Modernization Initiative. The RBC standards used by insurance firms do not have the supplemental leverage ratio requirements found in the Prompt Corrective Action that banking regulators have had to follow since the passage of Federal Deposit Insurance Corporation Improvement Act in 1992 (see Gilbert (2006)). Under the leverage ratio requirements, banks, in order to be considered well-capitalized, must comply with the broader and more stringent requirement that total capital be a minimum percentage of total assets. Vaughan (2006) examines these in her 2006 NFI *Policy Brief*; in her view, such a requirement is not necessary for insurance. Pressures in Europe exist to move to the adoption of such a requirement for banks as part of Basel III; the Solvency II regime will likely face the same. Vaughan (2009) describes the implications of Solvency II for the U.S. insurance industry, under which insurance regulators may feel pressure from European regulators and U.S. rating agencies to adopt an appropriate maximum leverage ratio for insurers. Banking regulators found that, during the financial crisis, U.S. banking firms were generally well capitalized; however European banks were less so as there was no leverage requirement. The FIO, as the primary federal insurance clearinghouse and representative in international negotiations, may wish to take the lead in this development in the United States.

A related critical issue in the post-financial crisis regulatory discussion is the limited effectiveness of capital requirements. VanHoose analyzes the shortcomings of capital requirements in promoting safety and soundness of commercial banks in two NFI papers (2006). While higher capital requirements have become the mantra of banking regulators, the bidding war to raise capital requirements can lead to lower quality lending and higher risk-taking at banks. The same is likely to be the case for insurers if regulators are more aggressive in boosting capital requirements.

As a result of the fall 2008 financial crisis, the FSOC and banking regulators are considering new liquidity requirements to supplement capital requirements to boost adequacy in times of illiquidity and market stress. If insurers are included in the scope of any such additional liquidity requirements due to systemic risk regulation considerations, the burden of regulation may be unnecessarily heightened. Insurers are not systemically risky and, except for AIG, were not exposed to liquidity problems in the financial crisis. Six insurers were approved for TARP funds, but four declined to participate. The two that did participate were approved for TARP funds eight and nine months, respectively, after the September 2008 crisis, well after liquidity issues had abated in financial markets. No doubt, access to very cheap funds after experiencing relatively large losses enhanced the willingness of these two firms to participate, despite the absence of systemic or liquidity issues. The FIO should consider this history and weigh in on the desirability of capital and liquidity standards for the industry as part of its responsible participation on the FSOC.

A broader concern for insurers is the management of duration mismatches and interest rate risk. Insurers manage interest rate risk with no evidence that the financial crisis or other market shocks seriously threaten them in a fundamentally systemic fashion beyond their management capability, operational controls and capital adequacy. In order to manage their interest rate risk, insurers are major purchasers of derivative products as end users, rather than originators, when compared to large commercial and investment banks. New regulations may force derivative trading onto exchanges, substantially raising the cost of their use by insurance companies. Insurers seek an exemption from new rules established by Treasury and the Commodity Futures Trading Commission regulating exchange trading, which may soon be granted. Insurance leaders at the NFI roundtables at the NAIC meeting indicated this will not be sufficient if the counterparties to their derivative trades are forced to use exchanges. There are indications that the Treasury may issue blanket trading exemptions in key derivative products such as interest rate and currency swaps.

The industry expects that the FIO will adopt a position on this issue. A guiding principle is likely to be that these high volume derivative products were relatively unaffected by the financial crisis or by earlier shocks to money and capital markets. These derivative product markets also would not benefit from mark to market and collateral requirement practices of organized exchanges because these are already standard industry practices for derivatives. Accordingly, there does not appear to be compelling reason for tighter regulation of these particular derivatives. Insurers and other regulators and policymakers are likely to reach a consensus on this conclusion.

2.3 How to modernize and improve the system of insurance regulation in the United States considering: consumer protection for insurance products and practices, including gaps in state regulation.

Key Recommendation:

- FIO should examine state-based market conduct regulation with an eye on balancing the attendant costs and inefficiencies for the insurance industry against effective consumer protection.

Discussion:

State regulation focuses on areas that are regarded by regulators to be about consumer protection (see Tennyson (2009)). In particular, state regulators place high but varying degrees of emphasis on regulating market conduct, especially licensing standards, selling practices, regulation of forms and rates, as well as compliance and complaints. Less emphasis is necessarily placed on safety and soundness issues, perhaps the most important issues for providing protection on insurers' long-term liabilities. This discrepancy in emphasis reflects both a lack of streamlining and a failure to move toward regulatory efficiency and effectiveness, which swept other financial sectors and their regulators in the 1970s and '80s. Bank regulators abandoned onerous market conduct regulation beginning in those decades without loss of protection, but with substantial gains in efficiency and effectiveness. Kwon (2008) is one of many analysts who have been critical of the efficacy and consumer benefit of market conduct regulation, referring to it as less structured and defensible than financial regulation.

Tennyson (2008) provides considerable analysis of the state-based consumer protection system, including the potential gains and losses from a federal-based consumer protection system. She provides the case for market conduct regulation, as well as its shortcomings and costs under a state-based system; she considers both possible improvements and downsides in moving such regulation to the federal level.

The fragmented nature of state-by-state regulation creates inefficiency for insurers. Tennyson (2009) explains that gaps in regulation increase when regulatory authority is unclear or accountability is shared, and when products cross institutional boundaries. Regulation of insurance under the Gramm Leach Bliley Act (**GLBA**) for banks with insurance subsidiaries, or even under the DFA, falls under these headings because of the multiplicity of state regulators. The separation of rule making from enforcement is another factor promoting gaps. A centralized enforcement authority that also has substantial rule-making authority would presumably avoid the presence of gaps and regulatory arbitrage. Tennyson notes that state insurance regulators do a better job of providing information and cutting costs than state banking authorities. For example, she notes that about half (26 in 2007) of insurance regulators have online complaint systems, and a majority (45) have toll-free hotlines for complaints.

Tennyson (2009) also argues that the current state-based system exacerbates fragmentation and inefficiency and that these could be avoided by creating a specialized single-purpose institution. To be effective, however, the state-based consumer protection efforts would have to be phased out to avoid problems of fragmentation, lack of accountability, difficulties of coordination with other regulators, and regulatory arbitrage. The biggest drawback of a single authority is the risk of over-regulation, which reduces market efficiency and the absence of effective competition with other regulators. Tennyson (2010) lays out basic principles for developing an effective consumer protection regulator and discusses these with reference to the existing state-based insurance regulatory system.

Harrington (2006) provides an excellent analysis of the state-based regulatory system and details its inefficiencies and the potential gains from regulatory reform, including the optional federal charter proposal and other schemes to simplify the costs and raise the effectiveness of regulation under some federal preemption proposals. The greatest problem with the existing state-based system is the multiplicity of state regulators, with widely different rules, coverage, processes and reporting requirements. The differing substantive and process standards used by regulators in carrying out market conduct reinforce these inefficiencies, costs, gaps and ineffectiveness.

2.4 How to modernize and improve the system of insurance regulation in the United States considering: the degree of national uniformity of state insurance regulation

Key Recommendation:

- FIO should consider a variety of regulatory alternatives that would promote uniformity of insurance regulation, including regulatory proposals that would utilize and leverage the existing strengths and structure of state-based regulation.

Discussion:

The FIO is charged to study the efficiency and uniformity of national insurance policy under the state regulatory system, and to make recommendations to the Congress on how federal legislation and an enhanced federal regulatory role might improve the efficiency, competitiveness and safety and soundness of the industry.[1] The performance of the state-based system is a critical component of the initial work of the FIO.[2] Equally important is the relative performance of the state-based system compared with a federal regulator, either a regulator supplying an optional federal charter, or a preemptive FIO with regulatory oversight powers over a continuing state-based system.[3]

Harrington (2006) provides a comparison of the existing state-based system, an optional federal charter and two other proposals that would create a federal role by enacting minimum federal standards for state insurance regulation. These standards would preempt non-conforming state regulation, or allow life, health, and property and casualty insurers to designate a "primary state," and to operate nationwide subject primarily to the regulations of that state. The FIO could actually implement and oversee either of the latter two proposals, should it recommend one of these approaches to the Congress in the January 2012 report, and should the Congress adopt it and provide the FIO with such powers. The FIO might also be able to move in this direction by determining that existing state authority in certain areas does not conform to best

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1 Scott (2007) anticipates the FIO, developing the logic and design of the regulatory structure required to implement an optional federal charter, including the discussion of how to deal with the existence of state-based guaranty funds/associations and consumer protection.

2 Warfel (2006) details the origins of the state-based system and the options for a federal role.

3 Grace (2009) suggests that the issue of a federal or state-based regulatory system is not which one dominates on efficiency grounds, but which system is better structured to minimize failure or the cost of regulatory failure.

insurance practices. The latter two approaches provide for a federal insurance authority that aims to achieve efficiency and uniformity, but in the context of a continuing state–based system.

2.5 How to modernize and improve the system of insurance regulation in the United States considering: the regulation of insurance companies and affiliates on a consolidated basis

Key Recommendation:

- The FIO must seek to strengthen the appropriate regulators' ability to monitor large insurance enterprises across both international and domestic borders.

Discussion:

Perhaps the most important lesson for insurance regulation from the recent financial crisis is the importance of consolidated regulation. The failure of AIG was a direct result of the absence of consolidated regulation, at least in practice. The DFA does not mandate consolidated regulation for insurance, but by inviting the FIO to report on this issue, the Congress opens a critical discussion of it.

In the AIG case, the New York State Insurance Department had authority over certain parts of the AIG family (including, along with other state insurance regulators, the well-capitalized AIG insurance companies) and the federal Office of Thrift Supervision had oversight over others, including AIG Financial Products Corporation. Neither regulatory body claimed responsibility for overseas components of AIG or the financial products division in London. These are curious claims, at least by the federal authorities, but they are not without precedent, including two notorious examples in U.S. financial history.

AIG is not the first example of gaps in enterprise-wide regulation. In the Billy Sol Estes fraud case (1964), bankers and regulators failed to conduct simultaneous audits on assets claimed to be held as bank loan collateral across states; as a result, a fraudulent finance scheme was created. In response, private sector lenders adopted better monitoring processes for loan administration. Audit procedures were reformed to ensure that, in the event of an audit of loan collateral and assets backed by loans, simultaneous audits would be conducted. Bank regulators have followed this practice since then.

A second example is the failure of Bank of Credit and Commerce International (**BCCI**), a global bank registered in Luxembourg and headquartered in Pakistan and London.[4] The failure of BCCI occurred similarly because of the ability of the bank to move assets across borders to make its various units appear solvent during weeks of audits by various national regulators, while overall the bank was insolvent and guilty of money laundering and other financial crimes, including taking over a prominent U.S. bank in Washington D.C. illegally.

Following the BCCI case, national regulators adopted formal agreements to ensure that an international bank was not able to game the national regulatory systems again. The agreements included the choice of a principal regulatory authority, international sharing of information among interested regulators and the ability of a national regulator to obtain information outside their perceived or explicit jurisdiction.

State insurance regulators have some power to pursue cross-border regulatory claims at their discretion because they control the ability of insurers to do business in their respective states. While this authority provides some leverage, experience suggests it is not adequate. A national regulator can more easily enter

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4 Price Waterhouse, BCCI "Sandstorm" Report to the Bank of England (June 22, 1991).

into international agreements and information-sharing arrangements and can also more easily mandate cooperation by state regulatory authorities.

Consolidated regulation is a critical component of effective regulation, even though it was not the practice before or during the financial crisis and still is not the standard of regulation today.

2.6 How to modernize and improve the system of insurance regulation in the United States considering: international coordination of insurance regulation

Key Recommendations:

- The FIO must set as a key goal enhancing and strengthening U.S. participation and leadership in cross-border regulatory collaboration.

- The FIO Director must seek to protect the United States insurance industry from regulatory-induced disadvantages at home or abroad.

Discussion:

The DFA calls for the FIO (along with the existing U.S. Trade Representative) to represent the United States in international insurance policy debates and in reaching agreements over insurance regulatory standards, including solvency requirements, capital adequacy and competitive practices. Increasing globalization pressures in the insurance industry have called new attention to the importance of regulatory burdens and how differences in regulatory practices erect barriers to international trade in insurance services. The Director of the FIO is charged under the DFA to represent the United States in international policy formulation, disputes and agreements, providing a central spokesperson to represent the best interests of the U.S. insurance consumer and the domestic insurance industry.

The state system of insurance regulation is a major impediment to participation in international discussions for standardizing regulation and promoting competitive domestic and international markets. This is the key presumption behind some of the industry support for the new FIO. The NAIC has ongoing efforts to serve as a spokesperson in international insurance regulatory policy disputes and efforts to improve coordination of regulatory policy and standards.[5] However, it lacks the support of federal authorities as well as the unanimous support and following of its state members, so it is limited in its ability to negotiate on behalf of the federal or the state governments.

2.7 Additional Factors: the costs and benefits of potential federal regulation of insurance across various lines of insurance (except health insurance)

Key Recommendation:

- In addition to focusing on lines of insurance, FIO should consider the differential impact of federal regulation on varying sizes of insurers.

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5 Vaughan (2009) explains the history of NAIC involvement with European regulators in the development of Solvency II, and the implications of the latter for the U.S. insurance industry and regulation. Vaughan (2008) assesses the role of Prompt Corrective Action for banks and the transferability of the concept for U.S. insurers, as well as the general issue of capital requirements for insurance in Europe and in the United States, including the potential for convergence of national standards with minimal cost.

Discussion:

The FIO's primary role is to inform the Administration and Congress of matters pertaining to the business, and most lines, of insurance (exclusions include long-term care, crop, and health insurance). In the FIO report to Congress in January 2012, the Director is to recommend changes to modernize and improve insurance regulation in the United States. The industry has concerns that the FIO is being asked to determine its own mission and scope of operations.

In carrying out its oversight mission, the FIO may require an insurer to submit information or data. Certain "small" insurers, as identified by the FIO, will be exempted from complying with such requests. Prior to requiring submission of information directly from an insurer, the FIO is required to seek information from other federal agencies and state insurance regulators as well as determining if the information is publically available. Only if the information is unavailable from the aforementioned sources is the FIO authorized to collect information directly from an insurer.

As the DFA-created agencies (and their attendant responsibilities) evolve, the FIO's data gathering role may expand. To the extent that the FIO recommends or is mandated to take on explicit regulatory authority, including the existing mandate to determine regulatory best practices, the FIO will require access to information that goes beyond the current data gathering powers granted by the DFA. Also in its cooperation with the new Office of Financial Research (**OFR**) the FIO will likely face pressures for increased information gathering and sharing. Moreover, in its oversight role, not to mention potential regulatory role, the FIO likely will face existing federal standards for transparency that could necessitate an expanded information gathering role.

Insurers currently bear substantial costs in complying with state regulation. The level of the regulatory cost burden of an insurance company depends on a large number of factors including its state of domicile, the number of states in which it operates, the number and types of insurance products it offers the public, its overall size and the level of its sales in each state of operation, the type of marketing channel(s) in use, its past history of regulatory compliance, and so forth. Insurers spreading compliance costs over smaller premium volumes are at a cost disadvantage to competing insurers writing more business. Smaller insurance companies typically invest less in information technology dedicated to compliance requirements and incur higher personnel costs as a result. The layering of federal compliance costs on state insurance regulatory costs will, therefore, encourage companies to seek scale economies through consolidation which may be achieved by larger insurers gaining market share through competition or by acquisitions and mergers.

To the extent that federal regulatory efforts are fragmented across insurance sectors, federal compliance and reporting requirements will actually multiply the existing burden of state regulation by adding fragmented and potentially duplicative requirements. The differential cost of regulation based on the size of market served, as measured by premium volume, may also encourage support for optional federal chartering. Insurers may have an incentive to arbitrage between state regulation and a federal charter if the costs associated with dual regulation can be avoided with an optional federal charter (**OFC**).

2.8 Additional Factors: the feasibility of regulating only certain lines of insurance at the federal level, while leaving other lines of insurance to be regulated at the state level

Key Recommendation:

- FIO should examine the characteristics of the various products under each line of business and consider the relative importance of maintaining state consumer protection.

Discussion:

The DFA excludes authority of the FIO to address health, long-term care, and crop insurance; Congress therefore recognizes, or even institutionalizes, the feasibility of federally regulating certain lines of insurance while leaving other lines to other regulators. Such an arrangement falls into the area where conglomerates or products cross institutional borders and, according to Tennyson's analysis (2009), it is an arrangement that could promote regulatory gaps and encourage regulatory arbitrage. Yet few conglomerates actually operate across all of these product lines, so the point may only be relevant in the abstract, or in the future when greater product diversification occurs among insurers.

It is conceivable that a federal regulator could eventually be the principal regulator for life and annuities or reinsurance or monoline bond carriers, while states continue to regulate health and property and casualty insurance, for example. The efficiency gains from a federal regulator, or preemption of market conduct rules, are greater, according to some large insurers, than the gains from providing such arrangements for small property and casualty insurers. On the other hand, the gains from eliminating a multiplicity of state regulators remain, even if one insurance sector is smaller and likely to operate in only a few of the 50 states. The gains are smaller, but remain substantial, even if the reduction is from two regulators to one.

The case for a federal regulator of non-life insurers is less strong than for life and annuity insurers because of differences in tort law across states, according to some leaders in the property and casualty insurance field. However, differences in state laws have not made federal regulation of banks impractical or less feasible, nor are federal securities laws less effective because of differences in security laws across states. There is evidence for a federal role in non-life insurance, where, for example, form and rate regulation are widely practiced (and despised by the industry) and pursued extensively by state regulators. However, there are relatively more small property and casualty insurers with less interest in gains from consolidating regulation in a single federal authority.

2.9 Additional Factors: the ability of any potential federal regulation or federal regulators to eliminate or minimize regulatory arbitrage

Key Recommendation:

- FIO should not assume that regulatory arbitrage is a negative result in all instances, but should weigh the potential benefits produced by a dual regulatory system.

Discussion:

Arbitrage can be both good and bad. Arbitrage promotes competition, efficiency and innovation, three highly desirable political and economic outcomes. But creating incentives for regulatory arbitrage can lessen the effectiveness of overall regulation. Costs may increase as regulators attempt to build barriers to arbitrage and to plug holes that encourage shopping. Some analysts have noted that most of the significant innovations that brought the greatest consumer and investor benefits in banking relationships came about because of the existence of both state and federal regulators and the resulting regulatory arbitrage. So there is a fine line between encouraging regulatory arbitrage and attempting to eliminate it.

Indeed, one of the strongest reasons to favor state-based insurance regulation (or for other financial institutions) is the multiplicity of laboratories for new innovations and appropriate regulation of them. Despite regulatory arbitrage between states, the testing of regulatory responses allows a race to the top in terms of achieving superior regulatory limits at minimum social cost. To introduce a federal role in insurance regulation adds a potential gorilla to the competition, with proportionate expected results.

Regulators naturally seek broad control and strive to minimize the ability to evade their rules and processes. A federal insurance regulator would be no different in this regard. Policymakers must encourage the minimization of regulatory arbitrage, but recognize that arbitrage may yield socially beneficial outcomes and more effective regulators. An effective federal regulator should do so as well.

2.10 Additional Factors: the impact that developments in the regulation of insurance in foreign jurisdictions might have on the potential federal regulation of insurance

Key Recommendation:

- FIO must have as a central goal enhancing the U.S. insurance industry's ability to compete on the international stage, in part by eliminating damaging discriminatory or retaliatory regulatory practices.

Discussion:

The DFA reflects a concern for the competitive pressures on the domestic industry from the movement to Solvency II standards in Europe. Solvency II is an effort in the European Union (**EU**) to standardize tough principles of safety and soundness on insurance companies operating in the EU. Such standards could be constructed to provide implicit or explicit barriers to U.S. firms conducting business in Europe or conversely could be used as an instrument to lower regulatory cost for European firms doing business at home or abroad, especially in the United States. Moreover, the centralized nature of a Solvency II standard suggests that it or other EU insurance regulatory standards could be used to retaliate against perceived discriminatory practices in the United States that discriminate against EU firms. Foreign insurers have powerful national and EU regulatory authorities that can act quickly and decisively. Their regulators are often frustrated with the inability of any U. S. regulator to negotiate and act in the same way. The state-based regulatory system has left states free to impose discriminatory barriers against foreign insurers, without any adequate means for federal negotiation. Foreign insurers could find, as many U.S. insurers fear, that unilateral trade retaliation against U.S. insurers could adversely affect their competitiveness.

2.11 Additional Factors: the ability of any potential federal regulation or federal regulator to provide robust consumer protection for policyholders

Key Recommendation:

- FIO should critically examine the widespread belief that state regulators are better able to provide consumer protection services, being mindful of the fact that insurance consumers fared quite well through the financial crisis and for decades before.

Discussion:

In the pre-crisis period, consumer protection was a major concern of insurance regulatory authorities and policy leaders.[6] The insurance system generates the greatest number of consumer complaints of any financial services industry segment, primarily because of the complex and long-term nature of many insurance products.[7] The belief that consumer protection issues are best handled close to home by a state regulator instead of by a distant federal bureaucracy is often the basis for an argument against the potential efficiency gains of a centralized federal insurance regulator.

The unprecedented wealth losses associated with recent crises and the recession, as well as the large bailouts and the failure of so many financial services firms (but virtually no insurance companies), fostered a political interest in strengthening consumer protection for financial products. The DFA creates a new Consumer Financial Protection Bureau (**CFPB**) to safeguard bank consumers. The DFA explicitly excludes insurance from the mandate of the CFPB. Some industry leaders and consumer advocates suspect that insurance could come under the purview of the CFPB over time. The new CFPB will be expected to address its existing mandate before it can discover a wider field of concern and mobilize political support for expanding its mandate.

The DFA and the CFPB beg a reopening of the question of whether the state regulatory system performs an adequate role in insurance consumer protection and whether there is a sufficient degree of efficiency in handling disputes and providing relief across states. The widespread belief that state authorities can provide consumer protection services more fairly, quickly and equitably remains an open question in the information age. Differences in tort law and other legal distinctions across states might argue for consumer protection services at the state instead of the federal level, at least for some types of insurance. Whether a federal agency, including the CFPB, could improve upon the performance of the various state authorities is equally an open issue.

2.12 Additional Factors: The potential consequences of subjecting insurance companies to a federal resolution authority, including the effects of any Federal resolution authority

Key Recommendations:

- FIO must recognize (and publicize) the differences between the obligations secured by the banking safety net (immediate demand deposit accounts) and by the insurance guaranty associations/funds (longer term insurance policies with varying maturation).
- The current state-based guaranty system is not inextricably linked to state regulation but could (and should) continue to protect policyholders under a federal or dual regulatory scheme.

Discussion:

Any system of regulation has to contemplate the kind of safety net that should be in place for companies that fail. That insolvency question will come up when the FIO considers the possibility of some kinds of insurers, now wholly state regulated, being federally regulated with a federal resolution authority – either through an optional federal charter or some other kind of federal regulation regime. At the 2009 Insurance

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6 See Tennyson (2007) for a discussion of the history and extent, economic effects, (in)efficiency effects and failed equity objectives of rate regulation in the state system.

7 See Tennyson (2009) for a discussion of the framework for the fundamental principles of consumer protection in insurance. The departure from those principles under state regulation is also discussed.

Reform Summit, NFI took up that aspect of consumer protection and had presentations by the Presidents of the two insurance guaranty coordinating organizations, the National Organization of Life and Health Insurance Guaranty Associations (**NOLHGA, www.nolhga.com**) (for life, annuity and health consumers) and the National Conference of Insurance Guaranty Funds (**NCIGF, www.ncigf.org**) (for property and casualty consumers), along with Scott Harrington, an academic who has written and spoken widely on the subject.

While they may not know it, American insurance consumers are protected by a nationwide system of insurance guaranty associations (sometimes also called "guaranty funds"). This system was formed by state lawmakers and insurance regulators 40 years ago, and it protects the average life/annuity/health and property/casualty insurance policyholder if an insurance company fails. The safety net operates in every state and territory and is coordinated by two national entities: NOLHGA and NCIGF.

Should an insurance company fail, the insurance commissioner of the state where the company is chartered will take control under court order, becoming the receiver of the company. The guaranty associations will begin working immediately with other associations in the guaranty system and with the receiver to assure that claims are paid promptly and that there is no gap in actual insurance coverage.

The assets that remain when an insurer fails are often substantial and typically serve as the primary source of funding guaranty association payments to policyholders. U.S. insurance receivership laws give policy-level claims priority over all other claims against an insolvent insurer's assets (aside from receivership administrative costs). This priority (requiring policy-level claims to be paid first, and in full, before any payment of general creditors' or subordinated claims) boosts the financial resources available for funding guaranty association obligations. Moreover, the increasingly conservative nature of insurance company investing, strong regulation, and rating agency pressure usually help to contain the "shortfall" of assets to liabilities.

To satisfy the company's obligations beyond what these assets can finance, the guaranty associations operating in states where the failed company wrote policies assess other insurers doing business in those states based upon each company's statewide market share. The dollars raised through these assessments are used, along with the available assets of the insolvent company, to satisfy the obligations owed to consumers. Some states offer insurers an offset on state premium taxes as a way to recover, over an extended period of time, a portion of the funds paid by the companies to protect consumers. In other cases assessments are recouped by means of rate increases or policy surcharges.

For life/annuity/health insurance consumers, the guaranty system typically works with the receiver to identify a financially sound insurer to take over the troubled insurer's obligations or may, in some cases, provide coverage directly by paying claims or continuing the insurer's policies. This continuation of coverage is especially important for life/annuity/health insurance consumers who, for example, may be unable to buy new coverage because of a preexisting medical condition. Property/casualty consumers without claims may simply seek insurance coverage from another carrier. If, however, the consumer has an outstanding claim against a carrier, the guaranty association will "step into the shoes" of the insolvent company to pay the claim against the policy as defined by state statute.

Each state's legislature establishes by law the coverage for the residents of its state by adapting national model life/annuity/health and property/casualty guaranty association statutes to local conditions and policy priorities. Most life/health guaranty associations provide coverage at limits of at least $300,000 for life insurance death benefits, $100,000 for life insurance cash surrender values, $250,000 for annuity withdrawal or payment values, and $100,000 for health insurance benefits. Most property/casualty guaranty associations provide coverage on a per-claim basis for personal injury and property damages up to $300,000, provide full benefit coverage for workers' compensation claims and provide for premium refunds.

Insurance laws vary from state to state, and the guaranty laws are no exception. Each state legislature establishes its guaranty laws in accordance with local policy priorities and economic conditions. The NAIC and other organizations, such as the National Conference of Insurance Legislators, have promulgated model laws on which state legislators draw heavily to formulate their own policies. For example, the NAIC recently recommended that states increase their annuity limits to a floor of $250,000 and their long-term care limits to a floor of $300,000. This recommendation has spurred many states to update their protection levels.

Bank accounts and insurance policies differ significantly. To meet the fundamental requirement of the banking safety net – assuring depositor liquidity by replacing <u>dollars with dollars</u> almost instantaneously – the Federal Deposit Insurance Corporation (**FDIC**) must fund its entire obligations for bank failures up front. The objective of an insurance safety net must be to replace <u>insurance with insurance</u>. Many insurance obligations are long-term in nature, taking years or even decades to mature; for this reason, the focus of a guaranty association must be on the delivery of insurance protection through a combination of technical insurance experience and operational capacity, combined with ample funding capacity. Policy service, claims adjusting, and other standard claims practices are offered just as though the originating carrier were still in business. In the guaranty system structure, these insurance functions are backed by a funding mechanism (assets remaining in the failed insurance company and assessments on insurance companies) that will allow the contractual commitments of the failed insurer to be honored.

So that's how the resolution systems – insurance v. bank – work today to protect consumers. There is evidence that any new federal regulator/resolution regime replacing the state regulatory/receivership mechanism could continue to use the existing state guaranty systems to protect consumers, just as they do today, without requiring some kind of new federal plan with attendant federal expense. In other words, the current state-based safety net could be adapted to cover insurance consumers in a federally-chartered entity, just as those consumers are protected today, and that is what most optional federal charter proposals have suggested. And, of course, the DFA leaves the current state-based receivership and guaranty systems in place for insurance companies, even SIFIs, under the new FDIC-centric orderly liquidation authority regime in Title II of DFA.

2.13 Additional Factors: clarifying the role of the NAIC in relation to the FIO

<u>Key Recommendation</u>:

- FIO should consider whether the existing structure of the NAIC can be used to unify and nationalize the state-based regulatory system.

<u>Discussion</u>:

One of the sensitive issues facing the FIO is its relation to the state insurance commissioners and to their association, the NAIC. Over the years, the NAIC has attempted to fill a void of a national supervisor for insurance companies, especially by acting as a forum for state of the art model legislation of common interests in the state insurance departments. The FIO may eventually go beyond such a consensus building role. It could define what conforming regulation is and push any state regulator to move into conformance with appropriate and effective regulatory practice. As a center of excellence in insurance practice and insurance regulation, the FIO is likely over time to replace the interest of state regulators in some of the services of the NAIC.

The FIO will have limited authority to mandate the delivery of company data, which might be expanded despite the DFA-mandated requirements to seek such data first from the NAIC, state regulators or other such sources. Working with the OFR, the FIO is likely to have the means to obtain industry information from all insurers and to process and make available insurance data that will prove useful for policymakers, researchers and all insurers, and freely or at prices that reflect the public good character of industry data. Kwon (2007) concludes that state-based regulation is likely to be more effective and efficient than an OFC or federal regulator if state regulators can unify their activities and improve their own efficiency, and if the NAIC could position itself as an association of regulators supported by members and surrendering (and replacing) its revenue base from publishing and selling trade books and data.

Appendix 1

The Industry Perspective on the DFA and the FIO, March 25, 2011, Austin, TX at the NAIC Meeting

In March 2011, NFI organized two industry roundtables at the NAIC spring meeting in Austin Texas, one for life and annuity firms and the other for property and casualty firms. The purpose was to explore industry concerns about the DFA and the FIO. Thirteen executives attended the life and annuity session, and 15 attended the property and casualty session. This section provides an overview of the industry discussions.

Concerns about Dodd-Frank

Insurers are centrally focused on the evolution of the FIO and harbor strong anxiety about the uncertainty surrounding the DFA generally. Specifically, insurers await the possible changes to the regulation of insurance that will emanate from FSOC and FIO. The level of anxiety is heightened because insurance executives believe that there is not much understanding of the insurance business and insurance products in Washington, particularly among banking regulators, and they fear that banking regulators will take on more control of insurance regulation. Small companies had thought that the DFA would not affect them at all, while large firms, many of whom earlier had supported the efficiency gains of the optional federal charter, are now fearful that they will be confronting new regulators who do not understand the insurance business. Insurers worry about a dual regime in which they will be confronted with both existing state regulators and new federal regulators with conflicting or simply overlapping requirements. The Office of Financial Research presents the spectra of new data reporting requirements that will raise costs and present privacy and proprietary issues that will threaten their franchises, or, at best, duplicate the costs of their existing reporting functions with state regulators and the NAIC.

The uncertainty over new rules is reinforced by the perceptions of secrecy with which the FSOC operates and the lack of adequate representation and impact of insurance experts on the Council. While the latter uncertainty will be removed by new appointments shortly, the effects that this uncertainty has had over policy and effectiveness of new insurance regulation will persist. The FIO will have to develop a strong action plan to remove doubts about the transparency and effectiveness of the policy development process in order to remedy these doubts.

A far-reaching federal concern is that the DFA is “bank-centric” and that the new federal regulators, especially on the FSOC, do not and will not understand the fundamental differences between insurance and banking. This is especially true with respect to the Federal Reserve, which will take the strongest leadership role in the FSOC. For example, insurers do not engage in extensive maturity transformation that might expose them to systemic risk. Insurance companies have long-term assets *and* liabilities, unlike banks. Also insurers that are bankrupt normally have long term contracts and are allowed to wind down slowly, unlike banks that close abruptly under a resolution from the FDIC. Large insurers that own banks reinforce this argument. They argue that the Fed does not understand their primary business and that large amounts of resources have had to be hired to educate the Fed on their business and for new compliance efforts to satisfy uninformed regulators.

Insurers have an underlying concern that federal policy makers, and by implication their new institutions – the FIO, the OFR and the FSOC, not to mention the CFPB, which initially is unrelated to insurance – are biased against insurance products, especially insurance products that can help with retirement goals, including annuities. They note that insurance products can help with state pension system underfunding and that guaranteed income annuity products can supplement Social Security, yet federal leaders often look upon these products with grave apprehension.

Positive Aspects of Dodd-Frank

The positive aspects of the DFA for insurers focus on the FIO. In particular, insurers are unanimous that having a strong leader and knowledge repository on international insurance issues will produce strong benefits. Also the FIO is expected to strengthen communication lines between the industry and both Capitol Hill and the Administration. As an insurance representative, the FIO will bring strength to international trade discussions and collaborative cross-border regulation, assisting the U.S. Trade Representative. Additionally, the FIO can bring convergence to discussions arising from Basel III and the Basel Accords, generally, as well as discussions of Solvency II, the new European solvency requirements. The FIO may also play a role in building respectability for reinsurance regulation in international circles, especially by reducing anti-competitive barriers facing foreign insurance competitors and thereby easing foreign pressures on the U.S. industry.

The FIO is expected to be a knowledge and information resource, or archive, at the federal level. It will also be valued positively as a research institution, but not as a regulator, according to several participants. Some insurers pointed to the FIO as providing an umbrella for oversight, or even perhaps even a channel for a redesigned regulatory system. It could also play a positive role in reducing reporting requirements and in resolving the surplus lines "mess" created by Congress in the DFA, in Congress's effort to simplify surplus lines regulation without an effective implementation strategy. The biggest risk here, according to a few insurers, is that the FIO, with limited responsibilities, will seek more powerful responsibilities that will likely adversely affect the industry.

What Should the FIO Do?

Industry spokespersons also weighed in on what the FIO should do, presumably in following the DFA mandate, but also extending beyond the DFA. The most immediate and uniform answer was to pursue the objectives of the OFC proposals, specifically to provide federal preemption of state rate and form regulation and to eliminate duplication in reporting and regulation by 50 state regulators versus one federal one. But insurers also emphasized that the FIO must be "fully preemptive" because otherwise there will be two regulators in each state, not just one, and the cost implications will be worse than they are without the FIO. There was no strong support for pushing for an OFC right away. Participators believe that the political climate is not favorable to introducing the OFC today and many of its objectives could be accomplished through the FIO. Also there was concern expressed that an OFC today or in near future could lead to efforts to move consumer protection in the insurance field to the Consumer Financial Product Protection Bureau, which is currently barred from coverage of the insurance industry and insurance products. This prospect was uniformly viewed negatively.

Another major issue for the FIO is to determine the appropriate role for the NAIC. Many insurers, especially on the life and annuity side, regard the role of the NAIC as requiring clarification. The NAIC currently participates in international policy discussions and addresses issues arising at the state level, but it is unclear whether industry interests are represented in either international or domestic policy discussions at the NAIC. The DFA does not provide clarity on this issue or the role of the NAIC, but the FIO will have to address both. Several participants expressed frustration that the NAIC views itself erroneously as an umbrella organization for state regulation instead of essentially a trade organization for the state insurance commissioners. The NAIC is a major provider of trade information for the insurance industry, but it has fashioned a role for itself in research and promotion of state-of-the-art regulation for the members, through the dissemination of model legislation on regulatory issues. Accordingly, the NAIC is a trade association that is trying to take on a de facto regulatory role through model legislation, attempts to become a data warehouse and acting as a supervisory college. But the NAIC has no political accountability (27 of the last 87 NAIC meetings have been closed, according to one participant). The FIO could be the instrument for greater uniformity and efficiency, such as uniform broker licensing.

The FIO, in the view of many insurers, could meticulously define and explain the role of the NAIC and how well it communicates with the states and the industry, so as to identify gaps in regulation and communication, especially for life and annuity firms. Many insurers also emphasized the importance of a "finding of real state inadequacy in regulation" for the FIO to move forward in an active regulatory role; many believe that there will be such a finding and the NAIC should be prepared for it. A counterpoint was offered in this regard, however, that it is important to appreciate the advantages of NAIC inaction. Not getting things done reflects the advantages of slow deliberate action sometimes attributed to the Congress.

Among the participants, there were proponents of a more focused regulatory role for the NAIC. In the view of some, the 50 states under the NAIC should be the center of regulation and the provider of insurance expertise to the federal authorities. Their key role is developing and disseminating best accounting practices and procedures and serving as the creator of policy for insurance regulation. However, regardless of whether the individual participants were for federal or state regulation, all shared the concern that a dual regulatory system would cause unnecessary duplication and compliance burdens, especially for information demands, investment restrictions, derivatives use and trading, and systemic risk regulation, especially at the federal level. They also agreed that there is a risk of regulatory overreach, not only from new federal authorities, but also from state regulator and NAIC reaction to the new competition.

The FSOC

As indicated above, insurers generally regarded the FSOC as a potential threat to their business. First, there was widespread agreement that the FSOC lacked critical regulatory transparency, at least at the outset, that it was bank-centric and should develop metrics more appropriate for insurance, at least to apply to insurance companies, and that it should not focus on size alone in determining which firms are systemically important financial institutions. The FSOC should first identify systemically risky activities and then determine which firms are engaging in these activities, not the reverse. Insurers think that SIFIs will face serious competitive disadvantages, despite the likely lower cost of capital that they may gain from such a classification and its related status of too big to fail. The expected cost disadvantage is expected to arise through mandated higher capital costs for SIFIs, as well as the induced inefficiencies arising from the fact that "nothing will ever kill an inefficient SIFI" and the stultifying effects of a federal regulator. Insurers are concerned that there will be waves of SIFI designations that will leave the U.S. financial industry looking like Europe's industry. When asked whether there were advantages to being named a SIFI, insurers said no, pointing out that only companies can stand behind their products, not a SIFI designation.

Insurers worry that the FSOC will cast a never widening net and in order to protect itself from a potential failure looming just beyond the limits of their definition of a SIFI. Insurers do not believe that they are a source of systemic risk because of their differences compared to banks and each other in their products, business models and interconnectedness. Moreover, more developed notions of a SIFI, which evolved after our roundtables, point to interconnectedness and availability of substitutes, in addition to size, as major criteria for SIFI status, as well as secondary considerations of leverage, extent of maturity transformation of liabilities into assets and the extent of existing regulation. The belief that insurers are not sources of systemic risk appears even clearer once one moves beyond size to consider these newer five features of

SIFI classification. Nonetheless, insurers suspect that large insurers will be cast as SIFIs, creating a two-tier set of capital requirements, business models, reporting requirements, and regulatory burdens, accompanied by a two tier system of regulation by data calls.

Guaranty Association/Fund Issues

Insurers pointed out that, during the recent financial crisis, no major insurers failed. Insurers are concerned that a move to federally regulate insurers will make their products more expensive by boosting their own liability insurance cost, as well as by politicizing their state regulatory consumer protection mechanism by moving it to the federal level. Also they note that the existing FDIC insurance for banks has an annual budget of $3.9 billion, which is far larger than the existing state insurance guaranty associations/funds, which total only $65 million and have far fewer employees. Yet the state system appears to be better funded, better priced and sustainable. Not surprisingly, there is concern over how a federally regulated insurance SIFI will be treated for federal and state guaranty fund purposes.

Lessons from the Great Recession

- State regulators, even in the most financially sophisticated states, did not fully understand the financial crisis, especially the importance of group regulation. This is critically important in moving forward, whether with reformed state regulation or a new federal regulatory authority.

- The NAIC's ability to set accounting standards came into question, and this raises the question of how and whether the FIO can take over the role of leader in accounting practices some noted that accounting practice is an International Accounting Standards Board (**IASB**)/Financial Accounting Standards Board (**FASB**) problem, though the FIO could step in.

- The financial crisis experience showed that insurance is not subject to systemic risk, at least not as an originator, though some insurers were affected by developments in the investment banking sector.

- Insurers argued that the experience the past 40 years – and certainly during the financial crisis – showed that the insurance guaranty system was healthy and adequate.

Too Big to Fail

Insurers are unsure whether being designated as a SIFI is good for a company from a competitive standpoint, though they are fairly certain that it will weaken the designee. By implication, one would expect that weaker SIFIs will weaken competition and weaken industry performance. Insurers did note that uncertainty, even about Too Big To Fail (**TBTF**), has adverse effects on the industry. Insurers are unsure whether the DFA solved the TBTF problem or enshrined it in the SIFI designation, though the discussion leaned toward the latter. The issue of the criteria for a SIFI designation is critical and there is broad agreement that size is not an adequate criterion. Interconnectivity is critical and the insurers are in agreement that this is not a problem for existing insurance firms or the industry. The extent of interest rate risk might be a superior criterion for insurance firms, according to a few insurers.

Advice to the FIO Director

Despite the many issues raised above, insurers raised only nine focused points when asked to suggest advice. They suggested that the FIO

- Interpret for leaders in Washington the meaning and lessons of the Great Recession for the insurance industry, especially that insurance firms are not banks;
- Focus on the role as international spokesperson for the U.S. insurance industry;
- Educate federal regulators and lawmakers about insurance;
- Act as an arbitrator among the NAIC, the NCOIL and others;
- Act like the Congressional Budget Office in evaluating costs of regulation to the industry;
- Establish strong and meaningful boundaries around the FIO's scope and authority;
- Understand that there is not unanimous support for the FIO in the industry;
- Understand that the FIO *cannot* speak for all the states; and
- Provide strong educational leadership on the role and functionality of the state regulatory system.

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