A Report to the Federal Insurance Office

FROM

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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 Wall Street Reform and Consumer Protection 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 are 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 six 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 challenges facing the insurance sector.

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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.** • The FIO should take the lead in developing solvency standards and liquidity requirements for the insurance sector in the United States. • The 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.** • The 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.** • The 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, the FIO should consider the differential impact of federal regulation on varying sizes of insurers.

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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.** • The 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.** • The 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.** • The 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.** • The 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.** • The 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.** • The FIO should consider whether the existing structure of the NAIC can be used to unify the state–based regulatory system to achieve minimum national/federal standards.

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In addition to these recommendations, NFI offers the following nine 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:

- 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.

NFI is uniquely qualified to take on the task of analyzing the mandated components for the 2012 report and developing key recommendations based on existing research. 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. The NFI Summit has become an important annual meeting of insurance leaders, members of Congress, state regulators, policymakers and academic researchers and has established NFI as a nationally recognized thought leader in insurance regulatory reform. **Section 3** of this report summarizes NFI's legacy in this space, and the **appendices** include abstracts for the full set of NFI's activities over the past seven years in conducting research on insurance reform, especially the potential role of the federal government. NFI is not new to the game. We have been thinking about the statutorily required study issues for a long time.

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 in 2012. 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. **Appendix 1** contains detail on the NFI Policy Briefs and working papers cited.

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 **(SIFIs)**, 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

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immediate payouts even by reinsurers, they do not lead to contagion or 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:

- The FIO should take the lead in developing solvency standards and liquidity requirements for the insurance sector in the United States.
- The 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 (see the summary of NFI's September 2010 regional insurance regulatory reform conference in **Appendix 2**). 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

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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) cited in **Appendix 1**. 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.

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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:

- The 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

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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:

- The 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 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

[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.

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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 illegally taking over a prominent U.S. bank in Washington D.C.

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 its 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 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 Recommendation:

- 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

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

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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, the FIO should consider the differential impact of federal regulation on varying sizes of insurers.

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 publicly 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

[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.

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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:

- The 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:

- The 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.

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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:

- The 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 negatively affect 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:

- The FIO should critically examine the widespread belief that state regulators are better able to provide consumer

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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 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:

- The 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, either through an optional federal charter or some other kind of federal regulation regime, perhaps with a federal resolution authority. At the 2009 Insurance 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

[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.

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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

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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 dollars with dollars 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 insurance with insurance. 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 the DFA.

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

Key Recommendation:

- The FIO should consider whether the existing structure of the NAIC can be used to unify and nationalize the state–based regulatory system to achieve minimum national/federal standards.

Discussion:

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

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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.

3. Networks Financial Institute and Its Relevance to the Federal Insurance Office

Networks Financial Institute in the Scott College of Business at Indiana State University facilitates broad, collaborative thinking, dialogue and progress in the evolving financial services marketplace through three targeted initiatives:

- Improve financial services industry decision making, innovation and progress;
- Develop future financial services industry leaders; and
- Improve financial literacy of current and future consumers.

With innovative programs and services, NFI provides an unprecedented link among educators, regulators, students, industry, professionals, policymakers and citizens/consumers. Launched in 2003 as an outreach of the Scott College of Business at ISU, NFI is made possible through a generous grant from Lilly Endowment Inc., an Indianapolis–based, private philanthropic foundation.

3.1 NFI Background and Its Mission

NFI is a national thought leader working to answer questions and tackle challenges surrounding the financial services industry through its network of prominent research fellows, along with NFI's own staff researchers. To expand its global influence and strengthen its public policy research output, NFI recruited two visiting scholars in 2010: Sandeep Gopalan, professor and head of the Department of Law, National University of Ireland, Maynooth, and Jiang Cheng, assistant professor in the Department of Accounting and Finance at Shanghai Jiao Tong University. Insurance industry regulation and regulatory reform issues have been central to NFI's research program. We also help inform industry leaders and decision–makers on today's most pressing financial services issues such as home foreclosures, corporate responsibility, interest rates and payday lending.

In spring 2010, ISU asked B&D Consulting in Washington to conduct a strategic assessment for NFI's work in financial services thought leadership and research, and also, in financial literacy and decision–making. Based on a landscape survey, followed by strategic interviews with key industry leaders, a gap analysis identified the most critical areas for NFI's work moving forward in the post–DFA world. In financial services thought leadership and with the scale and scope of federal insurance regulatory reform yet to be determined, the assessment findings were:

- Federal insurance regulatory reform has just begun, evincing a need for additional thought and study on the source, utility, and costs of financial services regulation generally.
- The AIG meltdown called into question historical understanding and identification of enterprise risk. There is an unnerving lack of consensus as to the definition of systemic risk and a belief that Congress has not yet adequately addressed this issue. In spite of this, the Financial Stability Oversight Council will soon be making game–changing determinations about which enterprises present systemic risk.
- Implementation of the DFA will dominate the financial services landscape for years to come. The insurance industry is most concerned about the FDIC's liquidation authority and the scope and reach of the Federal Insurance Office, as well as the new derivative regulations.
- Greater attention must be paid to the globalization of the financial services industry. All stakeholders must understand the implications of globalization and how to function in an ever–broadening marketplace and regulatory arena.
- Federal policymakers and regulators are new to insurance and, without proper (and more) education and information, could make ineffective or even harmful decisions.

The assessment reinforced NFI's need to sharpen its focus on insurance regulation in light of the DFA. It made a case for NFI to build and maintain a strong relationship with the Federal Insurance Office. It is in this spirit that NFI presents its research

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to the FIO for its early 2012 Congressionally–mandated report on central issues facing insurance regulation at the state, federal and global levels.

3.2 NFI's Expertise in Insurance Regulatory Reform Research

Beginning in 2006 with a continuously broader series of papers, NFI has expanded its insurance reform expertise and convened an increasing number of reform events. The 2011 Summit focused on the DFA; prior Summits examined the optional federal charter, the required federal institutions to implement an OFC or other proposed reforms, international insurance regulation, and consumer protection issues. Events included a May 2010 Capitol Hill briefing on systemic risk in insurance, a September 2010 Midwest regional insurance reform summit conference, and a set of roundtables in March 2011 to gain an industry perspective on the DFA at the National Association of Insurance Commissioners meeting in Texas.

Appendix 1 provides abstracts for more than thirty NFI working papers and Policy Briefs on insurance regulatory reform issues and on key areas of the DFA affecting insurance regulation and performance. Some of these papers draw upon experience in the banking industry, including systemic risk, solvency and capital requirements (Basel I, II, and III), market discipline, regulation of bank compensation and consumer protection, and are referenced throughout this report. **Appendix 2** describes NFI's insurance–related research events in 2010 and 2011. **Appendix 3** lists the preeminent industry thought leaders, legislators, scholars, policymakers and regulators who have spoken at the annual NFI Insurance Reform Summits.

Seventh Annual Insurance Reform Summit, March 16, 2011

In March 2011, NFI's Summit focused exclusively on the DFA. Entitled "In the Eye of the Hurricane: Preparing for the Federal Insurance Office and 2012 Report to Congress," the Summit started with the debate over passage of the DFA and focused on the tough struggle ahead surrounding its implementation. Summit speakers repeatedly returned to the theme of uncertainty surrounding the DFA and its anticipated implementing of regulations, coupled with the need for real input from the insurance industry and the three insurance experts on the FSOC when fully on board. Congresswoman Judy Biggert (R–IL) and Senator Jack Reed (D–RI) anchored the Summit from the Congressional perspective. Other speakers at the Summit – academic, regulatory and industry – provided a variety of perspectives on the DFA's mandates for the FIO and made several suggestions: Susan Voss, Iowa Insurance Commissioner and President, National Association of Insurance Commissioners; John Huff, Missouri Insurance Director and Financial Stability Oversight Council Member; Governor Dirk Kempthorne, President and CEO, American Council of Life Insurers; Leigh Ann Pusey, President and CEO, American Insurance Association; Scott Harrington, Alan B. Miller Professor, Wharton School, University of Pennsylvania; and Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute for Public Policy Research. That information is in **Appendix 2**.

Capitol Hill Briefing on Systemic Risk in Insurance, May 13, 2010

NFI Senior Fellow Martin Grace is the James S. Kemper Professor of Risk Management and Professor of Legal Studies and Risk Management and Insurance in the Robinson College of Business at Georgia State University and Associate Director and Research Associate at GSU's Center for Risk Management and Insurance, and is also an Associate in the Andrew Young School of Policy Studies, Fiscal Policy Center. Grace presented findings at a May 13, 2010 insurance regulatory reform briefing on Capitol Hill in Washington D.C. to a group of lawmakers, regulators and industry leaders. Grace's NFI Policy Brief, "The Insurance Industry and Systemic Risk: Evidence and Discussion," concludes from his research that the failure of AIG in 2008 and surrounding financial crisis shocks did not adversely affect major insurers and that systemic risk is not a characteristic of the insurance industry.

3. Networks Financial Institute and Its Relevance to the Federal Insurance Office

According to Grace, the governmental level at which insurance is regulated is immaterial as long as similar moral hazard risk (and the resulting consumer discipline) is present; if an optional federal charter law is enacted and the regulatory system shifts, the key would be to maintain that discipline.

Insurance Regulatory Reform Issues: A Regional Perspective, September 14, 2010

In September 2010, NFI held a Midwestern insurance regulatory reform conference in Indianapolis that brought together influential insurance leaders to share their perspectives on the DFA and how national and international regulatory changes are likely to impact U.S. insurers and the consumers they serve. As insurers operate in an increasingly global economy, the conference explored international financial regulatory trends, the concerns of state regulators, and how federal oversight should be balanced with the ability of U.S. insurers to remain competitive in a global marketplace.

Two academic thought leaders shared their perspectives on systemic risk and rethinking consumer protection. Sharon Tennyson, Associate Professor, Department of Policy Analysis and Management, Cornell University, spoke on consumer protection in the insurance markets. NFI Senior Fellow Martin Grace discussed emerging federal and state issues impacting the insurance sector, based in large part on his Policy Brief discussed above. Insurance regulators from Illinois (Michael McRaith), Indiana (Stephen Robertson), and Michigan (Ken Ross) provided a regional perspective on how the insurance sector is likely to be affected by new regulation at the federal and state levels.

Therese Vaughan, CEO, National Association of Insurance Commissioners, provided an overview of developments in U.S. regulation and addressed the implications of the DFA and the NAIC's Solvency Modernization Initiative, and gave her observations on capital and supervision issues. Four leaders of the insurance sector's trade groups also shared their members' perspectives on insurance regulation; these included Charles Chamness, President and CEO, National Association of Mutual Insurance Companies; Robert Gordon, Senior Vice President for Policy Development and Research at Property Casualty Insurers Association of America; Franklin W. Nutter, President of the Reinsurance Association of America; and Kevin A. McKechnie, Executive Director of the American Bankers Insurance Association and Director of Government Relations for the American Bankers Association Securities Association.

The Industry Perspective on the DFA and the FIO, March 25, 2011

In March 2011, NFI conducted industry roundtables at the NAIC spring meeting in Austin, Texas, for life/annuity and for property/casualty insurers. Participants gave frank voice to industry concerns about the DFA and the FIO. The greatest concern of discussants was possible changes to regulation that will emanate from the FSOC and the FIO. Bottom line, insurance executives believe that (a) there is a lack of understanding among federal regulators of the insurance industry and its products, and (b) models for banking regulation will be inappropriately applied to insurance regulation. Insurers generally regarded the FSOC as a potential threat to their business unless federal decision-makers can climb the learning curve quickly. Additional questions, concerns, and uncertainty surround the roles of the FIO and its Director, other mandated federal regulatory entities, the role of the NAIC, and implications of the systemically important financial institution designation.

Positive aspects of the DFA for insurers focus on having, through the FIO, a better understanding in Washington of how insurance works. In particular, insurers are unanimous that having a strong FIO leader, along with FIO's role as knowledge repository on international insurance issues, will benefit the industry and consumers. The FIO will be valued as a research institution, but not as a regulator, according to several participants.

More detailed information from these four 2010–11 events is in **Appendix 2.**

4. Contact Us

NFI is pleased to present this report in anticipation of the forthcoming FIO Report to Congress. Our expertise and long-standing interests in the issues of insurance regulatory reform and financial services industry performance, and our extensive contacts with industry leaders and the insurance research community, mean we are uniquely qualified to provide this input.

Should you have questions or want additional information, please let us know. Our contact information is listed below.

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www.isunetworks.org

APPENDIX 1

Research on Insurance and Insurance Regulation: 2005 – 2011
Networks Financial Institute at Indiana State University

www.isunetworks.org

The Regulatory Effect of Risk–Based Capital in Property–Liability Insurance

Working Paper 2011–WP–20
Jiang Cheng and Mary A. Weiss
August 2011

This study investigates how U.S. property–liability insurers changed their behavior in response to the risk-based capital (RBC) requirements implemented in 1994. We posit that insurers may have acted to manage their operations and/or exploit anomalies in the RBC formula so as to improve the RBC result. The sample consists of pooled, cross–sectional data of U.S. property–liability insurers included in the NAIC's database for the period 1991 to 2007. Simultaneous equations with partial adjustment models are estimated with change in a firm's operating risk characteristic (change in leverage ratio, change in proportion of premiums written in high–risk lines and change in proportion of stock and real estate investment) as the dependent variable. First, regressions are estimated by year for 1991–1996. Then pooled regressions are estimated with dummy variables reflecting insurers' financial strength added in the estimation. Two time dummy variables (1994 dummy and 1991–1993 dummy) are also added to study whether or how insurers adjust their behavior over time. We find that insurers adjust to their target ratio of leverage, proportion of premiums written in high–risk lines and proportion of stock and real estate investment simultaneously. We find that insurers in weaker financial positions may have had a larger response to the imposition of RBC requirements. Results indicate that insurers in different financial conditions respond to RBC differently. Further, insurers have adjusted their behaviors over time, and a new regulatory rule plays a role in affecting these adjustments.

Underwriting in Property-Casualty Insurance Markets: Regulation, Risk and Volatility

Working Paper 2011–WP–19
David Nickerson and Ronnie J. Phillips
August 2011

We offer a novel explanation of underwriting volatility in property-liability insurance markets in terms of private uncertainty over public regulatory policy. Underwriting involving random losses to policyholders is one source of risk to the equity value of insurance firms. Solvency regulations, however, pose a second source of risk to equity value when the implementation of such regulations randomly affects the return to underwriting but exhibits imperfect correlation with market conditions over time. Using a differential game in a standard no-arbitrage environment to model interaction between these two sources of risk, we derive the valuation equation for property-liability underwriting inclusive of the respective best-reply underwriting strategy of a representative insurance firm and the implementation strategy of a representative regulator. Owing to the conflicting effects of these strategies on firm equity, regulations adopted to reduce the solvency risk of insurers can, paradoxically, increase underwriting volatility in an otherwise efficient insurance market. Under certain parametric conditions, we also show that, even in the presence of complete financial markets, a subgame perfect Nash equilibrium of this game can exhibit a limit cycle in the value of underwriting which mirrors empirical evidence on the presence of cycles in property-liability insurance markets.

Consumers' Insurance Literacy

Policy Brief 2011–PB–06
Sharon Tennyson
July 2011

This policy brief reviews what is known about consumers' understanding of insurance and consumers' decision–making capability in insurance markets from existing studies and

summarizes the results of recent insurance literacy surveys of U.S. consumers. Avenues for improving consumers' insurance literacy are discussed in light of these studies, and the paper concludes by providing suggestions for future insurance literacy research.

The Role of Risk–Based Capital, Hurricane Exposure, Bond Portfolio Duration, and Macroeconomic and Industry–wide Factors in Property–Liability Insolvency Prediction

Working Paper 2011–WP–17
Jiang Cheng and Mary A. Weiss
July 2011

This research analyzes the performance of the risk-based capital (RBC) ratio and other variables in predicting insolvencies in the property–liability insurance industry during the period 1994 to 2008. This research contributes to the literature by analyzing a longer period of time than previous research, testing timely variables such as exposure to hurricane prone areas, and testing the role of macroeconomic and industry–wide variables in property–liability insurer insolvencies. The results indicate that the accuracy of the RBC ratio in predicting insolvencies is inconsistent over time and that some previously tested financial ratios that are part of the Financial Analysis Solvency Tools system do not always reliably predict insurer insolvency. In addition, the insolvency propensity is found to be significantly related to an insurer's hurricane prone area exposure, changes in interest rates, the industry–wide combined ratio, and the industry–wide Herfindahl index of premiums written.

Institutional Ownership Stability and Risk Taking: Evidence from the Life–Health Insurance Industry

Working Paper 2011–WP–14
Jiang Cheng, Elyas Elyasiani and Jingyi (Jane) Jia
July 2011
Forthcoming in the **Journal of Risk and Insurance**

We investigate the relationship between risk taking of life-health (LH) insurers and the stability of their institutional ownership within a simultaneous equation system model accounting for endogeneity of risk and institutional ownership stability. Several interesting results are obtained. First, stable institutional ownership of LH insurers is associated with lower total risk of the investee insurers, supporting the prudent–man law hypothesis. Second, large institutional owners do not raise the riskiness of the investee LH firms, as proposed by the large shareholder hypothesis. Third, institutional owners reduce total risk of the investees through an increase in their capital ratio and a reduction in their underwriting risk, though they do increase their investment risk, an area in which they have greater expertise. These findings have important implications for formulation of future regulatory policies, managerial decisions on attraction of institutional investors and investment choices of the market players concerning insurance company stocks.

Insurance Regulation and the Dodd–Frank Act

Policy Brief 2011–PB–01
Scott Harrington
March 2011

This paper discusses a number of key issues regarding implementation by the Financial Stability Oversight Council and the Federal Insurance Office of the Dodd–Frank Act's provisions affecting insurance. The paper emphasizes the fundamental differences between insurance and banking, including much lower potential for systemic risk and substantial market discipline in insurance, and how those differences favor solvency regulation and guaranty systems that reflect the distinctive features of each sector. The FSOC and FIO should carefully consider those differences in their analyses of possibly systemically important insurance companies and in the FIO's study and report to Congress on insurance regulation. Particular attention should be paid to the relatively low systemic risk and relatively strong market discipline in insurance compared with banking.

APPENDIX 1

Research on Insurance and Insurance Regulation: 2005 – 2011
Networks Financial Institute at Indiana State University

www.isunetworks.org

Will (Should) Dodd–Frank Survive?

Policy Brief 2011–PB–02
Peter Wallison
March 2011

Despite the fact that it grew out of a financial crisis, the Dodd–Frank Act was not the result of a bipartisan consensus. It received no Republican votes in the House of Representatives and only three Republican votes in the Senate. There are repeated statements by Republicans that they would like to repeal the act if they had the opportunity. One of the reasons for Republican opposition is the fact that the act seemed to be a regulatory overreach not warranted by the circumstances. There was a financial crisis, to be sure, but there were many indications that it was the result of U.S. government housing policies and not a lack of regulation. While repeal seems far–fetched at the moment, if the Republicans hold the House and take control of the Senate in 2012, significant modifications in the act are not out of the question. There are good reasons for substantial modification. The act authorizes a Financial Stability Oversight Council—an organization made up largely of the principal federal financial regulators—to designate certain companies as "systemically important" because their financial distress might cause instability in the U.S. economy. Once this designation is made, these companies are to be regulated and supervised by the Federal Reserve, giving that agency enormous power over their capital, liquidity, leverage and activities, and setting up the possibility of a partnership between the Fed and the largest financial institutions in the U.S. In addition, because they have been designated as too big to fail, these companies will have advantages over smaller competitors in obtaining credit and could drive smaller competitors out of business over time. The act's restriction on proprietary trading will weaken banking organizations by depriving them of another source of revenue. Finally, the Consumer Financial Protection Bureau has been established in the Fed, but has been made independent of the Fed, the President and Congress, raising questions about its conformity with the normal constitutional scheme.

Rethinking Consumer Protection Regulation in Insurance Markets

Policy Brief 2010–PB–07
Sharon Tennyson
September 2010

This paper examines consumer protection regulation in insurance markets and discusses how regulation could be made more efficient and robust. The paper argues that regulatory costs could be lowered and effectiveness enhanced by better targeting regulations to address market failures. Regulations should also recognize and attempt to harness the private incentives of market participants to encourage behaviors that are consistent with regulatory objectives. Applying theoretical and empirical insights from academic research and the experiences of other jurisdictions, specific approaches that make use of these principles are discussed.

The Insurance Industry and Systemic Risk: Evidence and Discussion

Working Paper 2010–PB–02
Martin F. Grace
April 2010

The financial market events in September 2008 seem unprecedented in modern times. While other systemically important events happened in the last thirty years affecting U.S. markets, the one month turmoil and government response is without equal. As a result, insurance industry economists have been dusting off dictionaries and looking up what systemic risk really means. Further, there are other policy analysts who are linking the insurance industry to systemic risk with a potential goal of changing the governmental level at which the entire industry is regulated. Systemic risk and the role insurers play in the market is of concern to both state regulators and Congress. This paper presents evidence regarding systemic effect of insurers and will discuss this in light of the rationale for federal regulation of the insurance industry.

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Global Impact of the Gramm Leach Bliley Act: Evidence from Insurance Industries of Developed Countries

Working Paper 2009–WP–13
M. Kabir Hassan and Abdullah Mamun
November 2009

This paper investigates the impact of the Gramm–Leach–Bliley Act (GLBA) on the insurance industries of developed countries. We find that the insurance industries of most of the developed countries in our sample have significant negative spillover effects from the GLBA. Further, we find that the impact of this deregulation on the insurance industries of any two countries is not the same. After controlling for country–specific effect, we find that profitability can explain the impact of the GLBA on non–U.S. insurance companies. This result is robust whether we use ordinary least squares or bootstrap as the estimation technique. However, we do not find any evidence demonstrating that the impact of the GLBA is statistically different for firms that are from European Union member countries versus those that are not.

The Implications of Solvency II for U.S. Insurance Regulation

Policy Brief 2009–PB–03
Therese M. Vaughan
February 2009

Much work has been done in recent years on the subject of insurance regulation and capital requirements, and the process of regulatory reform will continue. It behooves insurance supervisors to take a step back, revisit the underlying assumptions that have driven supervisory reform in the various sectors, and assess what implications, if any, their conclusions have for future work. The use of internal models to establish regulatory capital requirements cannot and should not disappear. However, they must be used appropriately, with recognition of their significant limitations. The optimal structure of insurance supervision is likely to be a combination of a rules–based and a principles–based approach. That is, internal models should be an adjunct to a rules–based capital requirement that establishes a floor for regulatory capital. Capital regulation is a necessary, but not sufficient, additional requirement for effective financial regulation. On–site examinations, offsite analysis of financial performance and trends, and frequent interaction with the regulated entity are equally important. Finally, current developments have demonstrated that market discipline cannot be relied on as a substitute for regulation and supervision. The optimal regulatory structure is one that encourages supervisors to take action when it is appropriate, and a system that incorporates duplicative regulatory oversight may advance that objective.

A Reexamination of Federal Regulation of the Insurance Industry

Policy Brief 2009–PB–02
Martin F. Grace
February 2009

The optional federal chartering (OFC) proposal introduced in the last session of Congress may have been the right bill for the introduction of federal regulation of the insurance industry at the turn of the 20th century. However, the current OFC proposal shows its 19th century roots, as it merely copies the banking industry's dual chartering provision and various aspects of state insurance regulatory law. This paper critiques the issue of federal regulation, not necessarily from the perspective of whether federal regulation dominates state regulation, but as to whether the federal or state regulation is structured sufficiently to minimize market failures or to minimize the effect of regulatory failures.

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Selected Research on Insurance Regulatory Reform: A Descriptive Bibliography

NFI Report 2008–NFI–02
Martha Henn McCormick
July 2008

Networks Financial Institute at Indiana State University, a national leader in addressing both ongoing and emerging issues impacting the insurance sector, provides this descriptive bibliography which addresses the myriad issues driving insurance regulation and reform. This resource provides more than 100 resources authored by industry thought leaders representing government, trade associations, the insurance industry, media and academia. This online bibliography of scholarly abstracts, research articles, journal publications, commentaries and proposals surveys the state of the insurance industry and will continue to be updated. As such, it is not a static document. The goal of this bibliography is to provide a comprehensive, "one–stop shop" or clearinghouse for resources relevant to insurance regulatory reform. NFI encourages users to bookmark the site and return periodically to find the latest updates on regulatory reform.

State Regulation and Consumer Protection in the Insurance Industry

Policy Brief 2008–PB–03
Sharon Tennyson
February 2008

In the recent debate over the appropriate governmental level at which to regulate insurance markets, opponents of a new federal role often raise concerns about the adequacy of consumer protection if regulation is removed from the states. This paper analyzes the need for market conduct regulation in insurance markets, and the arguments for state versus federal provision of this type of regulation. The paper then examines the provision of consumer protection regulation by the states in light of proposals for an increased federal role in insurance regulation.

The Implications of Prompt Corrective Action for Insurance Firms

Policy Brief 2008–PB–02
Therese M. Vaughan
February 2008

S. 40, the National Insurance Act of 2007, requires the development of a system of Prompt Corrective Action (PCA) for federally chartered insurers. This paper discusses the issues associated with developing a system of PCA and makes recommendations regarding its structure. First, the paper considers the historical motivation for the development of PCA in banking and insurance. Second, the paper provides an overview of PCA in banking and reviews the evidence regarding the extent to which banking regulators rely on PCA and its effects on Federal Deposit Insurance Corporation costs. Third, the paper provides an overview of the risk–based capital (RBC) requirements in insurance, and compares those requirements with PCA in banking. Fourth, the paper considers the banking requirements related to Least Cost Resolution and related language in S. 40. The paper concludes that PCA requirements should be included in any optional federal charter (OFC) legislation, and that NAIC RBC requirements provide a good initial structure. Furthermore, the paper concludes that other regulatory authority giving the Commissioner discretion to intervene beyond PCA is essential in any OFC system. S. 40 would benefit from the inclusion of a provision requiring review of costly insolvencies and transparency with respect to the results of that review and the costs of resolving insolvent insurers. Finally, S. 40 provides a clear objective for resolving insolvencies, a positive change from current insurance laws, but the appropriateness of the objective is dependent on the continued existence of the current guaranty fund system.

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Cross–Accountability in Insurance Regulation

Policy Brief 2008–PB–01
W. Jean Kwon
February 2008

Debates continue among Congressional members and industry leaders regarding the form of insurance regulation in the U.S. Regardless of the form of regulation they support – state regulation, national regulation or optional federal chartering – they all agree that the insurance industry must be subject to close regulation/supervision, that the regulation must be effective, and that the regulatory agency must be efficient. Nevertheless, most of the bills submitted in recent years seem to reflect mainly the political motives or business objectives of politicians and industry leaders, respectively. They fail to recognize why regulation exists and who must be ultimate beneficiaries of regulation in the insurance market. This paper attempts to offer answers to these questions. Particularly, the author discusses the importance of insurance regulation from a theoretical perspective and by examining the objectives stipulated in the insurance acts and regulations of selected jurisdictions. The discussion focuses on market (conduct) regulation, as the measures in this area are less structured than in prudent (financial and accounting) regulation. The author concludes that all parties of interest – the regulator, the insurance company (and the intermediary) and the consumer – need to recognize the importance of cross–accountability to each other for the development of sound insurance markets. The author recommends that the government self–regulate its quality of consumer services to improve regulatory efficiency, the insurance company implements an effective internal risk management program to minimize conflicts with clients (or cases of malpractices), and the customer learns that he or she bears the consequences of poor decisions for insurance consumption.

NAIC President Walter Bell's Remarks to the NFI 4th Annual Insurance Reform Summit

Policy Brief 2007–PB–06
Walter Bell
March 2007

Commissioner Bell's speech was prepared for the Fourth Annual Networks Financial Institute Insurance Reform Summit held on March 7, 2007 in Washington D.C.

Optional Federal Chartering of Insurance: Design of a Regulatory Structure

Policy Brief 2007–PB–04
Author: Hal S. Scott
March 2007

This paper examines the design of a federal regulatory structure for insurance companies in the United States, assuming some form of an optional federal charter is adopted. Any design must take account of the objectives of insurance regulation, the convergence of financial service powers among banks, securities, and insurance firms, the types of lines to be regulated at the federal level, and problems posed by the possible participation of nationally chartered insurers in state residual pools and guaranty funds. This paper argues that the creation of a new federal insurance regulator should be accompanied by more consolidation and less fragmentation in the overall federal regulatory structure, by placing the new regulator within an operationally strengthened President's Working Group on Financial Markets. Ideally, a new optional federal charter should provide a real federal option by having the federal government fully regulate the safety and soundness and product lines of all insurers choosing the federal option. However, if lines were to be split between federal and state regulation, safety and soundness regulation of all insurance companies choosing a federal option should take place

exclusively at the federal level, leaving the states with responsibility for consumer protection regulation in non–federal lines. While state guaranty funds have functioned effectively overall, a national guaranty fund would have the advantage of uniting responsibility for insurance and safety and soundness regulation, as in the case of banking.

Efficiency Consequences of Rate Regulation in Insurance Markets

Policy Brief 2007–PB–03
Sharon Tennyson
March 2007

Despite the presence of many and diverse sellers of insurance in most markets, insurance prices in some markets remain subject to regulation by state governments. Insurance rate regulation has a long and storied history in this country and the reasons for its continued existence are subject to debate and interpretation. This paper critically examines the arguments for rate regulation and discusses the consequences of this regulation for the insurance marketplace. It first provides a brief overview of the history, scope and objectives of insurance rate regulation, examines the most prevalent justifications for rate regulation and argues that they are incorrect or incomplete. It then turns to the consequences of rate regulation for insurance market outcomes, making use of both economic theory and empirical evidence from academic studies of regulated insurance markets. The paper concludes that insurance rate regulation entails high costs for society and for insurance consumers, and that alternative policies for meeting regulatory objectives should be considered.

Uniformity and Efficiency in Insurance Regulation

Policy Brief 2007–PB–02
W. Jean Kwon
March 2007

An intense debate over the choice of regulatory authority, e.g., state vs. federal regulation, continues in the U.S. The debate not only exhibits the diversity of political and economic interests of various groups such as the federal government, state governments and the NAIC, insurance companies and their associations, and policyholders and the general public. It also reflects the need of all parties of interest to align U.S. regulation with the changes in the financial services market and to preserve competitiveness of U.S. insurance companies in the domestic and foreign markets. This study summarizes the general directions of regulatory reforms internationally, reexamines the political history of insurance regulation in the U.S. to identify the motives behind each call for reform, and evaluates the current state–based approaches in comparison to proposed alternatives. The paper concludes that the current state–based system is preferred to any other forms of regulation in the U.S., provided that state regulators unify their activities and improve regulatory efficiency and that the NAIC positions itself as a true association of member regulators and is financially supported primarily by the members.

Insurance Regulatory Reform: An Evaluation of Options for Expanding the Role of the Federal Government

Working Paper 2006–WP–11
William J. Warfel
November 2006

In this article, the author explains the current state–based insurance regulatory system. Proposed legislation that would expand the federal role in regulating the business of insurance

is evaluated in terms of whether it could potentially improve the current state–based insurance regulatory system.

Federal Chartering of Insurance Companies: Options and Alternatives for Transforming Insurance Regulation

Policy Brief 2006–PB–02
Scott Harrington
March 2006

This paper provides an overview of the rationale and options for federal intervention in insurance regulation. Despite a number of positive and incremental reforms throughout the past decade, several key aspects of state insurance regulation, including regulation of rates, rate classification, and policy forms, remain substantially dysfunctional in many states – with no end in sight and with significant burdens on interstate commerce. A transformation of insurance regulation to reduce those burdens by promoting healthy price and product competition and eliminating regulatory micromanagement of price and product decisions will not be achieved without federal intervention. A well–designed system of optional federal chartering and regulation represents one means for attempting to achieve such a transformation. Two alternatives for transforming insurance regulation without creating a federal regulator and perhaps with less risk than optional federal chartering include: (1) enact minimum federal standards for state insurance regulation that would preempt non–conforming state regulation, and (2) 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.

Research on Capital Requirements and Basel Accords (Banking)

The Lure of Leveraging: Wall Street, Congress and the Invisible Government

Policy Brief 2010–PB–04
James A. Leach
August 2010

The author reviews the legislative framework of financial regulation, assesses public and private sector accountability for the economic trauma loosed in 2008, and appraises the legislative aftermath. His thesis is that the economy and the financial security of the country were unnecessarily jeopardized by the unchecked greed of a few; that at critical moments politics and ideology dominated regulatory decision–making; that the regulators, the invisible government, allowed excess leveraging out of excess confidence in risk–based mathematical modeling; that a conflicted Congress emboldened risk–taking at Fannie Mae and Freddie Mac; and that problems in commercial bank regulation related less to what Congress did than what it didn't do. As both a participant and observer in the legislative process, he has designed this review in part as a chronicle of Congressional interactions between the parties and with the Executive branch and in part as a take on regulation itself.

Assessing Banks' Cost of Complying with Basel II

2007–PB–10
David VanHoose
September 2007

This policy brief assesses the implications of Basel II for bank regulatory compliance costs. In spite of widespread complaints by bankers about the costs of complying with Basel II rules, the academic literature has given surprisingly little attention to

quantifying these costs. The brief discusses estimates of Basel II compliance costs based on commonly utilized rules of thumb and on survey data collected by the Office of the Comptroller of the Currency (OCC). In addition, it utilizes OCC bank–level compliance–cost estimates to speculate about the potential for economies of scale in Basel II compliance. There is unavoidable imprecision associated with compliance–cost estimates. Nevertheless, costs of implementing Basel II ultimately should matter for the U.S. banking industry, both in terms of how the overall magnitudes of compliance costs may influence banks' strategic–path choices as well as their ongoing operating decisions.

Evaluating the Policy Implications of the Other Two Pillars of Basel II

Policy Brief 2007–PB–08
David VanHoose
April 2007

This brief evaluates the supervisory–process and market–discipline pillars of the Basel II bank regulatory framework. It reviews and critiques their fundamental features and reaches three conclusions. First, the supervisory–process pillar provides too much scope for supervisory discretion and almost no support for a rules–based approach to regulation that arguably would be much more effective in promoting bank safety and soundness. Second, the market–discipline pillar's information–disclosure guidelines represent a useful first step for many nations with less–developed banking systems, but these costly guidelines fail to promote attainment of other conditions required to enhance market discipline in any of Basel II's participant nations. In light of these first two conclusions, the third conclusion is that these pillars of the Basel II framework require rethinking and reworking. In the longer term, global banking safety and soundness would more likely be enhanced by delaying implementation of Basel II until its framers replace the current supervisory–process pillar with a system of Prompt Corrective Action rules and expand the market–discipline pillar to include more features that might actually enhance bank market discipline.

Market Discipline and Supervisory Discretion in Banking: Reinforcing or Conflicting Pillars of Basel II?

Working Paper 2007–WP–06
David VanHoose
February 2007

This paper examines the market–discipline and supervisory–process "pillars" of the Basel II framework. It reviews the key features of these Basel II pillars and discusses and evaluates associated conceptual issues in relation to theoretical predictions and empirical findings in the academic literature. One conclusion is that while the market–discipline pillar is for many nations a potentially useful first step toward improving bank information disclosure, this pillar of Basel II falls short of promoting effective market monitoring by private investors or encouraging the utilization of market signals by both investors and bank regulators. A second conclusion is that the Basel II supervisory–process pillar is completely misguided in its reliance on regulatory discretion, so that implementation of this pillar could potentially have counterproductive safety–and–soundness impacts. Thus, the market–discipline pillar does not go far enough in the direction suggested by academic research, and the supervisory–process pillar actually goes in the wrong direction.

Basel II and Bank Credit Risk: Evidence from the Emerging Markets

Working Paper 2006–WP–10
M. Kabir Hassan and M. Ershad Hussain
October 2006

Existing literature has focused attention on the impact of Basel I and similar capital requirement regulations on developed

countries where such regulations were found to be effective in increasing capital ratios and reducing portfolio credit risk of commercial banks. In the present study, we study the impact of such capital requirement regulations on commercial banks in 11 developing countries around the world within a cross–section framework with the widely popular simultaneous equations model of Shrieves and Dhal (1992). Surprisingly, we find that such regulations did not increase the capital ratios of banks in the developing countries. This implies that particular attention should be given to the business, environmental, legal and cultural realities of such countries while designing and implementing such policies for developing countries. However, we find evidence that such regulations did reduce portfolio risk of banks. We also find that capital ratios and portfolio risk are inversely related in contrast to the predictions of "buffer capital theory," "managerial risk aversion theory," and "bankruptcy cost avoidance theory." Our evidence also shows that level of financial development and credit risk are inversely related, implying that as the financial sector of a country develops, it opens up avenues for alternative sources of finance, which results in reduced risk. Further evidence shows that liberalization is associated with bank risk.

Bank Behavior under Capital Regulation: What does the Academic Literature Tell Us?

Working Paper 2006–WP–04
David VanHoose
July 2006

This paper reviews academic studies of bank capital regulation in an effort to evaluate the intellectual foundation for the imposition of the Basel I and Basel II systems of risk–based capital requirements. The theoretical literature yields general agreement about the immediate effects of capital requirements on bank lending and loan rates and the longer–term impacts on bank ratios of equity to total or risk–adjusted assets. This literature produces highly mixed predictions, however, regarding the effects of capital regulation on bank asset risk and overall safety and soundness. Research also indicates that bank capital regulation can have procyclical macroeconomic effects and can impinge on the effectiveness of monetary policy. Although empirical research provides some support for the macroeconomic and monetary policy implications of risk–based capital requirements, conclusions about actual bank balance–sheet and risk adjustments to capital regulation are also mixed. Thus, the intellectual foundation for the present capital–regulation regime is not particularly strong. The mixed conclusions in the academic literature on banking certainly do not provide unqualified support for moving to an even more stringent and costly system of capital requirements.

Capital Regulation and Loan Monitoring in a Diverse Banking System

Policy Brief 2006–PB–13
David VanHoose
July 2006

Building on the literature emphasizing banks' monitoring functions, recent contributions to the literature examining the effects of capital regulation have focused attention on the influences of capital requirements on bank incentives to monitor loans for moral hazard risks. Empirical evidence suggests that this is a potentially important issue to contemplate when judging the usefulness of capital regulation as a means of reducing banking risks. This evidence also suggests, however, that various heterogeneities, which are commonly ignored in studies of the effects of capital regulation on bank monitoring and overall asset risk, are an important feature of real–world banking markets. In theory, bank heterogeneities can affect the manner in which the entire banking system responds to external shocks, such as the imposition of capital requirements. A few recent studies cast light on how diversity relating to loan–monitoring activities of banks affects their decision making and thereby influences market outcomes, which in turn feed back to alter individual bank choices regarding whether or how much to monitor their loans. In this way, the policy implications of capital regulation differ

from those forthcoming from standard studies of banking systems populated by identical, representative banks.

Keep the Leverage Ratio for Large Banks to Limit the Competitive Effects of Implementing Basel II Capital Requirements

Policy Brief 2006–PB–01
R. Alton Gilbert
January 2006

In October 2005, the agencies that supervise U.S. depository institutions proposed changes in the Basel I capital requirements that will apply to the banks that will not be subject to the Basel II capital requirements. An objective of the U.S. bank supervisors for proposing changes in Basel I capital requirements is to mitigate any competitive inequalities created by implementing Basel II capital requirements. This paper explains why the proposed changes in Basel I capital requirements would not mitigate such competitive inequalities for many of the banks that will continue to be subject to the Basel I capital requirements. In addition, this paper argues that an important means of limiting competitive effects from implementing Basel II capital requirements is to maintain the leverage ratio as one of the capital requirements for the banks that adopt Basel II capital requirements.

Research on Systemic Risk and Consumer Financial Protection (Banking)

Systemic Risks and Macroprudential Bank Regulation: A Critical Appraisal

Policy Brief 2011–PB–04
David VanHoose
April 2011

This paper discusses and critically appraises recent developments in the definition, measurement, and regulation of systemic risks. Although the issue of systemic risks has been subjected to considerable study, there is not widespread agreement on how to define this concept. Initial efforts to measure systemic risks emphasized aggregate financial ratios, and only recently have a variety of institution–level systemic–risk measurement techniques been proposed. Thus, regulators charged with conducting macroprudential regulation, such as the Financial Stability Oversight Council created by the Dodd–Frank Wall Street Reform and Consumer Protection Act, must act without a consensus about how to define and measure the form of risk they are charged with limiting. There are largely unexplored pitfalls associated with establishing a macroprudential–supervision apparatus: (1) An enlarged potential for regulatory capture and associated welfare losses; (2) A danger of over–relying on centralized governmental command–and–control mechanisms that might be at least as subject to breakdowns as private markets while under–relying on private market discipline; and (3) Failures to contemplate a role for private contractual (Coasian) solutions to externality problems that contribute to systemic–risk problems and to recognize that a broadened scope of regulations can actually undermine the incentives for financial institutions to contain these externality problems.

Analyzing the Role for a Consumer Financial Protection Agency

Policy Brief 2009–PB–13
Sharon Tennyson
December 2009

In the debate over the proposed establishment of a Consumer Financial Protection Agency (CFPA), much attention has been given to discussion of whether consumers are irrational or incompetent and therefore need paternalistic regulators to look after them, and whether inadequate consumer protection regulation was a contributor to the financial crisis. Arguments over these questions are misplaced. Consumer protection regulation is commonplace

in financial markets, and is essential even where consumers are fully rational and financial crises are distant. The potential role for a CFPA should first be examined based on consideration of the benefits and shortcomings of current consumer protection regulation, and how a dedicated consumer protection regulator would be likely to change things. Specific details of proposed legislation that affect the structure and authority of a CFPA should be evaluated separately rather than being used to determine whether such an agency is a good idea or a bad one. Consideration of the general principles for and against establishment of an independent CFPA may help to illuminate the strengths and weaknesses of specific legislative proposals.

Research on Regulation of Compensation (Banking)

Regulatory Restraints on Performance–Based Managerial Compensation, Bank Monitoring, and Aggregate Loan Quality

Working Paper 2011–WP–02
David VanHoose
February 2011

This paper evaluates the effects of binding regulatory restraints on the rate of performance–based management compensation within a banking framework in which the primary function of bank management teams is to monitor loans in order to eliminate deadweight default losses. Available management teams are endowed with heterogeneous levels of monitoring efficiencies, and obtaining services from more efficient monitoring teams requires payment of higher rates of performance–based compensation. In equilibrium, a fraction of banks choose to employ management teams that monitor. With or without binding capital requirements, imposing binding restraints on the allowed rate of performance–based compensation results either in lower bank efficiency or in a reduced fraction of monitoring banks and, hence, lower aggregate loan quality.

Regulation of Bank Management Compensation

Policy Brief 2010–PB–06
David VanHoose
August 2010

Since passage of the Economic Stabilization Act of 2008, the government has been explicitly and implicitly regulating the compensation of top managers at a number of U.S. banks. In addition, bank regulators have added evaluations of bank management compensation packages to the list of factors taken into account in supervisory safety–and–soundness examinations, and pending legislation would require the Federal Reserve to establish explicit standards for evaluating the risk implications of bankers' pay. Furthermore, the Federal Deposit Insurance Corporation has proposed incorporating the structure of bank management compensation into the determination of banks' deposit insurance premiums. This policy brief surveys the academic literature on the empirical relationship between bank management compensation and risk, discusses theoretical considerations that may underlie the mixed evidence regarding this relationship, and assesses potential pitfalls associated with actual and proposed regulations of the structure of management compensation in the banking industry. The main conclusion is that there is neither persuasive empirical evidence nor an unambiguous theoretical argument in favor of either direct or indirect regulation of bankers' pay.

APPENDIX 2
Recent NFI Insurance Regulation Events

Since 2003, NFI has conducted an extensive research program on insurance regulatory reform, much of which has been featured at its annual Summits in Washington, D.C. The Summit has become one of the most important annual meetings of insurance leaders, members of Congress, state regulators, policymakers and academic researchers and has established NFI as a nationally recognized thought leader in insurance regulatory reform. Beginning in 2006 with a continuously broader series of papers, NFI has expanded its insurance reform expertise and convened additional insurance reform events. The 2011 Summit focused on the DFA; prior Summits examined the optional federal charter and other federal tools, the required federal institutions to implement an OFC or other proposed reforms, international insurance regulation, and consumer protection issues. Other events include a May 2010 Capitol Hill briefing on systemic risk in insurance, a September 2010 Midwest regional insurance reform conference, and a set of roundtables in March 2011 to gain an industry perspective on DFA at the NAIC meeting in Texas.

In the Eye of the Hurricane: Preparing for the Federal Insurance Office and 2012 Report to Congress: NFI's 2011 Insurance Reform Summit, March 16, 2011, Washington, D.C.

Setting the stage for the Summit, Terrie Troxel, Executive Director of NFI, asked the central questions: As everyone waits for the FIO's report to Congress, where is the insurance industry headed? Will broad principles continue to drive regulatory policy? Is the financial services industry hamstrung by over–regulation? In his view, the industry is poised to address compelling public policy issues as it looks toward helping to steer implementation of regulatory policy. At the same time, it must also deal with topics long on its agenda: the role of an optional federal charter and other industry modernization issues, global competitiveness, and consumer service, as well as implementing market efficiencies in new ways.

Views from the House and Senate

U.S. Representative **Judy Biggert** (R–IL), Chairwoman, Subcommittee on Insurance, Housing and Community Opportunity of the House Financial Services Committee, expressed great concern that the FSOC is moving to "steamroll ahead," making determinations about crucial "systemic risk definitions" without representation from the industry or an open process, adding that the vacant FSOC and FIO positions must be filled. To be effective, the FIO must have a Director playing a critical role in negotiating international trade agreements to make U.S. insurers more globally competitive and to produce more jobs.

At the same time, Representative Biggert believes that new Basel III–like financial management programs will most certainly impact insurance companies. Such prospects make it important that the FIO and the FSOC remain within the boundaries of their authority, which may not extend to implementing Basel III for insurance.

The DFA will dominate the committee's work, Representative Biggert feels. As events unfold, the committee will provide ongoing oversight of the DFA, ranging from the CFPB to Orderly Liquidation Authority to a review of the Terrorism Risk Insurance Act and state–based guaranty funds.

Another insurance priority of the committee will be the National Flood Insurance Program **(NFIP).** Since NFIP represents $18 billion of outstanding taxpayer loans, its integrity must be restored, Representative Biggert insisted. "Communities and families rely on NFIP, which provides coverage for more than five million people," she said. New NFIP legislation must address three objectives: improving stability of the program, increasing private market participation in flood insurance and reducing its burden on taxpayers.

U.S. Senator **Jack Reed** (D–RI), Chairman, Subcommittee on Securities, Insurance and Investment, Senate Banking Committee, commented about the Senate's Banking, Housing and Urban

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Affairs Committee agenda that nothing they do is beyond improvement. Senate Banking, Housing and Urban Affairs Chairman Tim Johnson (D–SD) has laid out three overarching issues:

- What the committee can do to accelerate economic recovery and reduce unemployment;
- Oversight of the DFA, including hearings on implementation with the White House; and
- Housing reform.

On DFA oversight, after two years of drafting the legislation, implementation of the details should be left to regulators who are more able to respond and adapt to a changing situation, Senator Reed urged. As they carry out their responsibilities, the regulators must listen appropriately to consumers and the public sector.

To be effective, the resultant rules must be capable of being unambiguously understood and have the backing of sufficient resources to ensure their adequate implementation. For example, the Commodity Futures Trading Commission has appropriate resources to regulate the huge derivatives market properly, he noted. New regulations must take into account that insurance instruments are complex and have values in the trillions of dollars.

Senator Reed also spoke about the need to:

- Complete FSOC appointments;
- Name directors for the FIO and for the OFR and ensure an apolitical FSOC that will be far more capable than previous regulators to grasp events in financial markets and look ahead; and
- Adopt a five–to–seven year reform of Fannie Mae and Freddie Mac.

Research Perspectives

Scott E. Harrington, Alan B. Miller Professor, Wharton School, University of Pennsylvania, presented his NFI Policy Brief, "Insurance Regulation and the Dodd–Frank Act," arguing first that American International Group's central role in the recent financial crisis was an isolated incident and does not establish that insurers pose a systemic risk to the economy. Simply put, AIG's problems came from highly leveraged investments that were overwhelmingly associated with poor–quality mortgage loans. In other words, Professor Harrington said, the source of the problem was in the banking industry and not in the insurance industry.

AIG received a federal bailout, stated Harrington, not because it was insolvent but due to fears that its potential collapse could produce a policyholder run, similar to the run on banks at the start of the Great Depression. Quoting Treasury Secretary Tim Geithner's testimony to Congress in January 2010, "If AIG had failed, the crisis almost certainly would have spread to the entire insurance industry," Professor Harrington recounted.

What can cause this kind of systemic risk? Professor Harrington cited three possible factors:

- Risk due to a common macroeconomic shock large enough to shake other institutions;
- High interconnectedness and contamination–by–association cascading through an industry; and
- Fear of irrational contagion that can drive investors to withdraw totally from a market.

A common shock spurred the recent economic crisis. But, as stated previously, the shock had its actual origin in the banking and not the insurance industry.

In truth, the academic consensus is that systemic risk is relatively low in insurance markets, according to Harrington. It is very low for property and casualty insurance and still low

for life insurance. In comparison, Professor Harrington explained, banking crises have much greater potential to produce rapid and widespread harm to economic activity.

Harrington believes that the FSOC must keep these distinctions in mind as it sets out to identify institutions posing systemic risk, according to a list of 11 statutory factors it has established. While questioning whether any insurer can really be a systemic risk, Harrington listed several arguments against putting individual companies in this category:

- Likelihood of excessive regulatory burdens and costs;
- Possible distortion of a company's operating decisions;
- Gradual evolution to meaning "too big to let creditors fail," impacting the companies that people elect to buy from; and
- Little confidence that this designation will reduce the likelihood of another crisis.

Given these considerations, Harrington suggested that the FIO report to Congress must address a comprehensive set of issues, including:

- Systemic risk and capital requirements;
- The degree of national uniformity of state regulation;
- Regulation of insurance companies and affiliates on a consolidated basis;
- The costs and benefits of federal regulation for different lines of insurance (except health insurance) and feasibility of regulating only certain lines at the federal level; and
- The potential consequences of subjecting some insurance companies to federal resolution authority, including the effects on the operation of state insurance guaranty funds.

As opposed to banking, insurance markets are characterized by relatively strong market discipline and low insolvency risk, Harrington emphasized. Attempts at regulations should promote and not undermine this discipline, and formulation of capital standards should also take discipline and low risk into consideration.

In the end, Professor Harrington advocated that state regulators collaborate with the FIO in a decentralized approach to regulation.

Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute for Public Policy Research, examines possibilities for future legislative action on the DFA in his paper, "Will (Should) Dodd–Frank Survive?" He concluded that it should be, and is somewhat likely to be, repealed, if the insurance industry makes its views known.

Wallison pointed out that the over 2,300–page DFA law will result in thousands more pages of regulations, as the Act is interpreted and implemented. With its emphasis on systemic risk, he thinks that the DFA will ensure that the largest companies in the insurance industry will be so regulated that they will no longer be independent actors. Portraying the DFA as still controversial, Professor Wallison said, "If Republicans have an opportunity to perform major surgery on the DFA, it is likely they will."

He listed several reasons he supports DFA repeal:

- The recent financial crisis did not result from insufficient regulation, but rather from a set of housing policies that created 27 million deficient loans, affecting half of all U.S. mortgages.
- The DFA is the most restrictive act in financial services history.
- No one has defined systemic risk, leaving that crucial designation open to a judgment call.
- In stressing systemic risk, the DFA would sacrifice innovation and market competition. Regulators will likely start by naming large insurers as systemic risks, for the first time creating different sets of rules for large and small firms.
- The Act could easily forge an unhealthy alliance between the federal government and big financial institutions. In this alliance, companies would stop competing in the marketplace and try to defeat their competitors through manipulations of federal regulations.

- By designating companies as systemic risks, the DFA could create the very thing it is trying to eliminate: companies "too big to fail." Companies too big to fail will benefit from better credit terms, giving them the same kind of unfair competitive advantage that allowed Fannie Mae and Freddie Mac to drive secondary mortgage lenders out of the market.
- Eventually regulators could easily be tempted to place all insurers in the systemic risk category, to avoid looking responsible if any given organization should fail. Such outcomes would ultimately eliminate competition altogether, leaving consumers with no improvement and no choices.

Industry Perspectives

Two industry leaders discussed industry perspectives, reactions and priorities for the post–Dodd–Frank world. First, Governor **Dirk Kempthorne**, President and CEO, American Council of Life Insurers, pointed out that the recent financial crisis and subsequent moves toward global financial regulation, in addition to the DFA and FSOC, have spurred greater involvement of the federal government and the Federal Reserve in regulating the insurance industry. But, he continued, his organization believes the FSOC and the Fed are looking in the wrong place if they regard the insurance industry as a systemic risk to the overall financial system. The insurance industry has a unique character. It is diverse, highly competitive and highly regulated by states with extensive requirements for consumer protection and oversight. On top of this, Kempthorne added, the insurance industry operates on an international scale and, as a result, the Group of 20 nations have identified deficiencies in regulations and called for standards to prevent future financial chaos.

The American Council of Life Insurers also has a two–year plan to respond to global solvency and accounting initiatives, said Kempthorne. The CEOs in their FORUM 500 group are paying more attention to international regulatory actions, which, for the first time, are likely to affect state regulators and state–regulated companies. Kempthorne also expressed concern that the FSOC is moving ahead without industry leadership on board. Unless carefully crafted, hasty or overzealous regulations could create international incompatibilities. Or, they could limit access to products that consumers unmistakably desire, such as annuities.

A second industry perspective was provided by **Leigh Ann Pusey**, President and CEO, American Insurance Association. Pusey observed that debate on insurance regulation has changed quickly and drastically. A few years ago, the spotlight shined on efficiencies in the industry, she recalled. The 1999 signing of the Gramm–Leach–Bliley Act spawned the notion that insurance modernization would quickly follow. Then, the bottom dropped out of the economy, and nearly all regulatory thought abruptly turned to "safety and soundness."

Despite the swiftness of its coming, the DFA does, in some ways, recognize that insurance is not banking, Pusey said. For example, the DFA does not include insurers in its CFPB. Additionally, the liquidation and resolution section of the Act does not include insurers, at least directly. In other key ways, however, the DFA threatens insurance uniqueness. Pusey offered two examples of blurring the lines between insurers and other financial organization.

The first involves property and casualty concerns and the FSOC Section 113 systemic risk definition. Given an absence of insurance expertise at the federal level, the FSOC could wreak havoc on insurers, who are low–leveraged, heavily capitalized and well–regulated. The second example is a potential lack of political will to recognize that insurance, on the whole, did emerge out of the devastating financial crisis very well. By association, the word "big" can be interpreted as systemically risky. And, as others have pointed out, no one wants to be the regulator who allowed an insurance problem to arise.

As the European Union promulgates its Solvency II measures to assemble a single insurance system, we should not regulate by

reaction, Pusey warned. The FIO should launch its study, juggling and balancing state and federal concerns in a fair and balanced international system.

Part of the FIO's purpose should be to help U.S. companies be competitive in a global market. You cannot separate the needs for an efficient regulatory system from the need for an effective one, Pusey declared. Pusey additionally insisted that regulatory planning must be carried out with absolute transparency.

The State–Regulatory Perspective

Two distinguished leaders of the state regulatory system also discussed the DFA. First, **Susan Voss**, Commissioner, Iowa Insurance Division, and President, National Association of Insurance Commissioners, prescribed that we must put fair, uniform regulation into place, especially as it extends to the international arena. She sees state regulation as a good, while not perfect, model with which to start.

Voss' reservations about the DFA revolve around avoiding wild swings of the pendulum toward the extremes of under– or overregulation. She welcomes opening the lines of communications. The NAIC has never been more involved at national and international levels, she indicated. The DFA has required federal regulators to reach out to the NAIC. A series of key meetings between regulators and the industry has begun.

As international dialogue opens up, Commissioner Voss describes exchanges with the European Union as "cordial." Given that the United States controls 40 percent of the world insurance market, it must engage more frequently and closely in global talks. She hopes that the FIO will help bridge markets and international agreements, drawing upon a strong knowledge base and industry representation. As new commissioners engage in this changed environment, solvency and the DFA will be overriding concerns.

John Huff, Director, Missouri Department of Insurance, Financial Institutions and Professional Registration and Member of the FSOC, was the second state regulatory leader who spoke. According to Director Huff, the Affordable Care Act and the DFA will forever change the future of insurance regulation.

A non–voting member of the FSOC representing state regulators, he has attended the FSOC meetings. These have focused on study of how to implement the Volcker Rule of the DFA, which greatly limits depository banks' proprietary investment, as well as how to designate non–bank companies for financial supervision. To this point, Huff assesses that the insurance industry has fared well, and he predicted this will continue to be the case, if the FSOC can avoid the dangers of mission creep and steer clear of treating insurance companies like banks.

Designating systemic risks is not an exercise of singling out insurers who have or may have financial disasters, Huff explained. Instead, the FSOC is examining 11 factors to make this determination. Unfortunately, while creating a structure with nine standing committees, the FSOC has allowed limited opportunities to bring state insurance regulatory experts to the table. As the process moves forward, Huff underscored that he could not emphasize enough the need for the industry to make its views clearly heard on the definition of systemic risk.

Capitol Hill Briefing on Systemic Risk in Insurance, May 13, 2010, Washington, D.C.

Martin F. Grace presented findings from his NFI Policy Brief 2010–PB–02, entitled "The Insurance Industry and Systemic Risk: Evidence and Discussion," at a May 13, 2010 insurance regulatory reform briefing on Capitol Hill in Washington D.C. Grace, a professor of legal studies and risk management and insurance at Georgia State University who serves as a senior research fellow for NFI, addressed a group of industry leaders, regulators and lawmakers. Grace offered his methodologies for assessing systemic risk in the insurance industry – which includes system breakdown, causality of loss and uncertainty in evaluating

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the relative strengths of insurance companies – in an effort to inform decision-makers and to contribute to the discussion about increased federal oversight of the insurance business. Grace's findings have significant ramifications for the financial services industry.

"The structure, operations, and size of American International Group are unique, but they are no more likely to give rise to contagion or systemic risk than are traditional products," according to Grace's study. Traditional insurance products AIG and other insurers offer do not threaten contagious financial failures.

By examining the month–long turmoil that began in September 2008, Grace concluded that the insurance industry did not avoid systemic risk as a result of state–based insurance regulation. Rather, he argues that success is more likely attributable to the fact that insurers differ from banks. Demand for financial innovation to help banks manage their asset–liability maturity mismatch gave rise to securitizations that did not exist in insurance. While insurance companies bought derivatives for their own risk management purposes as end users, they did not create new securitizations or engage in other asset maturity transformation arrangements that banks, especially investment banks, did. This may explain the evidence of an absence of systemic risk across insurance firms.

There were three discussants for Grace's paper and presentation in Washington D. C.: **James Segel, Baird Webel** and **Eric Thompson.** Segel served at the time as special counsel to Congressman Barney Frank, then chairman of the House Committee of Financial Services. Webel is a specialist in financial economics at the Congressional Research Service and provides background information about the insurance industry to the House Financial Services Committee and the Senate Banking Committee. Thompson was then a senior professional staff member of the House Committee on Financial Services and is the chief insurance advisor for committee Republicans.

Open discussion included how the insurance industry might be assessed to fund the dismantling of insolvencies; the infeasibility of more bailouts in the current political climate; and the reactive rather than proactive nature of the current state–based insurance regulatory system.

Insurance Regulatory Reform Issues: A Regional Perspective, September 14, 2010, Indianapolis, Indiana

NFI's September 2010 conference was an important insurance regulatory conversation in a regional setting and explored implications of the DFA for U.S. insurers and the insurance consumers they serve. It examined the international insurance marketplace and highlighted concerns of state insurance regulators. Networks Financial Institute invited two academic thought leaders to share their perspectives on systemic risk and rethinking consumer protection, including recent research into each of these issues. **Martin Grace** of Georgia State shared his research on emerging federal and state issues impacting the insurance sector. Grace commented that while systemic risk has been a topic of intense discussion the past two years, the risk was only minimally considered prior to the turmoil that seized markets in 2008. He elaborated on the different challenges that banks and insurance companies encounter in managing risk based on their business models. According to Grace, the insurance sector business model is inherently better situated to address risk than banks. Whereas banks take in short term deposits and make long term loans based on an unknown future, insurance companies receive a continuing source of premiums that are paid out as claims over a very long term.

Grace noted that the guaranty systems for banks and the insurance sectors are also markedly different. Federal protection afforded to bank customers through the Federal Deposit Insurance Corporation, or to credit union members through the National Credit Union Administration, means that consumers feel secure with their deposits and rarely worry about risk when

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selecting a bank. In contrast, the lack of equivalent protection in the insurance sector can create consumer risk in high claims environments, especially for consumers living in high claims states such as Florida.

Systemic risk is also subject to shocks in the market. Grace said that when uncertainty increases dramatically in one sector, it typically spreads to other sectors as well. As a member of the financial services sector, insurance was naturally subject to scrutiny following the problems that seized Wall Street banks. Applying the business model, guaranty system and market shock criteria to the 2008 crisis, Grace said that, with the exception of AIG, the insurance system managed risk very well. The problems of AIG were more closely related to banking–type products it held, rather than the operation of its insurance unit. AIG essentially looked like the banks that received TARP funds. "AIG surprised the market so the rest of the sector suffered," he stated. In the wake of the AIG crisis, some have said that ongoing state regulation is the best resolution, but Grace argued that state regulation is not what saved the industry. "It's the nature of the business, not regulation, that saved the insurance sector."

What will the Dodd–Frank Act mean for the insurance industry? Grace gave four key areas where the DFA will impact insurance:

- A systemic regulator when certain high risk conditions are met: Grace said that Congress realizes it cannot prevent companies from engaging in the practices that contributed to AIG's problems, but that by monitoring size and holdings, Congress can help prevent other too big to fail scenarios.
- A Federal Insurance Office that may play a role in making insurance products more available for lower income consumers: Grace cautioned, however, that the good intention of making insurance more affordable might present the same risks that helped create the housing crisis. "Just as not everyone was capable of paying a mortgage, there will be consumers unable to make their insurance premiums," Grace said. He advised that insurers will need to pay careful attention to the products offered and ensure that they meet consumer demand both for product type and delivery mechanism.
- Preemption of state rules conflicting with international treaties is a third area where Grace said the DFA will likely have an impact. He said that the DFA's provisions with respect to international treaties are very narrowly crafted at the present but may expand.
- Finally, Grace said that the establishment of an insurance presence in Treasury will provide the insurance sector with an expert voice at the federal level. He said this could be an asset to the industry, noting, "I'm not an agent opposing regulation, just an agent opposed to bad regulation."

Sharon Tennyson, Associate Professor, Department of Policy Analysis and Management, Cornell University shared her perspectives on consumer protection in the insurance markets. She based her remarks on her NFI Policy Brief 2010–PB–03, "Rethinking Consumer Protection in Insurance Markets." Discussion surrounding regulations for the insurance sector has been broad and focused on overseeing competitive entrance into the market and monitoring the claims settlement process; however, other concerns exist around the clarity of insurance disclosures and explanation of consumer rights. Tennyson suggested some guiding principles that could help regulators and insurers provide effective consumer protection to insurance customers:

- Regulations should be targeted to reduce specific market failures. Consumer protection should focus on identifying the key problems in specific areas, such as insurance price subsidies for high claim markets, as opposed to prescribing a blanket solution to all insurers. We need to ask "what are the specific problems we're trying to fix?"
- Harnessing private market incentives could help protect consumers. Competition within the marketplace increases insurers' incentives to offer fair and transparent pricing and consumer incentives. Companies not providing fair, transparent pricing and policies would be subject to public

warning. Many consumers cannot understand the complex terms and disclosures associated with their insurance policies. One remedy Tennyson proposed is a public evaluation similar to the rating that investment banks receive, or the "report card" health grade assigned to restaurants in some regions.

- An ombudsman role could further contribute to market discipline. This role has worked in Canada and the United Kingdom to make dispute resolution more public and to encourage insurers to resolve consumer complaints.

What do regional regulators think about the future of insurance regulation?

The Midwest region has a strong presence of insurance organizations. To provide a regional perspective on how the insurance sector is likely to be affected by new regulations, Terrie Troxel moderated a panel discussion that included representatives from the Indiana Department of Insurance, Illinois Department of Insurance and Michigan Office of Financial & Insurance Regulation to share their perspectives. In "A Hoosier View," Indiana Insurance Commissioner **Stephen Robertson** said that health care reform has dominated public discussion, so very little attention has been paid to how the DFA may impact insurers. He referenced AIG and underscored Professor Grace's comments that the problems AIG experienced were not a result of its insurance companies, but of complex banking and securities products. Robertson gave three areas of the DFA that the State is closely examining:

- Reinsurance: Reinsurance is not expected to present a major problem under the DFA but Indiana looks forward to the NAIC's report on reinsurance under the DFA.
- Surplus Lines: Topics under review include a closer look at the "home state" of insured policy holders, and the uniformity of licensing, collection procedures and allocation of premium taxes across states.
- Consumer Protection: Robertson noted that in Indiana, about 10,000 consumer complaints are filed each year and that responses are typically provided within a three–day window. "When the consumer complains, we take action in a timely manner. We still don't know how the federal government will be able to deal with the volume of complaints that state regulators are well positioned to respond to."

In an "Illinois Perspective," **Michael McRaith**, at that time serving as Illinois Insurance Director, noted that the biggest challenge faced by most state governments is fiscal resources available for funding projects, staff, information technology and infrastructure. He advocated that state regulators focus on issues surrounding how companies price products, classify customers, and police the integrity of vendors who develop credit–based insurance scores. State regulators have an obligation to oversee the organizations that provide credit–based insurance scores and referenced his state's success in providing access to consumers who previously could not afford to purchase insurance products. At the national level, McRaith said a Federal Insurance Office is an absolute necessity. FIO can help the federal government better understand the issues that states face as they respond to large claims situations. "It's absolutely ridiculous that the federal government does not have access to the economic impact of disasters on the insurance sector, such as the costs that September 11, 2001 and Hurricane Katrina imposed on our industry," he said. FSOC will help identify vulnerabilities throughout the sector.

McRaith also addressed the Volcker Rule, which restricts U.S. consumer banks from investing federally guaranteed funds in speculative, high–risk investments, and noted that the law has not yet been applied to the insurance sector. At the international level, McRaith cited Article 1, Section 10 of the U.S. Constitution and its application to representing the interests of the $6 trillion insurance sector in international regulatory discussion. He also referenced Solvency II agreements scheduled to become effective in 2012. Expressing concern over the amount of oversight Solvency II affords European regulators, McRaith

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observed that it would provide regulators with prior approval authority over any director of an insurance enterprise. McRaith concluded by touching on health care reform and his conviction that the reform will prohibit outrageous premium increases or absurd refusals of coverage by insurers. "The bill is not perfect, but it meets a tremendous need in the U.S.," he said.

Ken Ross, Michigan Insurance Commissioner, presented the "Michigan Perspective." Commissioner Ross opened by sharing that he is responsible for regulating both banking and insurance within Michigan. From his viewpoint, health care reform remains the central issue facing state regulators. He projected that insurance regulators would be "fused at the hip" with the U.S. Department of Health and Human Services during a rule–passing phase that may extend over the next decade. Ross was hopeful that the individuals implementing new regulations under the DFA will engage state regulators and others throughout the industry.

He made some observations about how the DFA will impact the industry. The role of a newly created systemic risk regulator will make the industry subject to risk assessments. Ross expressed concern that the insurance industry will be burdened with additional costs. He agreed with Director McRaith that a Federal Insurance Office will provide a voice of expertise at the federal level to represent the insurance industry, although he was quick to point out that the Office is currently an unknown entity. Ross cautioned that the FIO could become an "inflatable platform" that begins with minimal regulations but transforms into a much broader regulatory entity calling for much higher capital requirements. Looking at risk, Ross said that the near–term risk is not regulation of products, but increased spillover effects from other industries such as banking, creating new regulations for insurance. Such "cross–pollination" might result in the federal government encroaching incrementally on state regulators' responsibilities.

Ross added that current economic times may result in more power being usurped away from the states to the federal level. "In good times, a dual chartering system works well. In times of crisis, power is quickly concentrated in Washington," he noted. As Congress scrutinizes the health care industry, Ross said that spillover may occur within the property and casualty sector as well, as Congress reviews all segments of the industry.

Therese Vaughan, CEO, National Association of Insurance Commissioners, provided an overview of developments in U.S. regulation and addressed the implications of the Dodd–Frank Act, NAIC's Solvency Modernization Initiative and shared some personal observations on capital and supervision issues. She stated that the Dodd–Frank Act will result in a number of new entities including the FSOC, an OFR, an Orderly Liquidation Authority and a CFPB, as well as a FIO. She noted that the Federal Reserve will have increased responsibility for monitoring the industry and searching out any signs of financial instability. Concurrently, the SEC will be given increased powers of detection and enforcement and that the Office of Thrift Supervision will be rolled into the Comptroller of Currency at the Department of Treasury.

Amidst these sweeping regulatory changes, Commissioner Vaughan noted the implications for the insurance industry will be far less than other sectors and expanded upon some of the exemptions. First, insurance will not be under the auspices of the CFPB. Secondly, non–variable annuities will be exempt from SEC oversight, provided the state has adopted the NAIC Suitability in Annuity Transactions model regulation. Proprietary trading restrictions for insurance companies affiliated with other financial companies such as bank holding companies will apply, but general accounts will not be restricted to proprietary trading restrictions.

Many implications for the insurance sector still appear unclear. For example, changes not directed at the insurance industry could portend spillover effects. The elimination of the Office of Thrift Supervision will require insurance groups with thrifts to be subject to Federal Reserve supervision. However, the impact on

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changes to derivatives regulation and the question of whether some insurance companies might be deemed systemically important is still unclear.

Vaughan provided an overview of the Federal Insurance Office's powers. The organization will function within the Treasury and have a designated federal insurance expert. The Office will identify those institutions in need of enhanced supervision. Additionally, the Office will develop federal policy on prudential aspects of international insurance and assist the Treasury Secretary in covering prudential insurance matters so long as they achieve substantially equivalent protection to that provided under state regulation. Vaughn said this approach will recognize the state regulatory system and move it into the international agreements model. "This approach allows the state system to fit into an increasingly global market," she commented. "My hope is that we take the best of the state regulatory system and partner it with a federal body that has the power to make regulations work," she added.

With regard to preemption of the state system, preemption would occur only if it resulted in less discriminatory regulation than that provided by the state. States and the federal government parallel each other. The Chevron Doctrine (of court deference to administrative agencies) does not apply. With regard to the savings clause, coverage cannot be preempted.

Vaughan also addressed how regulation will streamline multistate rules for non–admitted (surplus lines) and reinsurance. The home state of the insured will determine the regulator for non–surplus lines. Regarding reinsurance, a single state regulator will function as long as a state meets solvency requirements. The domestic state of a reinsurer has exclusive authority to regulate the solvency of the insurer, as long as the state is accredited or has similar solvency requirements.

At the international level, Group of 20/Financial Stability Board activities continue to focus on financial stability; there is an increased prominence of globally active firms operating in the insurance sector, and regulators continue to explore Solvency II and equivalent programs. Commissioner Vaughan provided some insight into the NAIC Solvency Modernization Initiative, which seeks to describe the U.S. insurance system based on a coherent set of principles and examines international developments and their potential impact on U.S. insurance regulation. The national system of state–based financial regulation doesn't view state regulation as a single state–by–state model but as a collectively competent system where regulation is a highly collaborative process. "It's not just risk–based capital that is required to have a good regulatory system. Capital is just one of a panoply of tools," she said. "The strength of our system is its data intensity. More than anywhere else in the world, the U.S. uses macro intelligence and a peer review process," she added, referencing the work of the Financial Analysis Working Group comprised of 16 national experts. Peer pressure essentially results in regulators motivating one another to do their best.

The NAIC's Solvency Modernization Initiative focuses on eight key areas, including capital requirements, accounting/reporting, valuation, financial surveillance, reinsurance, group solvency, governance, and risk management. This comprehensive model coupled with leading information analysis is "world leading," noted Vaughan. In the United States, regulatory capital has defined a clear floor at which regulators might intervene and serve to identify weak companies. While capital is one tool in evaluating an institution's risk, data–driven analysis and peer review are also extremely important. Moving forward, a key lesson from the 2008 economic crisis is the need for effective group supervision and a multijurisdictional approach. "Our system where regulators challenge other regulators . . . . That's what makes us good," she said. According to Vaughan, the multijurisdictional approach will help achieve a diversity of perspective and facilitate peer pressure to promote forbearance and regulatory capture. In order to avoid inefficiency, coordination will be essential, as well as the sharing of information and collaboration across the supervisory review process.

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A Panel of Thought Leaders Address the Industry's Present and Future

Networks Financial Institute capped off its regional insurance conference by inviting four leaders of insurance trade groups to share their perspectives on insurance regulation.

Charles Chamness, President & CEO, National Association of Mutual Insurance Companies (**NAMIC**), stated NAMIC's position on insurance regulation. NAMIC supports a reformed version of state regulation through modernization that would emphasize rate deregulation, streamlined licensing, reformed market conduct examinations and greater underwriting freedom. While the state system is not perfect, it is the system the industry is working in, and a properly constructed federal office could help the industry. During the turmoil of the financial meltdown, the insurance sector was largely unscathed. As regulators determine what issues to focus on, he suggested that other sectors including banking, mortgage and securities present more immediate needs for regulatory review. In reviewing key issues surrounding the Dodd–Frank Act, Chamness noted the size and scope of the DFA and how it contributes to growing financial regulatory bureaucracy. The DFA is 2300 pages, compared to 145 pages in the Gramm Leach Bliley Act, 66 pages in the Sarbanes Oxley and the three page document establishing the U.S. Department of Treasury. The DFA will be handed off to ten regulatory agencies, which may potentially propose 500 new rules, launch 60 new studies and generate 93 new Congressional reports. The CFPB will hire 2,000 new employees and begin with a $500 million budget, conjectured Chamness.

The FIO will monitor all aspects of the industry including regulatory gaps and advise the Treasury Secretary on major domestic and prudential insurance policy issues, while alerting the FSOC to insurers that should be subject to heightened regulation and finally, assisting in the administering of the Terrorism Risk Insurance Program. Yet, while the FIO has authority to preempt state insurance rules, subpoena insurance entities and negotiate international insurance agreements, it does not have authority to regulate insurance. With regards to an optional federal charter, Mr. Chamness noted it is not a growing concern for NAMIC. While an OFC was initially presented as a panacea, in a post–crisis world, an optional federal charter is not likely to be desired or accepted.

Robert Gordon, Senior Vice President for Policy Development and Research at Property Casualty Insurers **(PCI)** Association of America took an historic look at the role of federal insurance legislation over the past two decades, beginning with a mandatory federal regulation push in the 1990s, enactment of GLBA in 1999, the creation of the Treasury reform blueprint in 2001, as well as the House bill creating a council of regulators and the 2003 SMART Act program. The trend in regulation continued in 2006 with passage of the Surplus/Reinsurance bill in the House, the 2007 related SMART titles introduced, 2008 Treasury Blueprint and 2010 Dodd–Frank Act, which he noted partly achieves the Blueprint. Gordon commented that while the Obama Administration supports a mandatory federal charter, Congress promotes all four approaches presented in the DFA.

From PCI's perspective, Gordon said there is no desire to fix what isn't broken. "The Dodd–Frank Act should not impose Wall Street regulations on a safe and sound Main Street model," he noted. He added that home, auto and business insurance did not precipitate the financial crisis and that indeed the industry has remained stable despite the severe recession and the fourth–largest hurricane losses in history. Gordon added that the insurance sector is not systemically risky and the solvency program has worked well. He summarized his analysis of the DFA's impact on the insurance industry by noting it received the "lightest touch, compared to mortgage, banks and other financial entities." Gordon cited some positive regulatory reforms, including the SMART Act reforms covering surplus lines and reinsurance. With regards to a Federal Insurance Office, he was quick to note that the Office is not a regulator, that it has no funding and has limited treaty–making authority. "For most insurers, the impact of the Dodd–Frank Act will be largely

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negligible." He added that the FIO could present some positive solutions for international issues, although it also presents an opportunity for "mission creep" if its powers gradually morph beyond their original intent. Gordon referenced the trend towards global convergence and said that rules written in the European Union should not be imposed on the sector. "The corporate veil is being transformed into Swiss cheese," he noted. The DFA may provide some benefits for U.S. firms competing in an increasingly international marketplace, he added.

Gordon expects that division in Congress will result in reform being fragmented and incremental. He commented that big regulatory overhauls typically follow big failures and that the reaction to impose heightened regulatory metrics on the industry is to be expected given the 2008 market meltdown.

Franklin W. Nutter, President of the Reinsurance Association of America, shared his perspective on the 2,668 reinsurers in the United States. He noted that $58 billion in premiums was ceded in 2009 to offshore jurisdictions and that $22 billion was assumed by Bermuda reinsurers. Looking at a trend line, Nutter noted that the reinsurance business is tending to go offshore. Within the United States, 56 percent of reinsurance assumed risk is domestic and 44 percent is offshore. He added that 55 percent of premiums ceded to insurers on U.S.–based risk go offshore.

Kevin A. McKechnie, Executive Director of the American Bankers Insurance Association, also serves as the Director of Government Relations for the American Bankers Association Securities Association, representing both groups before Congress and the federal government. Opening his remarks, McKechnie said, "We're the 'too important to fail guys,' but we did let you get away unscathed." He noted that banking's role in insurance is fundamentally different from insurers. "Banks don't make insurance, they sell it," he stated.

Speaking about the DFA's impact on the industry, McKechnie said that all outlooks are speculative at best. "Chairman Dodd put it best when he said, 'We have no idea what will happen until it is implemented'." Sharing his personal perspective, McKechnie expects states to look for federal assistance from the FIO, yet states must realize the office will have no authority or ability to fund such assistance. "We're trying to legislate through a crisis in a way that's confrontational," he added. He does not expect a lot of change to how the insurance sector is regulated, though prices may increase along with industry scrutiny. "We're a fan of incremental changes, made over time."

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 specter 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 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 considerable resources have been spent to educate the Fed on their business and for new compliance efforts to satisfy uninformed regulators.

Insurers have an underlying concern that federal policymakers, 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 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 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 emphasize 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 is 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 emphasize 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 counter-point 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 agree 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 regard the FSOC as a potential threat to their business. First, there is widespread agreement that the FSOC lacks critical regulatory transparency,

APPENDIX 2
Recent NFI Insurance Regulation Events

at least at the outset, that it is 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 an ever–widening net 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/Financial Accounting Standards Board 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 argue that the experience of the past 40 years – and certainly during the financial crisis – showed that the insurance guaranty system is healthy and adequate.

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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 Director:

- 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.

APPENDIX 3
NFI Insurance Reform Summits • 2004 – 2011 Speakers

Ronald Reagan Building – Washington, DC

2011 Summit

Senator Jack Reed (D–RI), Chairman, Subcommittee on Securities, Insurance and Investment, Senate Banking Committee

Representative Judy Biggert (R–IL), Chairwoman, Subcommittee on Insurance, Housing and Community Opportunity, House Financial Services Committee

Susan Voss, Iowa Insurance Commissioner and President, National Association of Insurance Commissioners

John Huff, Missouri Insurance Director and Financial Stability Oversight Council Member

Governor Dirk Kempthorne, President and CEO, American Council of Life Insurers

Leigh Ann Pusey, President and CEO, American Insurance Association

Scott Harrington, Alan B. Miller Professor, Wharton School, University of Pennsylvania

Peter J. Wallison, Arthur F. Burns Fellow in Financial Policy Studies, American Enterprise Institute for Public Policy Research

2009 Summit

Representative Ed Royce (R–CA), Member, House Financial Services Committee

Representative Spencer Bachus (R–AL), Ranking Minority Member, House Financial Services Committee

Therese M. Vaughan, Chief Executive Officer of the National Association of Insurance Commissioners

Martin F. Grace, James S. Kemper Professor of Risk Management and Insurance, Georgia State University

Scott Harrington, Alan B. Miller Professor, Wharton School, University of Pennsylvania

Peter G. Gallanis, President, National Organization of Life and Health Insurance Guaranty Associations

Roger H. Schmelzer, President, National Conference of Insurance Guaranty Funds

Steve Bartlett, President & CEO, The Financial Services Roundtable

Charles Chamness, President & CEO, National Association of Mutual Insurance Companies

Governor Frank Keating, President & CEO, American Council of Life Insurers

Robert A. Rusbuldt, Chief Executive Office of the Independent Insurance Agents & Brokers of America, Inc.

2008 Summit

Debra T. Ballen, Executive Vice President, Public Policy Management, American Insurance Association

Robert R. Detlefsen, Vice President, Public Policy, National Association of Mutual Insurance Companies

Dr. Howard Frumkin, Director of the National Center for Environmental Health, Agency for Toxic Substances and Disease Registry, of the U.S. Centers for Disease Control and Prevention

Morton M. Kondracke, Editor of Roll Call and Journalist with Fox News

Thomas C. Koonce, Assistant Vice President, Federal Government Affairs, Independent Insurance Agents and Brokers of America

Kathleen L. Mellody, Counsel, Majority Staff, House Subcommittee on Capital Markets Insurance and Government Sponsored Enterprises

J. Kevin McKechnie, Director of Government Relations, American Bankers Insurance Association

Michael T. McRaith, Illinois Director of Insurance, for the National Association of Insurance Commissioners

Andrew J. Olmem, Counsel, Minority Staff, Senate Committee on Banking, Housing and Urban Affairs

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Stephen E. Rahn, Vice President & Associate General Counsel, Lincoln Financial Group, for the American Council of Life Insurers

Representative Ed Royce (R–CA), House Financial Services Committee

Professor Sharon Tennyson, Cornell University

Professor Therese M. Vaughan, Drake University

Greg D. Wren, Executive Director, Coalition Opposed to a Federal Insurance Regulator

2007 Summit

Walter A. Bell, Alabama Insurance Commissioner and President, National Association of Insurance Commissioners

John H. Brown, Vice President Government Relations, Jackson National Life Insurance Company

Wendy E. Cooper, Senior Vice President & Associate General Counsel, AXA Equitable Life Insurance Company

Representative Barney Frank (D–MA), Chairman, House Financial Services Committee

The Honorable Allan B. Hubbard, Assistant to the President for Economic Policy and Director, National Economic Council, The White House

William H. McCartney, Senior Vice President of Insurance Regulatory Policy, USAA

Representative Ed Royce (R–CA), House Financial Services Committee

Professor Hal Scott, Harvard University

Senator John E. Sununu (R–NH), Senate Banking and Senate Commerce Committees

Professor Sharon Tennyson, Cornell University

Greg Wren, Executive Director, Coalition Opposed to a Federal Insurance Regulator (COFIR)

J. Stephen Zielezienski, Senior Vice President & General Counsel, American Insurance Association

2006 Summit

Richard M. Bouhan, Executive Director, National Association of Professional Surplus Lines Offices

Jamie Burnett, Legislative Director to Sen. John Sununu (R–NH)

Scott Harrington, Ph.D., Alan B. Miller Professor, Wharton School, University of Pennsylvania

The Honorable Emil Henry, Jr., Assistant Secretary for Financial Institutions, U.S. Department of the Treasury

Gary E. Hughes, Executive Vice President and General Counsel, American Council of Life Insurers

Alessandro A. Iuppa, Maine Superintendent of Insurance and President, National Association of Insurance Commissioners

Representative Paul E. Kanjorski (D–PA), House Financial Services Committee

J. Kevin McKechnie, Associate Director of Government Relations, American Bankers Insurance Association

Charles E. Symington, Jr., Senior Vice President, Government Affairs & Federal Relations, Independent Insurance Agents & Brokers of America

Glenn E. Westrick, Counsel, House Financial Services Committee

J. Stephen Zielezienski, Senior Vice President & General Counsel, American Insurance Association

2005 Summit

Representative Richard Baker (R–LA), House Financial Services Committee

Lou Dobbs, Anchor of CNN's Lou Dobbs Tonight, the Lou Dobbs Financial Report and Columnist for Money Magazine and U.S. News and World Report

Representative Barney Frank (D–MA), House Financial Services Committee

LouAnn Linehan, Chief of Staff for Senator Chuck Hagel (R–NE), Senate Banking Committee

The Honorable Greg Zerzan, Acting Assistant Secretary for Financial Institutions, U.S. Department of the Treasury

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NFI Insurance Reform Summits • 2004 – 2011 Speakers

2004 Summit

The Honorable Wayne Abernathy, Assistant Secretary for Financial Institutions, U.S. Department of the Treasury

Representative Richard Baker (R–LA), House Financial Services Committee

Kathy Casey, Staff Director and Counsel for the Senate Banking Committee

Former Representative Rick Lazio, CEO Financial Services Forum

Mark Osterle, Majority Counsel, Senate Banking Committee

Karen Shaw Petrou, Managing Partner, Federal Financial Analytics

Senator John E. Sununu (R–NH), Senate Banking and Commerce Committees

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