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on

How Should the Federal Government Oversee Insurance?

Mr. Chairman, Ranking Member,

My name is Baird Webel. I am a Specialist in Financial Economics at the Congressional Research Service. Thank you for the opportunity to testify before the Subcommittee. This statement responds to your request for hearing testimony addressing the question "How Should the Federal Government Oversee Insurance?" It begins with a brief introduction focusing on insurance and the current financial crisis, and differentiating between lines of insurance. Following is a discussion of seven options for the federal government's role in insurance regulation. These options should be seen as encompassing a continuum of possibilities and it may be possible to combine aspects from different options, particularly for different lines of insurance. Many of these options have been embodied in legislation considered by this committee or discussed in previous hearings, so I will focus particularly on new suggestions that have largely arisen out of the current financial crisis.

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Insurance Regulation and the Current Financial Crisis

As reaffirmed by Congress in the McCarran-Ferguson Act of 1945,[1] the primary locus of insurance regulation rests with the individual states. Since the passage of this act, however, both Congress and the federal courts have taken actions that have somewhat expanded the reach of the federal government into the insurance sphere. Examples of this include Employee Retirement Income Security Act of 1974 (ERISA),[2] which effectively federalized health insurance regulation for a large swath of the American population; various court decisions limiting the phrase "the business of insurance" contained in McCarran-Ferguson;[3] and the Liability Risk Retention Act (LRRA),[4] which preempted the ability of non-domiciliary states to regulate certain types of property/casualty insurance.

Nevertheless, the Gramm-Leach-Bliley Act of 1999 (GLBA),[5] which enacted the most sweeping financial regulatory changes since the Great Depression, specifically continued to recognize the states as the functional regulators of insurance. GLBA also removed legal barriers between securities firms, banks, and insurers. This legal freedom, along with improved technology, has been an important factor in creating more direct competition among the three groups. Many financial products have converged, so that products with similar economic characteristics may be

[1] 15 U.S.C. §§ 1011-1015.

[2] P.L. 93-406, 88 Stat. 829.

[3] See CRS Report RL33683, *Courts Narrow McCarran-Ferguson Antitrust Exemption for "Business of Insurance": Viability of "State Action" Doctrine as an Alternative*, by Janice E. Rubin.

[4] P.L. 97-45 as amended by P.L. 98-193 and P.L. 99-563, 15 U.S.C. § 3901 *et seq.*

[5] P.L. 106-102, 113 Stat. 1338.

available from different financial services firms with different regulators and different regulation. Increasing competition between insurers, banks, and securities firms has played a role in increased industry demands for a wide-ranging federalization of the insurance industry. These demands have typically focused on various inefficiencies in navigating the multiple regulators in the state system as well as what some characterize as the overbearing content of some state regulation, particularly state rate and form regulation.

The current financial crisis can at least partly be traced to failures or holes in the financial regulatory structure. This has given increased urgency to calls for overall regulatory changes and federal oversight of insurance. While insurers in general have appeared to weather the crisis reasonably well so far, the insurance industry has seen two significant failures, one general and one specific. The first failure was spread across the financial guarantee or monoline bond insurers. Before the crisis there were only about a dozen bond insurers in total, with four large insurers dominating the business. This type of insurance originated in the 1970s to cover municipal bonds but the insurers expanded their businesses since the 1990s to include significant amounts of mortgage-backed securities. In late 2007 and early 2008, strains began to appear due to exposure to mortgage-backed securities. Ultimately some smaller bond insurers failed and the larger insurers saw their previously triple A ratings cut significantly. These downgrades rippled throughout the municipal bond markets, causing unexpected difficulties for both individual investors and municipalities who might have thought they were relatively insulated from problems stemming from rising mortgage defaults.

The second failure in the insurance industry was a specific company, American International Group (AIG).[6] AIG had been a global giant of the industry, but it essentially failed in mid-September 2008. To prevent bankruptcy in September and October 2008, AIG was forced to seek more than $100 billion in assistance from, and give 79.9% of the equity in the company to, the Federal Reserve. Multiple restructurings of the assistance have followed, including up to $70 billion through the U.S. Treasury's Troubled Asset Relief Program (TARP). AIG is currently in the process of selling off parts of its business to pay back assistance that it has received from the government; how much value will be left in the 79.9% government stake in the company at the end of the process remains an open question.

The near collapse of the bond insurers and AIG could be construed as regulatory failures. One of the responsibilities of jobs of an insurance regulator is to make sure the insurer remains solvent and is able to pay its claims. Since the states are the primary insurance regulators, some may go further and argue that these cases specifically demonstrate the need for increased federal involvement in insurance. There are aspects of both the bond insurer crisis and AIG's failure that may mitigate the arguments for federal involvement, particularly because AIG was also regulated by the federal Office of Thrift Supervision.

[6] See CRS Report R40438, *Ongoing Government Assistance for American International Group (AIG)*, by Baird Webel.

Lines of Insurance and Federal Involvement in Insurance

The insurance industry is not monolithic, but rather very diverse, serving multiple markets. Companies range in size from multiline insurers serving the entire country to small "captive" insurers that may insure a single company. In general, insurers fall into two broad segments: life insurers and property/casualty insurers. Some companies are organized as stock companies, whereas others operate as mutual or fraternal companies. Some companies are very large in size, whereas others are mid-size or small. Some companies specialize in large commercial accounts, whereas others write personal lines of business such as homeowners, automobile, or individual life and health policies. Still others concentrate on reinsurance, or the selling of insurance to insurance companies to assist them in spreading their risks. With this diversity of insurers, an argument could be made to focus federal involvement in insurance oversight differently for different types of insurers.

Life Insurance

Life insurers[7] in general face long-term and relatively stable risks and losses. Life insurance contracts typically last decades and actuarial tables are well developed. It may be impossible to estimate which individual people are going to die in a given year, however, with a large pool, actuaries can be very accurate in projecting the overall number of deaths and thus the overall losses a life insurer will likely incur. This increases the importance of the investment side of the life insurance business to generate profits. If life insurers face solvency problems, it is likely to be a result of poor investment decisions rather than huge unexpected losses. The risks covered in life insurance are much more uniform across the country and policyholders are relatively likely to be covered by a policy purchased in a different state from their current residence. Life insurers also offer many annuity products, which combine aspects of insurance and investment products. These annuity products also represent a significant exposure to investment gains and losses for life insurance companies.

Property/Casualty Insurance

Property/casualty insurers face a very different set of economic challenges. Most property/casualty contracts are relatively short-term, often six months or one year. The risks to these insurers can be much more variable than those faced by life insurers. In some lines, catastrophic losses can occur that will wipe out years of previously accumulated premiums. Accordingly, investment returns are important to the business, but to a lesser degree than they are in life insurance. Property/casualty policies can be much more localized and tailored to specific risks in specific areas. With relatively short-term contracts, policyholders are much less likely to maintain their policies as they move from state to state. Property/casualty policies are often required by a third party. For example, purchase of state licensed auto insurance is a common requirement for auto licensing and banks often require specific insurance purchases for a property loan. The near mandatory nature of some property/casualty insurance purchases has

[7] Health insurers are often included within the category of life insurers. Since health insurance is largely outside of the scope of the committee's interest, this analysis concentrates purely on life insurance.

tended to engender increased regulatory oversight and various mechanisms to ensure availability and affordable pricing for insureds.

Such differences have led to suggestions for different federal involvement for different lines of insurance. The most common proposal in the past has been to provide for a federal charter for life insurers while leaving property/casualty insurers in the state system. During the current financial crisis, life and property/casualty insurers have sometimes favored different government policies. Several life insurers have sought assistance through TARP, even going so far as to convert their corporate form to a federal bank or thrift holding company to qualify for TARP. Property/casualty companies have generally shunned federal aid, with one industry group arguing strenuously that property/casualty insurers typically do not present systemic risk and the federal government should avoid providing assistance to them.[8]

Options for Insurance Regulatory Reform

Seven particular options for federal involvement are presented in the following sections. These options range from minimal, or no, federal involvement to a federal takeover and complete restructuring of insurance regulation. To some degree many of these options have elements that are not mutually exclusive. Congress could take various aspects and apply them differently, for example, to different lines of insurance or to different aspects of regulation. Most of these options have been present in some form in proposals that predate the current crisis.

1. Do Nothing

While insurers have unquestionably been affected by the financial crisis, the instruments and practices generally identified as driving the crisis, the outsized losses, and the bulk of the federal assistance are in other areas of the financial services industry. This may be due to good regulation, good business practices, or simply good fortune for insurers, and it may very well change in the future, but for the moment the financial crisis is focused elsewhere. It could be argued that effort and attention should also be focused on the areas in crisis. One could even go further and argue that in such a time of general market uncertainty, it is not helpful to the market to be introducing additional regulatory uncertainties. “First do no harm” may be a principle to be applied to sick financial markets as well as sick medical patients.

2. Create of a Federal Office of Insurance Information

One of the correlates of the absence of direct federal regulatory authority over insurance has been a relative lack of awareness, information, and expertise on non-health insurance matters within the federal government. Other testimony before Congress has indicated that the Office of

[8] See, for example, an op-ed by the President and CEO of the Property Casualty Insurers Association of America, David A. Sampson, "Property, casualty insurers don’t pose systemic risk," *The Hill*, April 27, 2009 available at http://thehill.com/op-eds/property-casualty-insurers-dont-pose-systemic-risk-2009-04-27.html.

Thrift Supervision, which oversaw AIG, had only one insurance expert on staff[9] and informal inquiries have indicated to CRS that the Treasury Department does not have all that many more.

This lack of information and insurance expertise has been noted before the crisis, and how large an impact it had on the crisis may be debated; however, the crisis has generally shown how important accurate information can be. Much of the market uncertainties can be traced to lack of information about specific companies' exposures to mortgage-backed securities. Lack of information on the size of and exposures in the credit default swap market has also complicated regulatory responses to the crisis. Should a significant crisis event arise involving large insurers, additional information and expertise on the issues at the federal level would likely be helpful.

Some, particularly those strongly supporting the current state regulatory system, have expressed concern that such a federal office might be essentially a precursor to an eventual federal regulator. An alternate response to address such concerns might also be to increase cooperation and communication between federal officials and the National Association of Insurance Commissioners (NAIC). The NAIC is currently a major source of information regarding insurance issues and would likely be significant source of information for any federal office, particularly if, as was included in the proposed Insurance Information Act of 2008 (H.R. 5840 in the 110th Congress), the federal office would be limited to collecting publicly available data.

3. Harmonization of State Laws Via Federal Preemption

Most stakeholders in the insurance industry recognize the need for some harmonization, if not uniformity, of insurance regulation among the different state regulators. The NAIC has served as the primary forum for this since its founding in 1871. For harmonization to occur through state efforts, however, every state legislature must pass substantially similar legislation, a very difficult task. Federal law, however, would have the power to preempt state legislation and create such harmonization without state legislative approval. This is the approach, for example, taken by the Liability Risk Retention Act, which preempts most state insurance regulation of risk retention groups, except for regulation by the home state regulator. Application of similar principles to other areas, such as surplus lines or the licensing of agents, has been a feature of several bills before the committee in the past few years. Federal preemption of state regulation of the business of insurance is a congressional prerogative, and even the McCarran Ferguson Act which declared a policy of "the continued regulation and taxation by the several States of the business of insurance,"[10] recognizes the congressional authority to regulate the insurance industry.

This approach could be argued to be a "best of both worlds" approach, combining the experience and many of the strengths of the state regulatory system while ensuring greater efficiency through the ability of insurers to operate throughout the country. Much of the effectiveness of

[9] Testimony by Max Stier, President and CEO, Partnership for Public Service, before the House Oversight and Government Reform Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia, April 22, 2009. Retrieved through CQ Congressional Testimony.

[10] 15 U.S.C. § 1011.

this approach, however, would depend on the specific details chosen. As an approach, it is very broad. Congress could choose to preempt specific aspects relating to a single line of insurance, or a state's entire approach to insurance regulation. Without specifics about what state laws are being preempted and what they might be replaced with, it is difficult to analyze the partial preemption approach. If one were specifically trying to address issues related to the financial crisis, it may be difficult to do so through piecemeal federal preemptions. Much of crisis management and avoidance will be a question of individual regulatory decisions, which are more difficult to address through broader preemption efforts.

4. Create a Federal Systemic Risk Regulator

One new regulatory option being discussed in the current financial crisis is the concept of a "systemic risk regulator." The committee has held an entire hearing devoted to the subject, so I will focus on the systemic risk regulator and the insurance system.

Given the near systemic collapse that the financial system experienced last September, the need for someone to look after the entire system may seem self-evident to some. As concepts for a systemic risk regulator have become more advanced, however, the difficulties of going from the concept of needing someone to look after the system to how this concept would work in practice have become more apparent. Particularly with regard to the insurance regulatory system, there are a number of questions to consider, including:

Do any insurers present a systemic risk? If so, what criteria would be used to identify these systemically significant institutions?

> In the past, a familiar concern was that financial institutions may become "too big to fail." In the current crises, however, the concept of "too interconnected to fail" has also been injected into the debate. Metrics for "interconnectedness" are even less clear than those for size. Historically, insurers have generally not been considered to present systemic risks; insurers' liabilities are much more stable than those of banks and insurers have not suffered from depositor runs like banks have. The current crisis, however, has brought a different sort of run on financial institutions, namely the withdrawal of short term credit and demand from other counterparties for collateral payments. Such a "run" brought AIG down and other insurers might be vulnerable, although none have failed since AIG.

Who would make the decision on which institutions would fall under the systemic regulator's purview?

> The state insurance regulators would most likely expect some role in the process of identifying systemically significant insurers. If the insurance regulators and the systemic regulator disagree, however, a mechanism must be in place to arrive at a final decision.

Would a systemic regulator have day-to-day oversight over insurers judged to be systemically significant?

If it were to have day-to-day oversight, then the systemic risk regulator would be tantamount to a federal insurance regulator, which is the heart of the federal chartering debate and will be explored further later in this testimony.

If not, what specific preemptive powers would a systemic regulator have over the state regulators' decisions?

A particularly controversial aspect of such preemptive powers may surround regulation of insurance rates. Many states require specific regulatory approval for insurance rates. If these rates were insufficient to cover an insurer's risks, thus making insolvency more likely, it could directly concern a systemic risk regulator.

Would the systemic regulator have resolution authority over failed systemically significant institutions or would this be left to the state regulators and the guarantee funds?

The failure of large institutions like AIG and Lehman Brothers, who did not fall under existing resolution provisions as banks do, has been identified by many as a particular issue to be addressed by a systemic risk regulator. Treasury has released a proposal calling for such resolution authority. Such authority could, however, have a significant impact on the current system for resolving insurance company failures. Under current law, failed insurance companies are resolved by the state insurance regulators and guarantee funds. Generally, insured policy holders are paid off by the guarantee funds under certain guidelines with the guarantee funds then occupying a senior position with regard to claims on insurer assets. What position individual policyholders or guarantee funds might have under a federal resolution authority, however, is up to whatever laws would be approved by Congress. The current Treasury proposal for resolution authority does not change the current authority over insurance subsidiary assets. If the enacted resolution authority did change this, a systemic risk regulator might have an incentive to use the assets of a company such as AIG to satisfy creditors who are themselves systemically significant rather than directing these assets to satisfy policyholder claims.

What impact would identifying particular insurers as systemically significant have on the marketplace, particularly on competitors of these firms?

Competitors of AIG today have voiced many complaints that AIG is using federal support to undercut their prices. If an insurer were identified as systemically significant, and thus presumably one that is not allowed to fail, this could give such firms a competitive advantage. If this occurs, others would presumably seek to merge or otherwise grow in size so they might gain this advantage. This could have the paradoxical effect of making a future crisis worse as more financial institutions would have the potential to spread systemic harm in the event of their collapse.

Would being identified as systemically significant promote risk taking in these institutions, and thus make future crises more likely?

> The problem of "moral hazard" is well known in the insurance industry. In order to deal with it on the individual level, insurers institute a variety of policies, such as deductibles and copayments. Identifying an institution as systemically significant implies it will not be allowed to fail, which also creates moral hazard. To address this, a systemically significant designation could also include other policies, such as increased capital requirements or other regulatory scrutiny.

5. Create a Federal Solvency Regulator

Regulation of insurers can be broken down broadly into oversight of the company's interaction with customers (market conduct or consumer protection regulation) and oversight of its future ability to pay claims (solvency or prudential regulation). In the United States, regulation of both aspects is done by the individual states. Some other countries, however, separate these functions and have two distinct agencies for the two tasks. In theory, this could allow for increased focus on both tasks as each agency only has one goal. Adapting this approach to the United States could lead to the possibility of assigning consumer protection functions to the individual states, while giving solvency regulatory powers to the federal government. Such an approach would also dovetail with some arguments already advanced in the optional federal chartering debates. Proponents of the state regulatory system often cite consumer protection as a particularly successful area for the states and one in which the states can give much more individual attention to citizens than they are likely to receive from a federal bureaucracy, while proponents of a federal chartering system cite the increased complexity of financial instruments and company balance sheets which makes solvency regulation more difficult, thus requiring additional expertise which would presumably come with a federal regulator.

The operation of such a mixed system would ideally include substantial communication and trust between the consumer protection regulators and the solvency regulators. Establishing this trust in the aftermath of a federal takeover of solvency regulation could be a challenge. Another flashpoint might be the regulation of rates, as mentioned previously. Rates have a direct impact on insurer solvency, but regulation of rates is seen by many as a bedrock aspect of consumer protection. To limit conflict between the states and federal regulators, implementing legislation would need clarify what power the federal solvency regulators might have to overrule state regulators, or vice versa.

6. Establish a Federal Insurance Charter

The debate over the possibility of a federal charter for insurers has been ongoing for the past several years with the committee hearing on numerous occasions from both the proponents and opponents of the idea. A common proposal has been for an Optional Federal Charter (OFC) for insurers modeled on the dual banking system.

Current focus on the idea of a federal charter dates largely to the passage of GLBA, which specifically reaffirmed the states as the functional regulators of insurance but also unleashed market forces encouraging a greater federal role. This has led to increasing industry complaints of overlapping, and sometimes contradictory, state regulatory edicts driving up the cost of compliance and increasing the time necessary to bring new products to market.

Arguments advanced for federal chartering have included the following:

- The regulation of insurance companies needs to be modernized at the federal level to make insurers more competitive with other federally regulated financial institutions in the post-GLBA environment.
- The recent financial crisis has shown that some insurers present systemic risk and should be regulated by a regulator with a broad, systemic outlook.
- Insurance needs a knowledgeable voice and advocate in Washington, DC.
- The current system is very slow in approving new products, putting insurers at a distinct disadvantage in product creation and delivery.
- Insurers have difficulty in expanding abroad without a regulator at the national level.
- Consumers will benefit from a greater supply of insurance and lower cost to consumers as insurance companies are forced to compete on a national scale.

Arguments for state regulation have included the following:

- State regulated insurers have performed relatively well through the financial crisis, underscoring the quality of state regulation.
- State insurance regulators have unique knowledge of local markets and conditions and are flexible and adaptable to local conditions.
- The diversity of state regulation reduces the impact of bad regulation and promotes innovation and good regulation.
- Strong incentives, such as direct election, exist for state regulators to do the job effectively at the state level.
- A substantial and costly new federal bureaucracy would need to be created in a federal system.
- States would suffer substantial fiscal damage should state premium taxes be reduced by the federal system.
- A "race to the bottom" could occur under an optional federal charter as state and federal regulators compete to give insurers more favorable treatment and thus secure greater oversight authority and budget.

In the abstract, the federal chartering question could be simply about the "who" of regulation. Should it be the federal government, the states, or some combination of the two? In practice, however, OFC legislation has had much to say about the "how" of regulation. Should the government continue the same fine degree of industry oversight that states have practiced in the past? The OFC bills that have been introduced to this point have tended to answer the latter question negatively—the federal regulator that they would create would exercise less regulatory oversight than most state regulators. This deregulatory aspect of past and present OFC bills can be as great a source of controversy as the introduction of federal regulation itself.

7. Reform the Complete Financial Service Regulatory System

The question of federal involvement in insurance regulation could expand beyond the confines of insurance and instead be subsumed within a more comprehensive reform to the whole approach to regulating the U.S. financial system. General financial regulation in the United States is carried out by an overlapping set of bodies created at various periods during the past 150 years. Historically, the regulatory body was dictated by the charter of a given institution: banks were regulated by various banking regulators, thrifts by thrift regulators, insurers by insurance regulators, etc. Although GLBA aimed to refocus the system along functional lines, so that, for example, insurance regulators would regulate insurance activity whether it was carried out by banks or by insurers, regulation has still largely fallen along institutional lines. Simplification of the regulatory system is not a result that most observers would ascribe to GLBA. Even before the financial crisis, arguments were advanced that the system needed a significant overhaul, perhaps by combining overlapping institutions or completely rethinking the structure of the regulatory system. Several other countries have confronted similar policy choices in the past two decades with two regulatory models gaining favor: a “unitary” regulator and a “twin peaks” model.

A unitary model calls for a single regulator to oversee financial institutions regardless of the charter type or business activity that the institutions engage in. Such a regulator could oversee all aspects of financial activity, from systemic stability to individual institution solvency to consumer protection. Advantages of such an approach include a focus on financial regulation that avoids consumer confusion about who to call in the case of problems; clear regulatory authority over innovations in the financial system; and no possibility that financial institutions would “game the system” by playing one regulator off against another. The strengths of a unitary system when the regulator gets things right, however, are also its weakness if the regulator gets things wrong. With only one regulatory body, there are few checks and balances. If a mistake is made, it can more easily affect the whole system rather than be isolated within a particular type of institution or geographic area. Examples of countries adopting a unitary approach include Japan and the United Kingdom.

A twin peaks model typically separates the regulatory authority between solvency and consumer protection functions, with separate entities responsible for each. Such an approach arguably can offer many of the same advantages of a unitary system with relative uniformity of regulation across different financial institutions regardless of charter and an even clearer regulatory focus within each of the two regulators. Overlap between the two regulators could be minimized, but having two voices in the system offers at least the possibility of minimizing the impact of regulatory mistakes rippling throughout the system. Examples of countries adopting a twin peaks approach include Australia and the Netherlands.

In March 2008, then-Secretary of the Treasury Henry Paulson released a “Blueprint for a Modernized Financial Regulatory Structure.” Although the current financial crisis had begun at that time, the Treasury blueprint was not primarily a response to the crisis, but instead an attempt to create "a more flexible, efficient and effective regulatory framework"[11] The final structure envisioned in the Treasury blueprint could be described as "twin peaks plus." The Treasury model was to ultimately create a prudential regulator overseeing the solvency of individual companies, a business conduct regulator overseeing consumer protection, and a market stability regulator overseeing risks to the entire system. As interim steps to its final shape, the Treasury blueprint called for the initial creation of a federal office of insurance oversight to be followed by a full federal charter for insurers.

[11] U.S. Treasury, "Treasury Releases Blueprint for Stronger Regulatory Structure," press release, March 31, 2008, http://www.ustreas.gov/press/releases/hp896.htm.