CHAPTER 1

Modernizing Insurance Regulation: An Overview

John H. Biggs and Matthew Richardson

Stern School of Business, New York University

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INTRODUCTION

The insurance sector is an important part of the U.S. economy. For example, premiums collected by life and health (L/H) and property-casualty (P-C) insurers totaled $1.28 trillion in the United States in 2008, according to the National Association of Insurance Commissioners (NAIC).[1] Insurance allows individuals and businesses to protect themselves against potentially catastrophic financial risks. The traditional model of insurance is one in which insurers pool and diversify these idiosyncratic risks. In competitive markets, insurers price diversifiable risks on an actuarial basis, yielding tremendous utility gains to the previously exposed individuals and businesses.

Within this traditional model of insurance, it is reasonable to argue that systemwide defaults across insurance companies are unlikely because much of the risk is diversified away. If this type of risk is therefore not the primary concern, then it should not be surprising that the focus of regulation of insurance companies has been consumer protection in terms of individual firm solvency and the types of products offered. This partially explains why a regulatory system, dating back some 150 years, has revolved around state, not federal, regulations.

That said, why precisely insurance companies are regulated at the state rather than the federal level can be explained through two Supreme Court decisions, one in 1868 and the other in 1944. (See, for example, Harrington [2000], Webel and Cobb [2005], and Tyler and Hornig [2009], among others.)[2] In the earlier decision, in the *Paul v. Virginia* opinion, the Court determined that insurance was not interstate commerce and so for

all practical purposes insurance companies were not subject to federal regulation. Seventy-six years later, the court reversed that decision in the *United States v. Southeastern Underwriters Association* case, which ruled that insurance is interstate commerce and subject to federal antitrust laws.

However, in response to the 1944 ruling, Congress elected not to take on insurance regulation and quickly passed into law in 1945 the McCarran-Ferguson Act, which permitted states to continue the regulation of insurance companies, as long as state regulation was not deficient (albeit subjecting the insurers to the antitrust laws). The latter provision affected mostly property-casualty (P-C) companies because of their use of state rating bureaus and their standardized pricing of personal insurance.

Since the passage of the McCarran-Ferguson Act, a tug-of-war between federal and state regulation has been a regular source of conflict. As the equilibrium between state and federal regulation has been disturbed by exogenous shocks in insurance products and markets, the regulatory process has been for the states and its regulatory body, the NAIC, to respond by adapting the state system to these shocks or criticisms. The NAIC is a de facto national organization, albeit made up of the chief insurance officials of the 50 states.

But there is growing evidence that the insurance industry has moved away from the traditional model, exposing itself to fragility similar to other parts of the financial sector. While this process started some 50 years ago as banks and asset management firms began to compete for similar customers, it likely escalated with the passage of the Gramm-Leach-Bliley Act in 1999. This Act effectively repealed the Glass-Steagall Act, further blurring the lines between financial services companies by allowing affiliation among banks, securities firms, and insurance companies. Insurance companies, whether through their asset holdings, their product offerings like variable annuities (VAs) and guaranteed investment contracts (GICs), or their funding, look less like the insurance companies of a few decades ago. It should not be a controversial statement that financial markets of the twenty-first century are substantially different from those of the nineteenth and twentieth centuries, suggesting possible revisions in how insurance companies are regulated.

Many large, complex financial institutions effectively failed during the most recent financial crisis. While one can argue that the insurance industry was less impacted (for the reasons given in paragraph 2), it is clear that the industry was not entirely spared—for example, from the failure of American International Group (AIG) to severe financial distress at some monoline insurers to large increases in default risk at some of the largest life insurers.

The most recent financial crisis has exposed serious holes in the architecture of the U.S. financial system. As a result, the Congress passed

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the Dodd-Frank Wall Street Reform and Consumer Protection Act, and it was signed into law by President Barack Obama on July 21, 2010. The Dodd-Frank Act did not create a new direct regulator of insurance but did impose on nonbank holding companies, possibly insurance entities, a major new and unknown form of regulation for those deemed "systemically important financial institutions" (SIFIs)—sometimes denoted "too big to fail" (TBTF)—or presumably any entity that regulators believe represents a "contingent liability" for the federal government in the event of severe stress or failure.[3]

Such a holding company would be subject to regulation by the Federal Reserve, where the list of companies subject to that regulation and its form is still being worked out, but now features AIG and Prudential Financial as two insurers in the SIFI list.[4] This initiative arose due to the concern of massive support for AIG with direct funding from the Federal Reserve or the more limited bailouts of $950 million for Lincoln National and $3.4 billion for the Hartford Group under the federal Troubled Asset Relief Program (TARP). Other insurers, faced with large losses, made corporate moves so as to qualify for support from federal resources but were able to survive without actual drawdowns.

Because of the lack of any significant insurance expertise in Washington, the Dodd-Frank Act did create a Federal Insurance Office (FIO) in the Treasury Department, with a broad mandate to make recommendations and gather information but no broad regulatory responsibility. Significantly, it required that the director of the FIO submit a report to Congress with recommendations to modernize and improve insurance regulation within 15 months of the passage of the Dodd-Frank Act.

The law also provides that a person with "insurance expertise" should be nominated by the President and approved by the Senate as one of the 10 voting members of the very powerful Financial Stability Oversight Council (FSOC). It further provided that at least one other individual with "insurance expertise," to be nominated by the NAIC, should be one of the five nonvoting members of the FSOC. In fact, three of the appointments have been made and all three are former state commissioners.

In light of the financial crisis and the somewhat benign changes to insurance regulation contained in the Dodd-Frank Act (regulation of SIFIs aside), how should a modern insurance regulatory structure be designed to deal with twenty-first-century insurance companies?

The purpose of this book is to lay out the arguments for and against various types of regulation. The book focuses in particular on three key areas of insurance regulation: (1) state versus federal, (2) systemic risk, and (3) guaranty associations. The book purposefully provides opposing arguments by leading academics, regulators, and practitioners.

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This chapter summarizes the arguments laid out in the book and is separated into the following three sections, covering each of the three key areas.

STATE VERSUS FEDERAL REGULATION

As described in the introduction, the regulatory framework for insurance companies revolves around state, not federal, regulation. Aside from the advisory role of the new FIO housed in the Treasury Department, the only significant change is federal oversight of insurance companies deemed to be SIFIs. The question is whether this is sufficient for a modern insurance sector that includes companies operating across state and national lines and engaging in nontraditional insurance activities.

While not the primary focus of all the chapters of this book, almost all of the chapters touch on the issue of state versus federal regulation. The book starts with Chapter 2, by Dirk Kempthorne, CEO of the American Council of Life Insurers (ACLI) and former U.S. senator and governor of Idaho and U.S. Secretary of Commerce. While not calling for federal regulation per se, he argues that insurance regulation should be (1) uniform across different jurisdictions, (2) consistent with the business model of insurance companies (and not banks), and (3) efficient and, in particular, not duplicative. One could view points 1 and 3 as being more consistent with federal than multistate regulation. At the very least, Governor Kempthorne suggests that the new FIO will have to play a role in modernizing the system, especially with respect to coordination with international regulatory standards.

In Chapter 3, Roger Ferguson, CEO of TIAA-CREF and former vice chairman of the Federal Reserve Board of Governors, goes one step further and argues for the need for a federal regulator option for insurance companies. He argues that there has been a blurring of lines of business among financial companies, and that existing state regulation of insurance companies has led to a competitive disadvantage for those companies with a national footprint. Many of his concerns mirror those of Governor Kempthorne's in Chapter 2. Vice Chairman Ferguson admits that the NAIC has tried to fix some of these problems for multistate insurers. Nevertheless, he argues that, because the NAIC has no jurisdictional power across the states, national insurance companies cannot achieve speed to market for products and must satisfy a complex web of regulations for managing insurance sales. In addition to these issues, Vice Chairman Ferguson explains that a federal regulator for nationwide insurance companies would be better able to handle rules within an international setting and industry-wide threats or crises. He surmises that the majority of insurance companies would remain

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state regulated but, for the select few national companies, a federal insurer would serve them better.

In Chapter 4, Therese Vaughan, former CEO of the NAIC, sees the state versus federal regulation issue quite differently. Vaughan views the state system for insurance companies as a much more effective way to regulate the insurance sector. She describes historical evidence of the success of the state system and cites other international agencies' praise of its hands-on approach to regulation. Vaughan describes her experience at the NAIC and how the organization led to improvements in many of the state system's design faults described in Chapters 2 and 3. In contrast to those chapters, Vaughan questions the benefits of uniform regulation and cites examples of how federal regulation failed with respect to banks during the most recent financial crisis. She also sees a benefit of collaboration among state regulators. That said, there is recognition that inefficiencies remain, especially with respect to life insurers focused on asset management.

Chapter 5, by Eric Dinallo, partner at the law firm Debevoise & Plimpton and former insurance superintendent for the State of New York, concurs with Vaughan's Chapter 4. Commissioner Dinallo describes his experience in particular at regulating certain insurance subsidiaries of AIG before and during the financial crisis. He points out lapses in federal regulation and the danger of regulatory arbitrage, especially with respect to AIG's holding company and its use of credit derivatives. In his view, the strong protections of the operating companies at the state level through ring-fencing and tight capital regulation provide a robust solvency regime in times of financial distress. Commissioner Dinallo very much questions the need to federalize existing state regulation. Interestingly, however, the chapter places the business of insurance in a historical context and questions whether some of the activities performed by modern-day insurance companies are insurance per se and not some form of other financial activity.

With respect to solvency of insurers, in Chapter 11, Peter Gallanis, who leads the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA), provides theoretical arguments and evidence in favor of the existing state-based system. In particular, Gallanis describes the success of the current state guaranty associations system in protecting policyholders over the years, with respect to both the size of the safety net and the resolution of failed insurance companies prior to 2008. In contrast, in Chapter 10, John Biggs, who is the former CEO of TIAA-CREF and an executive-in-residence at the NYU Stern School of Business, takes an opposite view. Biggs sees the system as particularly weak with a lack of uniformity and risk-based pricing across state guaranty associations. In pointing out well-known problems with systems based

on post hoc assessments, Biggs is especially concerned that a number of guaranty associations did not or could not effectively participate in resolving the stress of large insurance companies in 2008 (such as AIG, Hartford Financial, and Lincoln Financial). Because there is a presumed reliance on the federal taxpayers in the event of widespread distress of large companies, and putting aside the Dodd-Frank Act's designation and resolution of SIFIs, Biggs calls for a risk-based, prefunded, federal insurer guaranty system.

With respect to state versus federal regulation, Chapters 6 through 9 of the book discuss this issue peripherally and for the most part argue either for or against federal regulation, depending on a given chapter's case for whether the insurance sector is systemically risky. For example, in Chapter 9, Viral Acharya and Matthew Richardson of the NYU Stern School of Business call for federal regulation. The argument is twofold: (1) It is simply inconceivable that federal regulation would not be required for a systemically risky sector since different state jurisdictions would not be able to manage the risk of such a sector, and (2) the Dodd-Frank Act's reliance on FSOC to look at a limited number of insurance SIFIs is not sufficient to pick up potential emerging systemic risks within the sector. While the chapter recognizes the advantage of state regulators' proximity to the ground and the relatively dismal performance of federal regulators, Acharya and Richardson also point out that a multistate system is prone to regulatory arbitrage, citing a recent paper by Koijen and Yogo (2013) as one such instance.[5]

In contrast, consistent with arguments made in some of the aforementioned chapters, in Chapter 7, David Cummins and Mary Weiss of Temple University and, in Chapter 8, Scott Harrington of the University of Pennsylvania's Wharton School point out that insurers have generally fared well through this and other crises. They argue that this is partly due to the success of the state regulatory framework and are concerned with any radical change to the current system. While Cummins and Weiss find some evidence for systemic risk for certain nontraditional insurance activities, their view is that federal regulation should focus in this area and not more broadly. Similarly, while Harrington is less convinced about systemic risk, to the extent that some new federal regulation will inevitably take hold for SIFIs, this regulation should be tailored specifically to insurance companies and focus on the nontraditional activities of these firms.

Of course, at the end of the day, the question of state versus federal regulation, particularly as it relates to systemic risk, is very much about the degree to which the insurance sector is systemically risky. The book devotes four chapters to this issue, and we briefly summarize the relevant arguments in the following section.

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SYSTEMIC RISK

In the book *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance* (edited by Acharya, Cooley, Richardson, and Walter [2010]), seven chapters are devoted to systemic risk regulation with a special emphasis on analyzing the economic implications of the Dodd-Frank Act's approach to systemic risk regulation. One of those chapters in particular focuses on insurance companies.[6] As such, the four chapters devoted to systemic risk of insurance companies in this book take a step back and ask the essential question: Are insurance companies systemically risky? Chapters 6 through 9 provide a broad range of views on this question.

On the one hand, as described earlier, insurance companies are not banking institutions and should be regulated differently than banks. All four chapters agree that the traditional insurance model is unlikely to produce much systemic risk. In fact, in Chapter 2 Governor Kempthorne argues that life insurance companies are not systemically risky. His chapter describes life insurance companies very much in the traditional sense.

On the other hand, as also described in the introduction and in some of the aforementioned four chapters, insurance companies have moved away from the traditional model of insurance. For example, the argument is given that the insurance industry is no longer traditional and instead (1) offers products with nondiversifiable risk, (2) is more prone to a "run," (3) insures against macroeconomy-wide events, and (4) has expanded its role in financial markets. If the insurance sector performs poorly in systemic states, that is, when other parts of the financial sector are struggling, then as an important source for products to the economy (i.e., insurance) and a source for financing (i.e., corporate bonds and commercial mortgages), disintermediation of the insurance sector can have severe consequences for the real economy.

Before summarizing Chapters 6 to 9's debate about whether insurance firms are systemically risky, it is first worthwhile to describe the exact procedure for determining whether an insurance company is systemically risky using the Dodd-Frank Act and subsequent rulings. Chapter 8, by Scott Harrington, provides an excellent discussion of the procedure involved in designating nonbank financial institutions SIFIs, including insurance companies.

The Dodd-Frank Act created the Financial Stability Oversight Council (FSOC) with the primary purpose of identifying and monitoring risks to the U.S. financial system arising from the distress or failure of large, interconnected bank holding companies or nonbank financial companies. FSOC is made up of 10 voting members from the major regulatory agencies such as the Federal Reserve, Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), Federal Deposit

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Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Consumer Financial Protection Bureau (CFPB), Federal Housing Finance Agency (FHFA), National Credit Union Administration (NCUA), Treasury, and, most important for our purposes, a presidential appointee with expertise in insurance. With respect to nonbank financial companies, the Dodd-Frank Act gives the FSOC (by a two-thirds vote) the authority to designate any nonbank financial company a SIFI subject to enhanced regulation by the Federal Reserve.

If a nonbank financial company is deemed to be a SIFI, then the Federal Reserve must determine a set of enhanced regulatory rules for the SIFI, including additional risk-based capital requirements, leverage and liquidity restrictions, resolution standards (especially with respect to capital structure rules), and short-term funding limits. The FSOC lays out six risk categories from which the SIFI designation will be determined. In particular, FSOC will consider (1) size, (2) leverage, (3) liquidity risk, (4) interconnectedness, (5) lack of substitutes for the firm's services and products, and (6) existing regulatory scrutiny.

The process involves three stages. The first stage will look at the six factors using publicly available data and information from regulatory agencies. The second stage involves a more detailed analysis of the company, involving additional information from the company, if certain quantitative thresholds are reached with respect to the six categories or if the global consolidated assets are over $50 billion. If FSOC deems that a company needs additional evaluation after the second stage, then a third stage is triggered. This final stage involves information collected directly from the company. After this stage is the required two-thirds vote of the FSOC to determine whether a company is a SIFI. If requested, a company can ask for a hearing, after which there is a new vote. Currently, AIG and Prudential have been designated as SIFIs and MetLife is in the third stage of review.

Governor Kempthorne's Chapter 2 and Scott Harrington's Chapter 8 both argue that insurance companies are not banks and that they are therefore not systemically risky, and focus their arguments on the fact that traditional insurance does not have systemic consequences. While the analysis in Chapter 8 allows for the fact that some noninsurance activities may pose additional risks, Harrington suggests that the regulation should be differentially focused on these risks and should not place the rest of the insurance company under the same regulatory regime. Harrington in particular is concerned with the potential consequences of FSOC's recent determinations on AIG, but especially Prudential Financial and MetLife.

Chapter 7, by David Cummins and Mary Weiss, provides a more detailed analysis of the FSOC risk factors in the context of the insurance industry. Their general conclusion is that most of the core activities of

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insurance companies are not systemically risky with respect to the six risk factors. Some exceptions they cite are for the large life insurers and possible interconnectedness in the property-casualty area. That said, Chapter 7 points out that noncore activities of the type mentioned earlier may be more problematic, such as investing in privately placed bonds and asset-backed securities, offering guaranteed investment contracts for annuities, writing financial guarantee insurance, and so on.

In Chapter 6, Anna Paulson, Thanases Plestis, Richard Rosen, Robert McMenamin, and Zain Mohey-Deen of the Federal Reserve Bank of Chicago provide some evidence that the U.S. life insurance industry is less traditional than commonly assumed. Specifically, they provide a detailed analysis of the liquidity of the life insurance industry's asset holdings and liabilities. They provide evidence that approximately 50 percent of liabilities are in a moderately to highly liquid category, allowing for some type of withdrawal. In light of the possibility that life insurance premiums are no longer as sticky, they also describe the liquidity of the insurance industry's asset holdings. In particular, they analyze stress scenarios in which the insurance industry would have to liquidate some of its assets. They find that, relative to runnable liabilities, these firms would have to dip fairly deeply into their holdings of corporate bonds and other less liquid securities (i.e., nonagency and nongovernment securities).

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In Chapter 9, Viral Acharya and Matthew Richardson describe systemic risk in a different way than FSOC's risk factors. Using theoretical arguments in Acharya, Pedersen, Philippon, and Richardson (2010), they estimate a firm's systemic risk as its expected shortfall in a financial crisis, denoted systemic expected shortfall (SES, or SRISK on NYU Stern's systemic risk website at http://vlab.stern.nyu.edu/welcome/risk).[7] In particular, systemic risk of a financial firm is its relative contribution to the aggregate capital shortfall of the financial sector. Chapter 9 then provides a detailed descriptive analysis of how insurance companies contribute to this shortfall and therefore to systemic risk.

Like Cummins and Weiss's Chapter 7, Chapter 9 also stresses the nontraditional nature of current insurance companies, yet argues that the insurance sector is more systemically risky than implied by Chapter 7. One of the main differences between these chapters is the different interpretation of systemic risk. Using the SRISK definition, it is likely that the impact of noncore activities will be greater because these activities expose insurance companies to aggregate shocks. Moreover, while there is some disagreement among Chapters 6, 7, 8, and 9 on how to measure systemic risk and with respect to the degree to which insurance firms are no longer in traditional lines of business, there is also a different interpretation about how to view systemic risk. Chapter 9 argues that systemic risk arises when there is an

aggregate capital shortfall in the financial sector and the sector as a whole begins to disintermediate. For insurance companies, this disintermediation might involve insurance companies no longer supplying the full slate of insurance products, or no longer being a primary financier of many of the credit-linked activities in the economy, such as corporate bonds or commercial mortgages.

Acharya and Richardson's Chapter 9 analyzes SRISK before, during, and after the financial crisis. They use publicly available pricing data from equities and credit default swaps of insurance firms. Their basic conclusion is that the pricing data shows that insurance companies contribute to the expected aggregate capital shortfall of the financial sector in a crisis. Interestingly, since the financial crisis ended, insurance companies have become systemically more important as a fraction of their assets. This is in contrast to the banking sector, which appears to have reduced its systemic risk. Cummins and Weiss, in Chapter 7, also employ the SRISK measure, albeit in a different way. Their focus is on trying to understand what characteristics of insurance companies are statistically related to SRISK. Consistent with much of the intuition across all of the systemic risk chapters, they document that firms engaged in noncore insurance activities or certain core activities, like separate accounts and group annuities, tend to be more systemically risky.

Harrington's Chapter 8 questions some of the assumptions underlying these systemic risk measurements; in particular, what constitutes a capital shortfall in banking may be different for insurance companies. Moreover, equally of issue, the assumption that an additional dollar of capital shortfall in the insurance sector has the same systemic consequences as that in the banking sector may be problematic. That said, Paulson et al.'s Chapter 6 suggests insurance companies are more banklike in their liquidity mismatch than implied by the common view of insurance. The assumption of equal consequences of capital shortfall may therefore be reasonable.

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GUARANTY ASSOCIATIONS

In Chapters 10 and 11, respectively, John Biggs and Peter Gallanis consider the modernizing of the safety net for insurance company policyholders in the event of an insolvency of an insurance company. These authors represent extreme opposites in opinion. Peter Gallanis highlights the success of the existing state-based guarantee system based on an after-the-failure assessment of surviving companies to cover losses. His chapter provides assurance to policyholders that the system would protect them in the future. In contrast, John Biggs critiques the state system from a variety of points of view. He suggests in Chapter 10 that a federal prefunded system would be more

consistent, transparent, and more capable of coping with major industry-wide failures (as in 2008) without federal government intervention.

Gallanis contrasts the success of state regulation and resolution, with only 15 life insurance companies liquidated compared to the failure of over 400 banks and other financial institutions. He focuses on the regulation and resolution of life and health insurers, but his presentation also covers similar matters for property and casualty companies (although their liability structure is markedly different from life companies and more similar to health insurance companies).

Gallanis outlines the macro prudential aspects of state insurer regulation in describing the basic financial model of insurers, and the resulting regulatory system. He highlights the important role of the NAIC and NOLHGA in standardizing regulation across the states. He reviews the way the "receivership" and "guaranties" operate. Those interventions over the years have resulted in relatively small assessments against the industry. He shows graphically how little the past decade's assessments to the life companies have been compared to the end of the last century, when several very large companies became insolvent. He also points out that a large percentage of those small assessments were recovered through credits against state-imposed premium taxes.

It is surprising how little the insurers themselves had to pay out in net assessments during the most drastic failure of the financial sector since the Great Depression. Yet this contrasts sharply with the enormous sums provided and guaranteed by the federal sector in its intervention to protect the insurance sector. Gallanis also provides data showing the capacity of the state assessment to be roughly $10 billion a year or at least $100 billion over 10 years. He points out at some length the long payout structure of a life insurance company's obligations and the matching of that with the annual assessments. Gallanis concludes that the insurance industry weathered the storm of the 2008 crisis rather well and met its commitments to consumers when a few relatively small companies did fail.

Related to the Gallanis chapter is Dinallo's Chapter 5, which defends state insurance regulation in spite of the federal intervention in AIG, which largely held insurance company assets. Dinallo, Gallanis, and others see the AIG crisis as due to poor regulation of insurance holding companies, and especially the lack of regulating the enormous guarantees through credit default swaps.

In Chapter 10, Biggs does not question the success of NOLHGA and the state commissioners in dealing with insolvencies under the existing state guaranty structure. He sees the structure itself as weak and not providing a stronger safety net for insurers. In his view, little of the 2008 burden was shouldered by the industry itself.

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In his critique of the system, Biggs points out the opaqueness of having 50 different benefit patterns depending on the insured person's residence, further aggravated by a provision in most state laws preventing any communication of the existence of the system. Also, the usual state provisions are inconsistent with the other widely publicized safety nets, like the Federal Deposit Insurance Corporation (FDIC) and particularly the Pension Benefit Guaranty Corporation (PBGC).

He criticizes the post hoc assessment system as (1) creating uncertainty in the speed of resolution, (2) preventing any form of risk-based charges, and (3) being "procyclical" (i.e., in making assessments against the industry when a broad-scale crisis creates stress on the entire industry). Biggs cites the economic literature that favors risk-based premiums for two reasons. The first is simply fairness since cautious underwriters and well-capitalized insurers would pay in less than more risky companies. The second is for reduction of moral hazard since risk takers relying on the government "put" would see their premiums rise.

Biggs also points out that the liability structure for many of our largest life insurers has moved to a large provision for immediately withdrawable preretirement annuities that are rarely annuitized into traditional long payment streams. These liabilities are more like bank deposits, and therefore more subject to risks of a run than are traditional life insurance obligations.

To counter these limitations of the varying laws of the 50 states, he proposes a uniform prefunded federal system that would strengthen the financial backing and make transparent to prospective policyholders the guarantees. Furthermore, he sees several additional advantages. A prefunded federal system could have responded to the 2008 crisis in some form, particularly in providing temporary TARP-type funding for prudently financed companies that could pay back at a penalty rate. Such an existing fund would accordingly provide a "last window of opportunity" to insurers comparable to what the Federal Reserve provides U.S. banks.

Additionally, Biggs sees the existence of a federal insurer guaranty system as providing the federal government with an experienced insurance regulator that could better deal with a 2008-type financial crisis than the bank regulators. He also argues that the federal insurance system would substantially eliminate the federal government's contingent liability to intervene to protect the insurance industry in the event of another major national financial crisis.

The editors' objective in this book is to lay out for interested readers the up-to-date positions on the Dodd-Frank Act's Congressional order to produce a plan for "modernizing insurance regulation." The issue of the guarantees, whether state or federal, has been the subject of Congressional debate before. Following a series of major property and casualty insolvencies in

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the 1960s, Senator Edward Brooke of Massachusetts introduced legislation that included a federal guarantee system. And again, after significant earlier losses from Executive Life and Mutual Benefit, Representative John Dingell introduced a bill in 1993 creating a federal regulatory system for insurers, which also had a prefunded federal guaranty system.

The structure of the insurance business has changed significantly since the guaranty association legislation was finally adopted by most states in the 1970s and 1980s. Since then we have seen the growing sophistication of the state system as it became "national" if not "federal." The question is whether the new issues are of sufficient concern to move away from the largely successful state system. If we may speak for the two sides, we might say for the state advocates, "If it ain't broke, don't fix it." However, others reflecting on the same set of facts might conclude that the state system met limited goals that did not reflect all the needs of policyholders and the industry, and required the federal government to intervene in the financial crisis of 2008.

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CONSUMER PROTECTION

The Dodd-Frank Wall Street Reform and Consumer Protection Act created a Consumer Financial Protection Bureau (CFPB). Oddly, from the point of view of this book, the Act specifically excluded products and services provided by insurance companies from regulation by the Bureau. Presumably this was in deference to the existing fact that insurance is regulated at the state level.

The academic literature is fairly light on its analysis of consumer finance protection and especially so in the area of insurance markets. For some analysis of the broader issues related to regulation of consumer financial products, we suggest the reader look at Chapter 3 of *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance* (edited by Acharya, Cooley, Richardson, and Walter [2010]).[8] This suggestion aside, Chapter 12 of this book, written by financial economists Santosh Anagol, Shawn Cole, and Shayak Sarkar, provides an interesting perspective.

While there is little substantive academic research on insurance product markets in the United States, Anagol, Cole, and Sarkar (2013) have performed detailed experiments in India's markets.[9] India has a single national regulator of insurance and up until 1999 had only one insurer! Chapter 12 discusses the ethical standard that regulators should impose on "market intermediaries" or "retail sales agents" in the life insurance market or, in U.S. language, on life insurance agents and brokers.

Chapter 12 debates whether the standard for insurance intermediaries' behavior should be a "suitable" or "fiduciary" standard. This legal distinction is currently hotly debated in the United States as to the proper legal standard

for stockbrokers. Financial advisers are clearly held to a fiduciary standard but brokers to a suitability one. The national regulator in India in 1913 required a "standardized suitability analysis."

In making an analogy with the Indian insurance markets, Chapter 12 describes the U.S. standard as "caveat emptor." Most state insurance commissioners would dispute such a characterization. They would argue that careful licensing and oversight of agent behavior result in a higher standard, probably close to suitability. However, legally it is difficult to use the words "agent of the company" without suggesting that the agent's primary duty is to the company and not the buyer. Again, U.S. state regulators would respond that the companies are responsible for the behavior of their agents and that their monitoring is reviewed by the state insurance department audits of companies.

State laws in the United States directly attack some particularly unsuitable actions by agents and brokers. For example, selling replacement policies can be very harmful to policyholders. It may be easier to sell a policy to a person who is already paying for an existing policy, and given the complexity of policy provisions, it may not be obvious to the buyer what the disadvantages are (e.g., paying the high acquisition costs a second time, or losing other benefits of the existing policy). States have an elaborate system requiring notification to the first insurer and clear illustrations.

Chapter 12 spends some time describing the experiments performed by Anagol and colleagues. In particular, Anagol et al. (2013) examines the advice given by India's intermediaries as to whether a young family prospect ought to buy the low-commission term policy or the high-commission whole life policy. With a saving feature and high first-year commissions and costs, this problem is a classic issue. One might guess how such a study of American life insurance sales to young families might vary from the Indian experience. One would hope that American buyers, even under a caveat emptor rule, would not buy the preposterous statements that some Indian agents are said to have used to justify the higher-commission policies. But the results might be similar. While Chapter 12 does not provide examples from the American experience of insurance markets, the work of Anagol and colleagues shows the possible need for enhanced consumer protection in some financial markets. It remains an open question whether this is true for insurance markets, and whether this role is better performed at the state versus federal level. (See previous discussion.)

If American insurance commissioners would be asked where they stood on standards for agent/broker performance on the spectrum of caveat emptor, suitability, or fiduciary, they would probably pick something higher than suitability. However, by law, their standard may well be only caveat emptor, which would be the basis on which a policyholder could avail himself or

herself of the courts. In Chapter 3, Roger Ferguson argues the merits of an optional federal charter. Clearly, the federal regulator of companies electing such a charter would have to consider whether an explicit suitability standard should be defined.

COMPARISON WITH THE FIO REPORT

As this book goes to press, the Federal Insurance Office (FIO), created by the Dodd-Frank Act (DFA) has released the report, required by DFA, on "How to Modernize and Improve the System of Insurance Regulation in the United States."

The Report includes many specific recommendations on improvements, primarily in how the existing state system should be changed. It also has several changes that would involve additional federal interventions. The Report reframes the federal/state debate to "whether federal involvement is warranted at this time and if so, in what areas." Accordingly, it differs from this book (Book) in approach to the possible federal role. The Report describes its recommendations as creating a "hybrid" federal/state approach.

The changes in state regulation in the Report would eliminate or mitigate existing widely recognized weaknesses in the present 51 jurisdiction regulation. Frequently, the recommendation simply pushes for acceptance by state legislatures of NAIC Model statutes. For example, the significant variation in guaranteed benefits under state guaranty associations could be remedied by all the jurisdictions adopting the model law. In another area, the FIO is concerned about the weakening of capital standards by some states using discretionary accounting and capital rules without the approval of the other states in which a company operates. Another is the seemingly egregious arbitrage in the use of captive reinsurance companies, established in states with weaker capital and reserve standards than the home state of the company.

This Book, on the other hand, approaches the federal/state discussion with an examination of the pros and cons of basic regulation at either the state or federal level. Those papers inclined toward state regulation do not identify the kind of issues raised in the FIO report.

As to the issues of systemic risk, this Book looks at a variety of ways to measure insurers' role in creating systemic risk or in being a "victim" of risk created by other institutions. The Report doesn't take a position on how to determine systemic risk but is concerned more with the regulation of an entity that is deemed systemic. The Report introduces the idea of "Global Systemically Important Insurers" (G-SII) as determined by international standards.

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The Report also has a good deal of coverage of the need for state regulatory changes in overseeing a "group," or "non bank holding company" "in DFA language. The Report benefits from the time spent by the FIO since its founding in negotiating international treaties, a responsibility formally assigned to the FIO in the DFA.

This Book explores the guaranty associations in much greater detail than the Report. The only substantive issue in the Report was the concern about uniformity of guarantees—for which it recommends that all states pass the NAIC model statute. This Book, in one paper details the operation of the current system with no recommendations for improvement, and in the other critiques its structure and proposes a federal system similar to the banks' FDIC.

The Report has much more than the Book to say about marketplace regulation. This Book has the one paper on the oversight of producers/agents and pushes for a suitability standard. A specific counter to that issue is the Report's urging compliance with the NAIC Suitability in Annuity Transactions. Also, there are several recommendations for a Federal database for agent licensing.

We hope that the different emphases and approaches in this Book and the Report combine to give Congress useful academic and policy making analyses of the complex issues in creating a Modern Insurance Regulatory System.

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CONCLUSION

In Chapter 2, Governor Kempthorne makes the argument for the crucial role life insurance companies play in multiple ways in the U.S. economy. Life insurance companies provide help to widows, parents and children, retirees and businesses, and provide major investment capital to corporations through purchases of corporate bonds and commercial mortgages. These points are only strengthened by the fact that the baby boom generation is approaching retirement age. Most of the authors of the chapters in this book would agree with Governor Kempthorne's view of insurance companies.

The importance of the insurance sector, however, prompts the question: Is the current regulatory system for insurance companies, developed long ago, up to the task of dealing with modern-day insurance companies? And, if not, will this put the economic system in jeopardy if insurance companies can no longer intermediate at their optimal level in times of distress and crisis?

The chapters in this book provide disparate views on these questions. The hope is that this will provide readers with the relevant line of reasoning on all sides of these questions, so they can make their own informed assessment.

NOTES

1. There are two broad types of insurance—life and health and property-casualty—that exhibit substantial differences in how insurers operate and are regulated. Life and health insurers (hereafter, life insurers) sell financial protection against human life contingencies. For example, life insurance protects against financial loss due to unexpected death, annuities protect against financial issues if living longer than expected, and health insurance covers unexpected medical care, disability, and long-term care costs. Many types of life insurance, such as variable annuities, include substantial investment aspects. Property-casualty (P-C) insurers sell insurance protection against a wide and mostly familiar set of risks such as auto, fire, and homeowners insurance. Other major lines of business include tort liability, flood, hurricane and earthquake, medical malpractice, workers' compensation, officers' and directors' liability, marine coverage, and reinsurance.
2. Scott Harrington, "History of Federal Involvement in Insurance Regulation," in *Optional Chartering and Regulation of Insurance Companies*, AEI Study, 2000, ed. Peter J. Wallison; Baird Webel and Carolyn Cobb, "Insurance Regulation: History, Background, and Recent Congressional Oversight," CRS Report for Congress, 2005; Ralph Tyler and Karen Hornig, "Reflections on State Regulation: A Lesson of the Economic Turmoil of 2007–2009," *Journal of Business & Technology Law* 4, no. 2, (2009): 349–370.
3. For a detailed analysis of the systemic risk regulations contained in the Dodd-Frank Act, see Chapters 4 to 9 of *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, ed. Viral V. Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter (Hoboken, NJ: John Wiley & Sons, 2010).
4. Globally, too, there are currently nine insurers in the Financial Stability Board (FSB) designated list of global SIFIs.
5. Ralph Koijen and Motoriho Yogo, "Shadow Insurance," working paper, London Business School, 2013.
6. Viral V. Acharya, John Biggs, Hanh Le, Matthew Richardson, and Stephen Ryan, "Systemic Risk and the Regulation of Insurance Companies," Chapter 9 in *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, ed. Viral V. Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter (Hoboken, NJ: John Wiley & Sons, 2010).
7. Viral V. Acharya, Lasse Pedersen, Thomas Philippon, and Matthew Richardson, "Measuring Systemic Risk," working paper, NYU Stern School of Business, 2010.

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8. Thomas Cooley, Xavier Gabaix, Samuel Lee, Thomas Mertens, Vickie Morwitz, Shelle Santana, Anjolein Schmeits, Stijn Van Nieuwerburgh, and Robert Whitelaw, "Consumer Finance Protection," Chapter 3 in *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, ed. Viral V. Acharya, Thomas Cooley, Matthew Richardson, and Ingo Walter (Hoboken, NJ: John Wiley & Sons, 2010).
9. See Santosh Anagol, Shawn Cole, and Shayak Sarkar, "Understanding the Advice of Commissions-Motivated Agents: Evidence from the Indian Life Insurance Market," Harvard Business School Working Paper 12–055 (2013), 20.

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