Testimony before the

Senate Committee on Banking, Housing and Urban Affairs

on

Regulatory Modernization: Perspectives on Insurance

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Introduction

Mr. Chairman, Ranking member Shelby and Members of the Committee good morning and thank you for the opportunity to testify before the Committee on the topic of modernizing insurance regulation.

My name is Martin Grace. I am the James S. Kemper Professor of Risk Management at the J. Mack Robinson College of Business at Georgia State University. I am also the Associate Director of the Center for Risk Management Research and an Associate at the Andrew Young School of Policy Studies. I have been at Georgia State for 21 years coming to GSU from the University of Florida where I earned a law degree and a Ph.D. in economics. Previous to that I attended the University of New Hampshire where I earned my undergraduate degree.

My entire career at Georgia State has been spent conducting research in insurance regulation and taxation. Since the industry is regulated at the state level, this has been predominately an exercise in the study of state regulation. However, the question of whether the state is the appropriate level of regulation is becoming more important and I have spent the last four years thinking about that question.

This brings me to what I have been asked to talk about today. I will focus on three main points in today's testimony.

- First is the value of regulation in insurance industry. There are valid rationales for insurance regulation, but the business of insurance is quite different than banking and has a need for a different style of regulation.

- Second, is a mild but nonetheless important critique, of the current proposals to regulate the insurance industry. An Optional Federal Charter (OFC) is not necessarily the only way to think about insurance regulation. The current proposal is cobbled together from a federal banking law and decades old state insurance model laws.

- Third, something like the Office of Insurance Information, as source of expertise and an advice to the Federal Government about the insurance industry is needed, but it should not by itself be used to restructure the relationship between federal and state regulation.

The question of who should regulate the insurance industry has been debated in the United States since the time of the Civil War. Insurance continues to be regulated by the states despite several challenges to their authority over the years. The states' authority over insurance was supported in various courts' decisions until the *Southeastern Underwriters* case in 1944. In *Southern Underwriters*, the Supreme Court determined that the commerce clause of the Constitution applied to insurance and that insurance companies (and agents) were subject to federal antitrust law. The Court's ruling caused the states and the industry to push for the McCarran-Ferguson Act (MFA) in 1945, which delegated the regulation of insurance to the states.

At that time, the majority of insurance companies favored state over federal insurance regulation. However, today the bulk of insurance is written by national (and international) companies operating across state borders. Many of these insurers have come to view state regulation as an increasing drag on their efficiency and competitiveness: these insurers now support a federal regulatory system. This is reflected in recent proposals that would establish an optional federal charter (OFC) for insurance companies and agents. The proposal would allow them to choose to be federally regulated and exempt from state regulation. As you are quite aware, there is fierce opposition to an OFC from the states and from state-oriented segments of the industry.

One of the main problems with the OFC approach is that it is based upon a structure designed in the 1860s through the National Banking Act and cobbled together with state consumer protection language. The OFC approach is based on a view of the world that had changed significantly in the last two years. While the authors of the proposal now add a systemic risk regulator to the mix, they still beg some questions about who should be subject to federal regulation.

The current problem facing insurance regulation, though, is quite different from regulatory issues of the past century. Today's problem is not based on regulation of solvency, market conduct, or insurance pricing which have been undertaken by the states. It is, instead, the problem of systemic risk which, for the most part, has not been an issue with the insurance industry. Further, systemic risk is of national rather than state in scope. Specifically, the types of market failures used historically to justify regulation of the insurance industry have been ones that pertain to local markets. This is in direct contrast to the effects a failure of a company like AIG has on national and international markets.

Why Regulate Insurance?

Economists believe the role of government is to rectify market failures.[1] In the insurance industry, potential market failures are due, in essence, to imperfect information. Customers cannot, for example, observe the behavior of insurance company management. For a life insurance consumer, this might be important because of the long time between when a contract is purchased and when a payout might occur. Also, there is no effective way to discipline the insurer's management. For example, a life insurance consumer cannot "punish" a "bad" company by exchanging his long term policy for one with another insurer. Thus, economists would argue that government can and should monitor a firm's solvency position and take action to prohibit insurer actions which reduce the value of life insurance contracts.

A second potential market failure is related to the imperfect information embodied in the insurance contract itself. An insurance contract is a complicated financial agreement, so the government could standardize contracts or approve contract language to reduce errors and misunderstandings in the contracting process.[2]

A third informational problem might arise from an insurer's strategy and marketing structure. Because insurers have different marketing (direct versus independent agents) approaches and different levels of capital backing, shopping for the right policy is costly to consumers because they do not have the information to make accurate judgments about the

[1] See Skipper and Klein (2000) for a more thorough treatment of how economists think about the regulation of insurance.

[2] This standardization is common in personal lines products (like homeowners and auto), but it does not always solve all problems as there are new problems with contract interpretation that are costly to resolve. The Katrina wind/water litigation is just an example of this problem.

services and the quality of services provided by insurers. Arguably, the government could guarantee a level of service after a claim or set prices so that a consumer would know that the contract is priced fairly. In addition, prices could be set to keep insurers from using their market power to exploit consumers through higher prices. This last rationale is often provided for price regulation of insurance, even though most personal lines insurance markets (which are the most likely to be regulated) are competitive markets. There are many competitors in these markets which reduces the likelihood of any one of firms being able to influence prices (Tennyson, 2007).

These arguments form the standard historical rationales for insurance regulation. A further rationale, with a more immediate application in banking regulation, is that regulators should prevent market failure caused by the externality of one bank failure leading to a loss of consumer confidence in the financial system and other bank failures should be prevented. Banks have solvency regulation to protect depositors and to defend the banking system from contagion risk. Historically, insurers did not present a real contagion risk to the financial system, but this may no longer be true. Financial companies are now interconnected in ways that are without historical precedent. Holding companies have evolved which contain many different types of regulated and unregulated firms. A bank with an insurer as part of its operations can extend the contagion risk to its insurance operations. Alternatively, an insurer with a large and unregulated derivative trading business which suffers large losses can trigger questions about the overall soundness of the insurance operations. Counter parties to trades by such an unregulated entity can cause significant harm and potentially disrupt the banking system. In insurance, the focus of regulation has been on the individual company and not on the group or holding company. This

needs to change, at some level, to allow for the proper accounting of systemic risk.[3] A state regulator cannot realistically regulate an insurer for its possible systemic affects on national and international markets especially in situations where the insurer within the state is a separately organized corporation from the corporation which might induce a systemic risk issue.

The Level at Which Regulation Should Be Applied

Ideally regulation should be applied at the level where the greatest costs and benefits due to the regulation arise. A simple example would be the proper placement for restaurant safety inspections versus airplane safety inspections. Local governments would be the obvious choice for restaurant cleanliness because local patrons would obtain the benefits and bear the costs of the safety inspections. In contrast, airplane safety inspections costs and benefits are national in scope and air travel is conducted nationwide. Thus it makes sense for air safety to be regulated at the national level.

A large percentage of insurance premiums are written interstate. If there are interstate externalities to insurance regulation, then it makes sense for the federal government to regulate it. Phillips and Grace, in a 2007 paper, document some of these interstate externalities in terms of how states can export the costs of regulation to other states. The authors were not able to measure the benefits of regulation, so it is not possible to provide a conclusion about the role of federal versus state regulation.

Some of the benefits of state regulation are that local tastes and preferences are best met

[3] Prior to the introduction of the National Insurance Consumer Protection Act and the creation of a systemic risk regulator, I thought legislation that granted the Federal Reserve the right to assess systemic risk through the use of normal administrative agency powers of investigation would be sufficient for any firm that might create systemic risk. New legislation which sets up a formal systemic risk regulator will likely spell out these powers and their scope in more detail.

by state legislatures responding to local voters' concerns about the insurance industry. This is often touted as a rational for federalism. Yet, I suspect that with some exceptions (price regulation, for example) a few voters could discuss their state's insurance regulations. Due to diverse state regulations, nationwide companies often have significant compliance costs which increase the price of insurance without providing any benefits provided by a federalist laboratory. States do not look to see if there is a better way to regulate insurance. So, there is tremendous inertia in state's regulatory processes and it is a rare event that causes all states to act together.

If the criterion for a state-based insurance regulatory system to be successful is that states must regulate to minimize compliance costs, then the current state regulation of insurance is doomed to failure. One of the major rationales for federal regulation is reduction of nationwide insurer costs of trying to satisfy multiple states' regulators. The NAIC has stated that it is trying to reduce these types of costs through model legislation and interstate compacts. Its good intentions notwithstanding, it is not capable of getting the states to operate quickly and efficiently together. Even Congress cannot obtain quick compliance from the states. In the Gramm-Leach Bliley Act of 1999, Congress mandated that the states set up a nationwide licensing system for agents. After ten years, not all of the states participate in this system to reduce multistate licensing costs.[4]

In 2007, for example, the NAIC proposed the Military Sales Model Practices Regulation as a result of a law enacted by Congress in 2006. This regulation is designed to protect young

[4] A recent report (NAIC, 2008) states that 43 states are in compliance. What is important is that three important states (FL, NY and CA) are not in compliance some nine years after enactment of the Gramm-Leach-Bliley Act. Without the large states participation, compliance costs are not reduced and the supposed benefits of increased state cooperation as a reason for avoiding an OFC bill are illusory.

soldiers, sailors, marines, and airmen from aggressive sales tactics directed at military personnel. As of late last year, only 18 states have enacted it. Presumably, this was an important issue for Congress, yet it has not been adopted by a majority of states in its first two years. Depending on universal action among the states to enact laws that prompt action is just not feasible. Grace and Scott (2009) document a number of other examples which suggest that joint actions by the states are never going to be able to solve national problems regarding compliance costs and uniformity quickly and efficiently.

The Potential Federal Role and Regulatory Modernization

There is a role for the federal government in insurance regulation. Where it can succeed and be economically valuable is in the area of removing the costs of conflicting state laws and reducing the effect of systemic risk on all financial markets. Reduction of compliance costs is the rationale behind the 2009 OFC proposal introduced by Reps. Bean and Royce called the National Insurance Consumer Protection Act. The new proposal includes the role of a systemic risk regulator who will have the authority to mandate that certain insurers be federally chartered companies.[5] With the exception of this concept, there is little modern thinking in the NICPA about how insurance regulation should work.

The authority of the systemic risk regulator is very important. It is only now being discussed. However, how this is undertaken can cause significant disruptions in markets. If the risk regulator's authority is associated with a "too big to fail" certification, then the underlying

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[5] Essentially, there is a double option on the table now. From the description in the press, insurers could opt to become federally chartered, but the Federal government could opt to regulate a state chartered company if part of a holding company that might create a systemic risk.

competitive insurance market might be at risk. Firms designated as "too big to fail" will have an implicit incentive to take on more risk (sell more insurance and other risky products) knowing the government will provide assistance. A rational firm may decide not to compete in that market. Thus underlying insurance markets are likely to wither away leaving only those firms that are "too big to fail".

If all insurers are subject to the systemic risk regulator's jurisdiction, there is no signal that every firm is "too big to fail". However, most insurers will never be systematically important but will be subject to another layer of regulation that does little for its customers, its shareholders, or society in general. Even large, significant insures operating nationwide are not necessarily important from a systemic risk perspective. So the question becomes how does one determine whether a firm should be subject to risk regulation? Ideally, one would want firms undertaking risk outside of insurance risks to fall under the authority of the risk regulator. For example, suppose a future AIG-like company petitions its primary regulator to exempt its "Financial Products" subsidiary from insurance regulation. Because of that exemption, the firm should fall under the jurisdiction of the risk regulator. The risk regulator can examine the risk and require appropriate reserving techniques if needed.[6] By having to show the risk regulator the insurer's underlying business model a specific finding can be made if a systemic risk is possible and remedies to mitigate the systemic risk can be implemented. Ideally what the risk regulator's job would be is to prevent possible systemic risks through evaluation by a competent regulator.

[6] Note, though, that if New York did not exempt the AIG Financial Products subsidiary and treated it like a bond insurer it would have had some level of reserves. Further, because it would have to place reserves for each new bond insured it would have also limited the scope of the sale of CDSs as well as the scope of the eventual losses.

One of the dangers of merely just prohibiting financial innovation is that economically valuable innovations would never evolve. However, permitting financial innovation without proper reserving is also harmful to society. Thus, the risk regulator must be more sophisticated about these products than a typical state insurance department in two ways. First, it must be able to understand the product and its risks. Second, it must appreciate the rewards of such innovation.

Problems with Current Federal OFC Proposals

As mentioned above, the OFC proposal is cobbled together from banking and insurance law. There has been little discussion of the structure of a regulatory body from a fresh perspective. A recent paper by Grace and Scott (2009) examined a portion of the issue from an administrative law viewpoint and showed how little discussion there was of how a federal insurance regulator should be organized. There are a number of regulatory models available in the United States. For example, there is the multi-commissioner, administrative body like the SEC. This is in direct contrast to the single administrator overseeing the Office of the Comptroller of the Currency. There is also an independent (from the executive branch) administrative agency like the Federal Reserve Board of Governors. Again, this contrasts directly with the administrator of the Office of the Comptroller of the Currency. The fact that the 2009 OFC proposal merely copies the structure of the banking system and begs the question why is the national banking system structured this way? The Treasury *Blueprint* as well as others (see e.g. Brown (2008)) discuss other options. What is noteworthy is that these options were not conditioned on the current financial crisis. The *Blueprint's* proposal is to use a three-pronged regulatory approach with a systemic risk regulator, a solvency regulator, and a market conduct regulator that would oversee *all* financial services including securities and commodities trading.

This would be a major innovation in financial regulation in the United States. The OFC bills, in contrast, are not innovative from the perspective of what is regulated or how the regulation is accomplished as the approach in both bills (with the exception of a systemic risk regulator) is to shift traditional regulatory powers from the states to the federal government.

Other methods of regulation of the insurance industry are also possible. Some insurers have joined unofficial self-regulatory organizations like the Insurance Marketplace Standards Association (IMSA) to increase their ability to understand their customers and to increase the likelihood that their policies will more closely meet the needs of those customers. These types of standards are different from state-based rules which are often decades old and have not suffered an across-the-board reexamination, except after a regulatory failure. From a practical point of view, Congress is not likely to delegate monitoring powers to private entities for some time. The approach of organizations like IMSA, can assist in the development of modern approaches to market conduct regulation.

In sum, there has been no real systematic discussion of modernization of the regulatory approach over the last decade outside of allowing for greater integration of financial services through enactment of the Gramm-Leach-Bliley Act of 1999 (GLB). Other than allowing banks and insurers to be owned by a common parent, GLB did not change the content of insurance regulation beyond mandating that states attempt to resolve interstate differences in agency licensing. Other important substantive aspects of insurance regulation have not been reexamined. For example, there has been little, until recently, discussion of the proper and economically efficient regulation of risk.

In addition, solvency regulation has not been scrutinized since Congress made states and the NAIC do so in the late 1980s and early 1990s. Bank regulators have adopted aspects of the Basel accords, but insurance regulators have not. Many insurers are complying with Basel II by developing their own capital models and the tests which support the models. They are not required to do so by law but are doing it to be responsible stewards of capital. To be fair, there has been an attempt to standardize certain product approval processes through the use of the new Interstate Insurance Product Regulation Commission. However, the Commission has taken time to get started and was created, at least in part, to stave off any OFC type of regulation. This history of insurance regulation suggests that state regulation in this area is reactive. Regulation only changes because of a crisis or Congressional pressure. It is interesting that Congress (and not the states) also proposed the SMART Act that would have pre-empted the states' ability to regulate and transferred that authority to the Federal government. This proposed Act started a conversation about regulation, but it did not address the fundamentals - just what level of regulation is appropriate for insurance. The OFC bills have structured this debate in such as way as to eliminate discussion of reform. Given that many aspects of regulation are important, more reform ideas should be on the table.

A Role for an Office of Insurance Information

A proposed Office of Insurance Information (OII) is an important first step in any role the federal government may have in the future. Even if the federal government decides in the near future to pass on regulating the insurance industry the OII still may be an important innovation for three main purposes. First, there is a paucity of individuals at the federal level who know its component industries, its market structures, its products, its taxation or its pricing. Further,

because of the unique nature of insurance (e.g., premiums are received now and claims are paid at some future time), there are a number of important technical accounting and actuarial issues that need to be understood regarding reserving and pricing. This type of knowledge currently resides at the state level.

One could argue that the NAIC or National Council of Insurance Legislators (NCOIL) could provide this type of information to the federal government, but there is no real incentive for them to do so unless these organizations think by doing so they can postpone or reduce the likelihood of any eventual federal regulation. Further, having to rely upon other organizations which have their own agendas for the needed insurance expertise has its own costs.

Finally, there is an important issue that may arise depending upon the powers granted to the OII. Because financial markets are international in scope the federal government is often on the forefront of negotiation with other countries about regulation and international cooperation in regulation. By providing negotiators with information about the industry better policy can be made. However, the main point here is not likely information provision to negotiators, but the real possibility of the OII having (or eventually obtaining) the ability to preempt state laws inconsistent with international accords. Many foreign companies (and governments) view state insurance regulation as a barrier to entry (See e.g., Cooke and Skipper, 2009). The OII and the federal government, through preemption, could conceivably dismantle the current system of state regulation.

This would be a piecemeal change of the insurance regulatory system that would likely lead to real disruptions in regulation. However, a top down reexamination of the regulation of

the industry would provide for a more systematic review of the proper role of the federal and/or state regulatory power.

The Role of the State and Federal Governments in the Future of Insurance Regulation.

The future role of states in insurance regulation is in question. There are serious barriers to coordination among the states which prohibit them from being effective regulators on certain issues. There is also a dearth of expertise on insurance at the Federal level. In addition, because of the predominance of nationwide operations, there are potential externalities that can be remedied by a federal approach to regulation. To be fair, there are also potential problems with federal regulation that need to be addressed. State regulation does protect the industry from bad regulation in the sense that if a state were to make a serious error regarding regulation, the negative effects of the error will likely be most felt in the state with the “bad” regulation. In contrast, a mistake at the federal level hurts the entire industry nationwide. Further, merely copying state regulation without thinking about the merits of the regulation is also inefficient. A third and final problem with federal regulation is the possibility that risks that previously were insured in private markets may become more socialized in the sense that federal regulations may reduce the ability of private insurers to set risk based prices.

Conclusion

The policy debate regarding the regulation of insurance concerns the appropriate level of regulation for the industry. Ideally, the appropriate level of government would be the one that would be able to contain all of the benefits and costs of regulation within the state (or federal

level) borders. Further, it is possible solvency and market regulation conduct arguably can be conducted at the federal level at lower cost to society than separate state regulation of these same activities. Evidence suggests there are some economies of scale in these activities and the costs of regulation are spread beyond the borders of a single state.

Insurance regulation needs to move beyond this level of discussion. It is important, but the other aspects of regulatory improvements must not be forgotten. The proposed 2009 version of the OFC bill does address the issue of systemic risk. While this is important to prevent future events like AIG, it is not clear how relevant it is for a supermajority of other insurers. However, if a risk regulator bill is passed, one could predict we would have a better understanding of the relationships between various aspects of the financial service industries. This is a beneficial aspect of the law, but there is still avoidance of real subject matter regulatory reform.

Finally, I am pessimistic about the role for the state in the future of insurance regulation. States have absolutely no ability or incentive to be proactive. At best they are reactive and cannot reach anything like a consensus when one is needed. The perfect example is the inability for every state to integrate its agency licensing system or join an interstate product licensing commission, even in the face of federal preemption of a significant part of regulatory authority. Thus, a state based understanding and appreciation of systemic risk and how it should be treated in a holding company structure is not likely to be implemented on a relatively uniform base any time soon.

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