PREPARED WRITTEN TESTIMONY

OF

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Thank you, Chairman Dodd, Ranking Member Shelby, and members of the Committee for permitting me to testify before you today on regulatory modernization as it relates to the insurance industry.

As the Committee knows, the insurance industry represents an important place in the U.S. framework of financial regulation. As of the first quarter of 2009, the total assets of U.S. life and property-casualty insurers were $5.7 trillion, quite significant when compared with total assets of U.S. commercial banks of $13.9 trillion.[1] Despite being a national (indeed international) industry within the financial sector whose size can be measured in the trillions, insurance—unlike the banking or securities sector—is regulated almost exclusively by each of the 50 states instead of the Federal Government.

This structure comes from a bygone era and, in the wake of the ongoing global financial crisis, must be reconsidered and changed. I believe reform, at least initially, should come by way of establishing an optional federal charter (OFC).

[1] Federal Reserve, Statistical Release Z.1 (June 11, 2009).

My testimony is organized in three parts.[2] Part I addresses the case against the status quo and the need for an OFC. Part II outlines how an OFC regime should be structured, and Part III introduces some additional issues to consider in reforming insurance regulation in the United States.

I. The Need for an Optional Federal Charter

In contrast to other financial services, such as securities and banking, Congress has not sought to exercise either concurrent or preemptive authority over insurers. Indeed, the McCarran-Ferguson Act of 1945 explicitly found state regulation of insurance to be in the public interest and provided that no federal law should "invalidate, impair, or supersede" any state insurance regulation or tax.[3] The net result of congressional abstention has been that more than fifty regulators currently regulate insurance within their jurisdictions. Yet it has not always been assumed that the states should be the exclusive regulators of insurance. There have been numerous proposals for a federal role in insurance regulation since the time of the National Banking Act, which set up the dual-chartering provisions for the banking industry in the 1860s. Indeed, many such proposals have been put forward recently. For example, in April 2009 Representatives Melissa Bean (D-Ill.) and Ed Royce (R-Calif.) introduced H.R. 1880, the National Insurance Consumer Protection Act, which sets forth a scheme for an OFC for life and property-casualty insurers (as well as reinsurers), largely modeled on the National Bank Act of 1864.

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[2] Portions of this testimony are excerpted from my prior work on the subject, namely Martin F. Grace & Hal S. Scott, "An Optional Federal Charter for Insurance: Rationale and Design," in *The Future of Insurance Regulation in the United States* 55-96 (Martin F. Grace & Robert W. Klein, eds. Brookings Press, 2009), and the Committee on Capital Markets Regulation's recent report entitled *The Global Financial Crisis: A Plan for Regulatory Reform* (May 2009).

[3] P.L. 15, March 9, 1945 (codified at 15 U.S.C. §§1101-15).

A. The Case for Abandoning the Status Quo

The status quo is undesirable for at least three reasons: (1) state-based regulation is inefficient; (2) the current system stifles uniformity, innovation, and speed to market; and (3) the fragmented framework puts the insurance industry at a competitive disadvantage with other firms offering the same products. We need to create an OFC to remedy these problems, although I acknowledge the political difficulties of doing so.

1. State-Based Regulation Is Inefficient

The most basic problem with the current framework of multistate regulation is its sheer inefficiency. The precise costs of that inefficiency are somewhat difficult to calculate. A simple cost comparison between current state and federal financial regulatory systems is only partially informative, because each state agency has a slightly different mission. For example, some states expend a great deal of time on rate regulation and issues related to pricing, profitability, and market conduct. Other states have relatively little price regulation but may spend more resources and time on other issues salient to voters in the state.

Scholars and economists that have attempted to quantify the costs associated with multistate regulation agree they are significant. For example, Professor Steven Pottier of the University of Georgia finds that the total additional cost of having multistate regulation of the life insurance industry is about 1.25 percent of net premiums annually.[4] This translates into approximately $5.7 billion each year. While these figures are for the life insurance industry, one would expect similar results for property-liability firms.

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[4] Steven W. Pottier, "State Insurance Regulation of Life Insurers: Implications for Economic Efficiency and Financial Strength," in *Report to the American Council of Life Insurers* (2007).

Like many others, I believe that if a significant portion of insurance regulation was aggregated at the federal level, many of these duplicate costs would be eliminated. The outcome would be lower regulatory costs to the government and lower compliance costs to the regulated firms. For example, every state undertakes regulation of insurance agents. According to Professor Laureen Regan of Temple University, the average life agent has about nine state licenses.[5] This cost is born by the agents, their employers, and their customers. Further, every state licenses the companies operating within its jurisdiction. The average property-liability company holds sixteen state licenses and the average life-health company holds twenty-five.[6] An optional federal charter with one licensing regime could eliminate these multiple layers of cost.

A particular industry or product should be regulated at the jurisdictional level best able to capture all the costs and benefits of regulation within its limits. In layman's terms, the more interstate the business, the stronger the argument is for federal regulation. There was a time in American history when the sale and provisioning of insurance of differing kinds was primarily a local business. But that time has long passed. Based on information available from the National Association of Insurance Commissioners (NAIC), Professor Martin Grace and I calculated that for 2006, out-of-state insurers provided over 80 percent of all insurance in the United States.[7] In certain categories of insurance, the numbers are even more striking. While the in-state market

[5] Laureen Regan, "The Option Federal Charter: Implications for Life Insurance Producers" in *Report to the American Council of Life Insurers* (2007).
[6] National Association of Insurance Commissioners, *Annual Statement* (Kansas City, Mo. 2006).
[7] Martin F. Grace & Hal S. Scott, *supra* note 2 at 61-64.

share for property-liability insurers is 18.13 percent, for life-health insurers the average in-state market share is only 7.52 percent.[8]

2. State-Based Regulation Threatens Uniformity, Innovation, and Speed to Market

Related, but distinct from the inefficiency of multistate regulation, is the potentially negative effect of the status quo on the uniformity of standards and regulations, product innovation, and the speed with which new products enter the marketplace. The promulgation of federal laws and regulations—particularly those with the requisite force to preempt state laws—would, by definition, be uniform throughout the United States. Uniformity not only produces greater cost efficiency but also enables consumers and regulators to monitor the compliance of a particular company or product with a set of standards applied across state boundaries.

Multistate regulation has arguably impeded the ability of the insurance industry to provide consumers with improved products. If products are approved quickly, then firms can compete more efficiently on product innovation and design. However, if products are approved slowly, the incentive for insurers to develop and market new ideas is reduced. The problem is exacerbated if a product is approved in one state with a certain set of conditions and in another state with a different set of conditions, as is presently the case. NAIC's attempts to reduce these costs have not been entirely successful. Most recently, NAIC has tried to improve the process by the formation of the Interstate Insurance Product Regulation Commission (IIPRC) for life insurance, an interstate compact. According to information on the IIPRC, thirty-six states and

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[8] *Id.* at 65.

related jurisdictions were members as of July 2009. However, five large insurance states are missing from the compact: New York, California, Illinois, Florida, and Connecticut.[9]

3. State-Based Regulation Creates Horizontal Inequity with Other Financial Industries

A final point is that the current multistate framework puts the insurance industry at a competitive disadvantage to other financial services firms offering competing products. Non-insurance financial institutions can ask their federal regulators for nationwide approval of a product and receive an answer within a relatively short period of time, compared to the time it takes for insurers to obtain state approval. This provides these other financial institutions a significant advantage over insurers for the marketing of similar products.[10] Furthermore, states are often more restrictive on product offerings than is the federal government. For example, federally regulated financial institutions are permitted to use relatively aggressive hedging strategies, which can reduce their risk, whereas insurers typically are not.[11] The market is quickly and dramatically changing, yet states typically resist allowing insurers to use the strategies commonly used by other financial institutions. It may be that state regulators are apprehensive because they lack the resources to monitor and evaluate these strategies. A federal regulator with better analytical resources could permit life insurers to engage in investment and hedging strategies that would be more appropriate, more efficient, and less risky.

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[9] *See* http://www.insurancecompact.org/. New York, Illinois, and California do have proposed legislation.
[10] Kelly Greene, "Mutual Funds Pitch Alternative to Annuities," *Wall Street Journal*, at D8 (Jun. 9, 2008).
[11] Martin F. Grace, et al, "Insurance Company Failures: Why Do They Cost So Much?" (Washington: American Council of Life Insurers 2007).

B. The Benefits of an OFC

As explained above, the status quo no longer represents an effective means of regulating the U.S. insurance industry. The question thus becomes whether the addition of an optional federal charter[12] will bring more benefits than costs. Although there are costs arising from maintaining regulation at two levels of government, such costs should be more than offset by the efficiencies of the emerging federal system. Some also contend an OFC may lead to reduced consumer protection since state regulators may be more responsive to local complaints due to the political consequences of not doing so. However, the Obama Administration's proposal for the new Consumer Financial Protection Agency, which, as discussed below, should have jurisdiction over federally chartered insurers, may greatly alleviate that concern. Furthermore, an OFC would reduce the negative externalities imposed on out-of-state customers and insurers resulting from the current state-based regulatory system. Finally, the creation of a federal chartering agency would enable greater cooperation in the international arena among the various national insurance regulators. In sum, the need for an OFC is clear, and the ongoing financial crisis presents a compelling reason and an unparalleled opportunity for meaningful reform of U.S. insurance regulation.

II. Design of the Regulator of Federally Chartered Insurance Companies

Apart from possessing the requisite technical expertise, the federal entity created to regulate, supervise, and enforce a new OFC regime will have to be situated within the U.S. financial regulatory structure. There is also an important issue of whether the federal regulator should charter lines of business or firms.

[12] At this time, I do not advocate a mandatory federal charter for all insurance companies, though a mandatory role for the federal government may be necessary with respect to certain large insurance firms. *See* Part III.A.

A. Place in the Regulatory Structure

From a broad perspective, I believe the overall U.S. financial regulatory structure is seriously in need of reform. A rapidly dwindling share of the world's financial markets is supervised under the fragmented, sectoral model still employed by the United States. In May 2009, the Committee on Capital Markets Regulation (CCMR) issued a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform* that called for the U.S. financial system to be overseen by only two, or at most, three independent regulatory bodies: the Federal Reserve, a newly-created independent U.S. Financial Services Authority (USFSA), and possibly another new independent investor/consumer protection agency.[13] I believe this model is the right one to replace our highly fragmented and ineffective regulatory structure.

Under the CCMR approach, the Federal Reserve would retain its exclusive control of monetary policy and its lender of last resort function as part of its key role in ensuring financial stability. In addition, its regulatory power would be enhanced to deal with systemic risk, such as exclusive control of capital, liquidity and margin requirements, as well as payment and clearing and settlement. The USFSA, on the other hand, would regulate all other aspects of the financial system, including market structure, permissible activities, and safety and soundness for all financial institutions (and possibly consumer/investor protection with respect to financial products if this responsibility were lodged within the USFSA). It would comprise all or part of the various existing regulatory agencies, such as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, and the Commodities Futures Trading Commission. For its part, the

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[13] Committee on Capital Markets Regulation, *The Global Financial Crisis: A Plan for Regulatory Reform* 203-210 (May 2009), available at http://www.capmktsreg.org/research.html.

Treasury Department would coordinate the work of the two (or perhaps three) regulatory bodies, and would be responsible for the expenditure of public funds used to provide support to the financial sector.

If the U.S. financial regulatory structure is consolidated and improved as CCMR has recommended, then regulation of federally chartered insurance companies would be shared, as it would be for banks, between the Federal Reserve and the USFSA. The chartering authority itself would reside within the USFSA, which would also have resolution authority over all insolvent institutions, including federally chartered insurance companies. Regulation of insurance would thus be independent of the Executive Branch, insulated to some extent from political pressures while, at the same time, integrated into the overall supervisory framework. The USFSA would work closely with the federal consumer-investor protection regulator—whether it is a division within the USFSA or an independent entity along the lines of what the Obama Administration envisions. If there is to be a federal charter, then federal—rather than state—consumer protection laws should apply to those institutions.[14] Some have opposed an OFC out of concern that consumer protection would be weakened but this need not be the case if a strong, dedicated agency or division of a USFSA were created. Furthermore, if a robust federal consumer protection regulator is created, any regulations promulgated by it should entirely preempt any relevant state laws or regulations. The same should be true with respect to other financial services industries where strong federal consumer protection laws and regulations apply. The need for state enforcement may exist under our current weak federal protection of consumers—a

[14] Note that the Consumer Financial Protection Agency proposed by the Obama Administration does not have consumer protection authority over insurance companies. This makes sense as long as these insurance companies are exclusively state-regulated. Otherwise, there could be irreconcilable conflicts between state safety and soundness and federal consumer protection requirements. To the extent that federal consumer protection requirements overrode state safety and soundness concerns, the states, through state guaranty funds, would have to bear the cost. If insurance companies become federally chartered, however, both safety and soundness and consumer protection regulation could be conducted, and reconciled in some fashion, at the federal level.

need, with its attendant multistate inefficiencies, which would not exist in the presence of strong federal consumer protection.

We must also consider what a federal regulator should look like if the current sectoral regulatory structure remains in place, i.e. if no USFSA-type structure is created. In this respect, it is useful to consider how state insurance regulators are organized and funded. The typical state insurance regulator is constituted as an autonomous agency, formally part of the executive branch, with one chief official appointed by the governor. No state insurance regulator appears to operate through a multimember commission. A minority of states has an elected chief official for insurance, but this structure cannot be constitutionally replicated within the federal administrative structure. Another minority of states brings insurance regulation within another executive department, which is usually devoted either to commerce and consumer affairs or to banking and other financial services. State experience suggests that the federal regulator of insurance should be independent of the executive branch—unlike the recommendation of the Bush Treasury Department's Blueprint which proposed an Office of National Insurance to be part of the Treasury Department.[15]

In addition, the latitude currently given to state insurance departments in the setting and collecting of fees suggests that a federal insurance regulator should be self-funding, at least in part. Self-funding would further enhance the regulator's degree of independence from the political process.

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[15] U.S. Dep't of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* 126-133 (Mar. 2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf.

B. Licensing of Firms or Products

Currently, insurance companies are organized and chartered by the states as life-health companies, as property-liability companies, or as specialty companies such as title insurers. Legally, a life-health insurer can offer various lines or products within its general area, such as term life policies, whole life policies, and annuities. Similarly, a property-casualty insurer may offer personal auto and homeowners, as well as commercial lines like commercial multiperil and workers' compensation. So one insurance firm may be chartered through different companies to conduct different insurance businesses in the same state. Thus, it is common for a number of affiliated insurance companies to belong to a group owned by a parent or holding company.

Some prior proposals, such as the Bush Treasury Department's Blueprint, have contemplated federal chartering by business line, as currently exists among the states.[16] Many have advocated keeping property and casualty insurance at the state level. Thus, for a given insurance holding company or parent firm, some of its companies and products would be chartered and regulated at the federal level and others at the state level. It would therefore be possible for firms to have the choice of being regulated at the federal level for some businesses but not others.[17] I might note that there is a very strong case for a federal licensing option for reinsurance, as this is not a consumer product that directly affects the welfare of the citizens of a

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[16] See U.S. Dep't of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* 129 (Mar. 2008), *available at* http://www.treas.gov/press/releases/reports/Blueprint.pdf ("An OFC should be issued specifying the lines of insurance that each national insurer would be permitted to sell, solicit, negotiate, and underwrite.").

[17] Minimum capitalization requirements vary by line and by state. During the 1990s the National Association of Insurance Commissioners (NAIC) sought to harmonize state regulation by adopting model minimum risk-based capitalization (RBC) requirements for most lines (including life and property-casualty). *See* for example N.Y. Ins. L. sec. 4103; *see* also. Kathleen Ettlinger, et al, *State Insurance Regulation* (Malvern, Pa: Insurance Institute of America 2005). A multistate, multiline insurer generally must meet the greater of its minimum RBC requirements or the minimum capital requirements of each state in which it is licensed to do business. There is no reason that a federal regulator could not promulgate solvency regulations that would be not only equally sensitive to the different risks posed by different product lines but also more uniform.

particular state. Although proposals for the federal chartering of distinct business lines have merit, I do not believe they are optimal.

The cleanest and most efficient solution would be to license firms, rather than sectors, lines, or functions. Indeed, we have no federal historic experience with the licensing of lines of business: the entire national bank or securities firm experience is based on the chartering or licensing of firms, not products. I see no reason to depart from that practice in this context. Indeed, the financial crisis teaches us that one regulator should have authority over an entire firm. It is bad enough to divide responsibility at the federal level for a single firm; it would be even worse to do so as between federal and several state authorities.

An important question related to the operations of the federal regulator is whether it should establish a guaranty fund system similar to those present in many states. These funds are in place to compensate for the losses suffered by third parties and policyholders due to insurance company insolvency. If licensing and regulation of insurance activities were to be conducted at the federal level, for firms choosing federal charters, state guaranty funds would then be at risk for federal regulatory failures. This is the reverse of our past problems with state-chartered banks whose regulation put the federal deposit insurance system at risk. This is an inherently unstable situation.

I recommend simply installing a federal guaranty fund for federally chartered insurers. Such a fund would successfully tie federal regulation to a federal guaranty. There might also be some subsidiary benefits of a federal fund. It would imply uniformity of protection for federally chartered insurers. In addition, if a diverse group of insurers choose to operate under federal charter, then there might be better pooling of risk as compared with state funds, which have a more limited geographic base from which to draw members.

III. Additional Issues to Consider: Mandatory Federal Charter and Capital Requirements

As I hope to have demonstrated above, state-by-state regulation is simply not an effective means of regulating what is truly a complex national industry. What is more, I hope to have established a persuasive case for an optional federal charter. Before I bring my testimony to a close, there are two additional issues I would like to raise for the Committee's consideration.

A. Mandatory Federal Charter for Large Institutions

The above discussion assumes that federal chartering will be optional. However, it may well be that federal regulation, if not chartering, should become mandatory for large insurance companies over a certain asset threshold. Firms that are too big, too interconnected, or too complex to fail impose added costs to the government and, ultimately, the taxpayer in the form of government assistance. These institutions are "systemically important," although I do not recommend that they be so identified *ex ante* and publicly by regulators, in order to minimize moral hazard and avoid an implicit federal guarantee. In addition, such determinations will be difficult to make and could rapidly change for some firms, like hedge funds. In most cases, use of a simple metric like size would avoid these problems.

A traditional insurance company may pose less of a systemic risk than the typical bank for a number of reasons—they have less leverage and interconnectedness. Nevertheless, as the AIG case shows, there are certain large insurers that have a potential for imposing systemic risk on the economy. To date upwards of $150 billion in taxpayer funds have been used in some form or another to bail out AIG. If such firms are to be rescued by the federal government, it seems reasonable to insist that the federal government have supervisory and regulatory powers over such firms. To be sure, AIG was the exception rather than the rule in the insurance industry. AIG's troubles stemmed not from its traditional insurance activities but from the derivative business of its holding company. That said, the key derivative was the credit default swap, which is essentially a type of insurance against the default of a specified firm. The failure of an insurance company to honor either its derivative or insurance obligations could raise systemic risk concerns.

B. Capital Regulation

The final issue—but in many ways the most fundamental of all—is how to establish an effective capital adequacy regime for insurance companies as well as more traditional financial institutions. At the center of the global financial crisis was the complete failure of our regulatory system to ensure that financial institutions maintained sufficient capital cushions. When banks found their individual balance sheets unable to sustain declining asset values, capital firewalls proved inadequate to prevent the contagion from spreading throughout financial markets.

The case of AIG, as noted above, illustrates the potential for insurance companies to suffer similar erosion in their capital bases, which can lead to systemic tremors and government bailouts. A mandatory federal charter for certain large institutions will bring with it federal prudential supervision. But I believe more than supervision is needed for large insurers—they should also be subject to robust capital requirements established by federal regulation in conjunction with those requirements set for other similarly-sized, federally-regulated financial institutions. The overall methodology for setting capital adequacy standards for insurance firms should be different than that used for banks and lending institutions, taking into account the differing nature and risk of the industry.[18] Exactly how to set such capital requirements for

[18] *See* Hal S. Scott ed., *Capital Adequacy Beyond Basel: Banking, Securities, and Insurance* 3-14 (Oxford University Press 2005).

insurance companies—particularly in light of the failure of the existing Basel II framework for banks—is beyond the scope of this hearing but should be an important part of this Committee's agenda.

Thank you and I look forward to answering your questions.