

Insurance Regulatory Reform

On June 17, the Treasury Department released a white paper outlining its proposal for financial services regulatory reform. While the white paper focused primarily on banking-related reforms (including mortgages, credit cards and derivatives), it also proposed the creation of an Office of National Insurance (ONI) within the Treasury Department and laid out a broad framework for insurance regulation to be considered by the ONI, key elements of which include:

- Identifying insurance companies with the potential to pose systemic risk to the economy that should be supervised as Tier I Financial Holding Companies by the Federal Reserve;
- Broadening the regulation of insurance companies to include the financial condition and risks borne by holding companies;
- Increasing national uniformity in insurance regulation through either a federal charter or effective action by the states; and
- Increasing international coordination on insurance regulation.

These proposals are only the opening salvo in what is certain to be a lively and contentious debate on insurance regulatory reform. While Treasury's banking reform proposals are quite prescriptive, its insurance proposals are at best directional, leaving Congress with substantial authority over exactly how they are to be implemented. Some of the proposals, such as the systemic risk regulation role to be assumed by the Federal Reserve, were widely anticipated and likely to meet minimal resistance. Others - the optional federal insurance charter (OFC), for example - stir greater emotion and are likely to be the subject of heated debate.

In this month's *A View from the Bridge*, we examine the perspectives of various interested parties and venture some early opinions as to how insurance regulatory reform is likely to play out.

The Parties and Their Interests

Large P&C Carriers - Large multi-state P&C carriers are most impacted by the current web of state-specific regulations and by and large favor a stronger federal role to impose a degree of homogeneity on the fractious states. While large carriers are far from unanimous in their views, those in favor of a stronger federal role hope that dealing with a single regulator will enable them to leverage their scale into a competitive advantage, particularly over smaller carriers. With a membership consisting predominantly of larger carriers, the AIA advocates an optional federal charter.

Smaller P&C Carriers - Smaller P&C carriers, typically focused on a specific region or just a single state, tend to favor a reformed state-led regulatory system over a federal option. Since they only deal with a limited number of state regulators today, these smaller carriers don't have as much to gain from a single regulatory body as larger carriers who conduct business in many of the 50 states. Additionally, a number of the smaller carriers have invested significant resources (dollars and time) in building relationships with state insurance regulators. Such relationships give them an advantage in their home states - an advantage that would be lost with a single federal regulator. The PCI, whose membership consists mostly of small and medium-sized carriers, is opposed to an OFC. Smaller carriers take comfort from the fact that the Independent Insurance Agents & Brokers of America (IIABA or the Big "I") also supports a state-led regulatory regime.

Life Insurers - While a small versus large carrier split analogous to that in the P&C segment exists among life insurers as well, the position of the life insurance industry is most heavily influenced by the larger carriers who generally support stronger federal oversight of insurance and a possible federal charter. This position was evident in ACLI's favorable response to Treasury's proposal. Over the past two decades, life insurers have expanded aggressively into investment and retirement products, and in doing so, found themselves competing directly with commercial banks, investment banks and asset managers. Dealing with individual state



regulators on new product approvals, life insurers assert, puts them at a competitive disadvantage to financial institutions who require only the approval of a single regulatory body.

Independent Agents and Brokers - Independent agents and brokers are not of one mind on regulatory reform. The Big "I", with its 300,000 members drawn largely from the ranks of independent agents, has a fairly nuanced view of the right regulatory framework. It is strongly opposed to the creation of a standing federal regulatory body but in favor of targeted federal legislation to bring about greater uniformity in the state-led system. High on its list of priorities is a streamlining of agent and broker licensing to deal with the costly and conflicting requirements that are a feature of the existing system. The Council of Insurance Agents and Brokers, representing what it describes as an elite class of commercial brokers and agents, supports creation of an Office of National Insurance as just the first step toward a more prominent federal role in regulating insurance, and has gone as far as to publicly support an optional federal charter.

State Regulators - State insurance regulators, with arguably the most to lose from a stronger federal role, are keen to maintain their existing power bases. Though wrapped in the goal of protecting consumers by ensuring the solvency of underwriters and proper market conduct, the message of state regulators is clear - maintain their role as the primary overseers of the insurance industry. State regulators support modest reforms that do not threaten their leading role - for example, limited federal oversight in cases of systemic risk, creation of a federal insurance database, and producer licensing reform. They adopt the position that an OFC would lead to regulatory arbitrage, an argument strengthened by the elimination of the thrift charter in Treasury's reform proposal. State regulators are a force to be reckoned with, as many are well connected and have political ambitions that go beyond the state department of insurance.

Consumers - Those who have the most to gain from effective reform or to lose from ill-conceived efforts - consumers - want access to high quality, reasonably priced insurance from carriers who will efficiently and fairly adjudicate claims. Most consumers are agnostic on the necessity for insurance regulatory reform, with the possible exception of systemic risk oversight, due to awareness of the need for a federal rescue of AIG. Consumer advocacy groups have largely lobbied for continuation of a state-based regulatory system due to state regulators' historic focus on consumer protection.

Likely Outcomes

In 2009, the Federal Reserve will, in all likelihood, be assigned responsibility for regulating institutions, including insurance companies, with the potential to pose a systemic risk. While this authority is likely to focus more on life than P&C carriers due to the longer duration of their investment portfolios, we anticipate that some large P&C carriers and reinsurers will eventually warrant systemic risk regulation due to their exposure to catastrophic events such as hurricanes, earthquakes and large-scale terrorism (though backstopped by TRIA).

The ONI is likely to be established within Treasury over the same time frame. The ONI will use the threat of an optional federal insurance charter to encourage progress toward greater uniformity and more effective regulation at the state level. Barney Frank, chairman of the House Financial Services Committee, and the Obama administration have both said that an OFC is not in the cards, but it could be resurrected unless the states (potentially assisted by the NAIC) work together to drive sufficient uniformity in state-level regulation. Such a bill is ready to go, in the form of the National Insurance Consumer Protection Act drafted by Reps. Melissa Bean and Ed Royce. Industry and consumer advocacy groups are now weighing in on Treasury's proposal, and the ONI's actual form is just beginning to take shape.

The Trojan horse in Treasury's proposal may be ONI's authority to "enter into international agreements and increase international coordination on insurance regulation." This would give ONI the authority to supersede state-level regulatory authorities whenever international cooperation on insurance regulation is at stake. The threat of such authority at the federal level could on its own inspire state regulators to fight a powerful ONI with all the tools at their disposal.

Let the legislative battle begin.