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CONGRESSIONAL HEARING REPORT

DATE OF HEARING: July 28, 2009

SUBJECT: “Regulatory Modernization: Perspectives on Insurance”

COMMITTEE: Senate Banking, Housing and Urban Affairs Committee

STAFF MEMBER COVERING HEARING: Rebecca Konst

Witnesses

Mr. Travis B. Plunkett - Legislative Director, Consumer Federation of America

Mr. Baird Webel - Specialist in Financial Economics, Congressional Research Service

Professor Hal Scott - Nomura Professor of International Financial Systems, Harvard Law School

Professor Martin Grace - James S. Kemper Professor of Risk Management, Department of Risk Management and Insurance, Georgia State University

Overview

The Senate Banking, Housing, and Urban Affairs Committee held a [hearing](#) today on the “Regulatory Modernization: Perspectives on Insurance.” The hearing focused primarily on the issues of an Optional Federal Charter (OFC), a systemic risk regulator, the proposed Office of National Insurance, and how to deal with “too big to fail” (TBTF) institutions. The members present did not seem to generally take issue with the Administration’s proposed Office of National Insurance and most of the members present agreed that the notion of TBTF needs to be addressed.

Topics discussed at the hearing include but are not limited to: 1) Systemic Risk; 2) Federal Regulation of Insurance / Optional Federal Charter; 3) Pre-emption; 4) Office of National Insurance; 5) Too Big To Fail; 6) Resolution Authority; 7) The Role of the Federal Reserve; 8) CFPA; 9) Derivatives; 10) Capital Requirements; and 11) State Powers.

Chairman Christopher Dodd (D-CT) noted that the Committee held a hearing in March on insurance issues and plans to hold several more. **Senator Dodd** emphasized that Congress needs to protect those consumers and make sure the insurance industry is strong and stays strong. Senator Dodd explained that there is a strong argument for state based

regulation of insurance which has historically operated well but noted that there is also a strong case for change since insurance has become more global.

Ranking Member Shelby (R-AL) noted the bailout of AIG cost American taxpayers \$170 billion, and he claimed that comprehensive insurance regulatory reform “must be part of the reform plan.” He suggested that the Administration’s plan does not go far enough because it would only have federal regulation of systemically important insurance companies and the Office of National Insurance would only collect data. **Senator Shelby** expressed the need to look at: (a) whether the Fed is the appropriate regulator for insurance; (b) whether there should be mandatory or optional federal regulation of insurance; (c) if there is no federal regulation, should there be more coordination between the states; and (d) what regulatory gaps need to be filled.

Questions and Answers

Systemic Risk

Senator Shelby asked how many insurance firms are systemically risky. **Grace** stated that he has not studied this yet because in order to study it there would need to be a definition of what systemically risky actually is.

Senator Shelby asked about looking into what percentage of insurance firms would bring the financial system down. **Grace** stated that he would look to see if there were companies that looked like AIG, but the search would have to go global. He stated that other risks insurance companies undertake could be problematic also.

Senator Shelby asked since most insurance firms are not systemically risky, whether at some point they should be separated. **Grace** explained that NAIC has a “Nationally Significant Company” designation that would serve as a “nice dividing line.” He claimed that these designated companies conduct 50% of the insurance business in the U.S and AIG was one of them. He noted that there were 7,000 insurance companies in the U.S.

Senator Corker (R-TN) asked whether systemic risk is different for life insurance than it is for property or casualty. **Grace** stated that AIG was really a property/casualty firm with some life insurance mixed in.

Senator Corker asked how large a company would need to be to be regulated at the federal level under the OFC. **Scott** noted that the Fed separated out the largest 20 banks so there could be a similar cutoff for insurance companies which would be easier than determining systemic risk.

Senator Corker asked whether all the emphasis placed on systemic risk is misplaced and whether Congress should focus on making sure current regulations are working. **Webel** suggested that too much faith may be placed in systemic risk regulation. **Grace** claimed that there “is little chance that if there was one more regulator watching, that the problems would have been avoided,” reminding the Committee that there were regulators watching AIG but they did not do their job.

Federal Regulation of Insurance Companies/Optional Federal Charter

Senator Dodd, observing that an optional federal charter (OFC) is not the only way to proceed, asked what other options are available. **Grace** stated that there are a number of options, one of which would give the federal government the ability to mandate a federal charter for those companies that are deemed “different” whether because of their systemic risk, size or the global nature of their business. **Scott** stated that the OFC would have a built in provision that required mandatory federal charters for large institutions. He claimed that the mandatory requirement should relate to size and not systemic risk since systemic risk is too difficult to define and constantly changes.

Senator Reed (D-RI) asked whether there should be a federal guarantee fund for the OFC. **Scott** stated that state guarantee funds are fairly successful, and that there should not be federal regulation and a state guarantee funds, suggesting that if there is federal regulation there should be a federal guarantee fund.

Senator Johnson (D-SD) stated that the Treasury reform proposal states that it supports proposals that increase uniformity through either a federal charter or through action by the states. **Plunkett** advocated for keeping consumer protection at the state level and supports the CFPA as a minimum standard basis to regulate credit-based insurance. **Webel** stated that if the goal is uniformity the federal charter is not necessary but some sort of federal action is necessary to push state standards in a certain direction. **Scott** stated that to achieve uniformity there needs to be federal pre-emption but cautioned for this action to only take place if there is a strong consumer protection regulator. **Grace** suggested that a federal charter will do better at increasing uniformity.

Senator Johanns noted that post 9/11 if a topic was boxed as “national security” it was more likely to make it through Congress. He voiced concern that the same is happening with financial regulation reform. **Plunkett** claimed that the OFC and federal pre-emption will not solve all the problems but will bring increase quality with more uniformity. **Scott** stated that the idea of OFC existed before the crisis as a means to increase efficiency and reduce costs. He noted that the mandatory portion of the OFC is intended to reduce risk. **Scott** conceded that these are different concerns but claimed they both involve federal action so they are placed together.

Pre-Emption

Senator Reed asked whether there should be a total pre-emption of state insurance laws. **Scott** stated that there should not be a total pre-emption, for example state Attorney Generals should not be pre-empted. However, for consumer protections, **Scott** advocated for total state pre-emption if there is a strong federal regulation. **Plunkett** stated that there should be prudential regulation at the federal level but claimed that it should not be optional. He stated that the CFPA should stand as minimum requirements for consumer protection on credit related products but if stricter rules are needed then states should be allowed to adopt them.

Office of National Insurance

Senator Dodd asked whether it is fair to assume the Office of National Insurance is a minimum step that needs to be taken. **Webel** stated that there is a lack of information about insurance at the national level. The rest of the panel agreed that the Office of National Insurance is a needed step.

Senator Johnson noted that the Administration's plan calls for an Office of National Insurance, and he asked what is missing from this proposal that would make it more effective. **Plunkett** stated that CFA supports the creation of an Office of National Insurance and even supports the possibility of eventually making this Office into the prudential regulator. He noted the pre-emption power which excludes some state consumer protection functions but advocated that the language should be examined to ensure it is not too broad. **Scott** stated that the Office of National Insurance (ONI) does not go far enough, advocating for a OFC. He argued that if the ONI is enacted it should not be located in the Treasury and should be separate entirely from the executive branch. **Grace** stated that the ONI is a good first step, and further action should not be undertaken until "we see where this goes."

Too Big to Fail

Senator Warner (D-VA) noted many Americans are frustrated with how the government dealt with AIG. He claimed that someone in the federal government should understand insurance and know what to do if an insurance company is in trouble. **Senator Warner** advocated for placing systemic risk into the hands of an independent council which would serve as a check on the prudential regulator. He also advocated for putting a price on getting too big, namely increased capital requirements for companies that grew too big. He asked what other barrier should be placed to prevent TBTF. **Grace** stated that there should be increased costs of holding capital so that companies would not get too big. He claimed it would need to be an "intelligent tax," namely "significantly relevant risk based capital requirements." **Scott** stated that "capital is the first line of defense." However, he noted that the track record is not very good for banks and capital requirements. **Scott** did point out that capital requirements are different for banks than insurance since there are no Basel requirements coming into play. He stated that tying capital requirements to risk might be difficult and asked whether certain activities should be banned.

Both **Senator Shelby and Dodd** voiced the opinion that the "too big to fail" distinction needs to be eliminated because it merely causes more trouble.

Resolution Authority

Senator Warner noted that there is no robust resolution authority in the financial sector and that if a company is failing they should be allowed to fail. He asked what type of resolution authority is needed and whether there should be a pre-funding aspect. **Grace** stated that the issue is complicated because when states deal with a failing insurance company their losses are generally based on policies held in the actual state. He claimed that most states deal with small companies and was not sure what would happen in the case of a large one. **Scott** stated that the Committee on Capital Markets advocated for an extension of the resolution authority so that any federally chartered institution should be subject to the same resolution authority (i.e. a federal mechanism). He also stated that a study should be

conducted on the merits of pre- versus post- resolution funding. **Webel** stated that the lack of a resolution authority is a hole and claimed that “maybe the bankruptcy procedure is not as disruptive as once thought.” **Plunkett** stated that the state guarantee funds might not be able to handle multiple failures at once.

Senator Corker claimed that the Administration’s plan is basically a codification of TARP because it allows the government to use taxpayers money to put a company into receivership and then put it back out into the market later. **Scott** stated that most institutions should be resolved but he warned that the ability to keep a company alive should be woven into any resolution authority so that if a company will have a huge impact on the economy it can be saved. He noted that this authority should be very limited.

The Role of the Federal Reserve

Senator Shelby asked whether the Fed is the appropriate agency to regulate insurance since they have no insurance expertise. **Scott** stated that there is a difference between regulation and supervision, with regulation as making rules and supervision is hands on examination. He claimed that since the Fed has expertise with capital requirements it would be good a dealing with those issues but as far as hands on supervision the Fed should not be involved. **Scott** advocated for a unified prudential regulator (that is not the Fed) that deals with banking, insurance and securities.

Senator Reed claimed that there are two ways that insurance firms get into trouble: through their subsidiaries; or through their own investments. He claimed that the subsidiary issue has been dealt with since the companies will now be considered Financial Holding Companies and will be regulated by the Fed. **Senator Reed** stated that underwriting standards need to be addressed which fall under states powers and asked whether insurance companies without subsidiaries should also fall under the Fed. **Grace** stated that they should if it is beneficial to consumers. He claimed that “plain vanilla” insurance companies do not have the same solvency problems as ones with subsidiaries.

Consumer Financial Protection Agency

Senator Dodd asked what the proper role for the federal government is for consumer protection in insurance. He asked if the government does not take a central role, whether there will be a “gaping hole” in systemic risk regulation. **Plunkett** claimed wariness over giving the federal government power to regulate consumer protection for insurance because the insurance industry has already made claims that they would oppose core aspects of the consumer protection proposal. He claimed that at a minimum the CFPB should have the power to regulate insurance products that are closely tied to credit.

Senator Corker asked whether there should be a different level of consumer protection for life insurance than there should be for property and casualty insurance. **Plunkett** stated that life insurance is more of a national market whereas property and casualty is more regional. He claimed if life insurance is regulated at the federal level there needs to be higher standards. **Plunkett** pointed out that there is greater variance at the state level for property and casualty so it might be preferable to have state regulation.

Derivatives

Senator Shelby asked whether many insurance companies use derivatives. **Scott** stated that most insurance companies do not use them to the extent that AIG did. **Senator Shelby** asked how states could regulate these derivatives in the insurance context. **Scott** stated that states could not regulate derivatives because it is more of an international activity.

Capital Requirements

Senator Shelby pointed out that many companies were engaging in activities without proper capital. **Grace** claimed that the lack of capital requirements was a failure of the NAIC.

Senator Corker asked whether capital requirements should be different for life insurance than those for property and casualty. **Grace** stated that capital requirements for life insurance are different because there are more longer term contracts whereas property and casualty is shorter term. He claimed that even though their risks are based on capital formulas which are different there is no need for two levels of regulation.

Senator Dodd noted that there are different risk assumptions based on the different types of insurance. He asked whether there should be different capital requirements based on the type of insurance. **Scott** stated that the differences between the types of insurance are not large enough to warrant differing treatment. He noted concern that if treatment was different (namely covering one type of insurance under federal regulations and another under state) that it would result in a “splitting up of oversight over a single firm.”

State Powers

Senator Shelby asked whether states could adequately oversee the failure of other large institutions. **Scott** stated that they could not because of the way that states deal with insurance companies, since they can be licensed in multiple states there is no way to deal with one company if it has multiple states that it operates in. He claimed that for firms with “cumulative activities” no state can have an overall view of what is going on when they operate in multiple states.

Senator Dodd noted that states have very different laws. He asked whether for insurance the federal government trying to set rates in different states would raise difficulties. **Webel** stated that states cannot set rates currently. He noted that insurance companies have to operate under different state regimes so there are arguments on both sides since local regulators might understand the needs better but federal regulators should be able to learn.

Excerpts from Witness Testimony:

Mr. Travis B. Plunkett, Legislative Director, Consumer Federation of America

- In order to fully understand and control systemic risk, we believe that the federal government should take over solvency/prudential regulation of insurance.
- A single solvency/prudential regulator with national systemic risk as part of its portfolio is required to eliminate any potential national systemic risk.

- There are significant systemic risk issues associated with certain lines of insurance. Congress should consider creation of a systemic risk regulator for insurance.
- A federal office, similar to the Office of National Insurance proposed by the President, should be a repository of insurance expertise, data collection and analysis, and should also engage in international insurance issues. While a federal insurance office should be knowledgeable about insurance matters to help Congress and the Administration sort through the tremendous complexities of this industry, the office should not be granted vague and open-ended powers of preemption regarding state consumer protection laws or rules in areas that Congress has chosen not to explicitly preempt.
- A federal consumer protection agency with jurisdiction over credit markets should be granted authority to put minimum standards on the books regarding credit-related insurance transactions. The Consumer Financial Protection Agency should also be authorized to study insurance matters that are important to consumers and appear before the states or the courts on behalf of consumers on issues regarding personal lines of insurance, i.e., homeowners and automobile insurance
- The states, being nearer to the people, seem to be more responsive to consumer needs.
- While CFA supports a greater federal insurance role in several targeted areas, we vigorously oppose an optional federal charter (OFC), since such a system cannot control systemic risk, has failed miserably in protecting banking consumers and sets up pressures that can only lead to reduced consumer protections through regulatory arbitrage.
- Believe that the states should continue to handle consumer protection regulation at this time.
- Other Important steps Congress should consider: Repeal of the antitrust exemption in the McCarran-Ferguson Act must be part of any efforts by Congress to reform insurance regulation. Collusion in the pricing of property/casualty insurance should not be allowed in the 21st century. CFA endorses [H.R. 1583](#), the “Insurance Industry Competition Act of 2009,” introduced by Rep. Peter DeFazio.
- As Congress considers creating an Office of National Insurance with knowledge about insurance, it should also either restore the ability of the FTC to study insurance or, if a Consumer Financial Protection Agency is created, grant this authority to the new agency. This would allow the federal government to assist the states in identifying consumer protection issues that have national ramifications.

Mr. Baird Webel, Specialist in Financial Economics, Congressional Research Service

- Options for regulatory reform:
 - Do nothing
 - Create a Federal Office of Insurance Information
 - Harmonization of State Laws Via Federal Preemption
 - Create a Federal systemic risk regulator
 - Create a Federal solvency regulator
 - Establish a Federal insurance charter
 - Completely reform financial services regulatory system

Professor Hal Scott, Nomura Professor of International Financial Systems, Harvard Law School

- Th[e] 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).
- 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.
- [T]he Obama Administration’s proposal for the new Consumer Financial Protection Agency 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 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. I believe this model is the right one to replace our highly fragmented and ineffective regulatory structure.
- I recommend simply installing a federal guaranty fund for federally chartered insurers. Such a fund would successfully tie federal regulation to a federal guaranty.
- 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.

Professor Martin Grace - James S. Kemper Professor of Risk Management, Department of Risk Management and Insurance, Georgia State University

- 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.
- 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.
- 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.

- 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.
- 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.
- A proposed Office of Insurance Information (OII) is an important first step in any role the federal government may have in the future.