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The Economic Crisis and Lessons from (and for) U.S. Insurance Regulation

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
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The Economic Crisis and Lessons from (and for) U.S. Insurance Regulation

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Abstract

Policymakers and scholars are asking what role regulation played in creating the recent financial turmoil, and how the structure of financial services regulation should change to prevent similar financial crises in the future. Policymakers argue the U.S. needs an increased focus on systemic risk and a resolution authority for systemically risky institutions. While the final outcome is still uncertain, it is clear that the structure of U.S. financial services regulation will change. Much of that change will address issues broader than or outside the scope of insurance regulation, but some of it will inevitably interact with insurance regulation. This article summarizes theories that are often used to explain regulatory failure and examines the unique structure of U.S. insurance regulation within the context of those theories.

Introduction

The recent financial turmoil has focused considerable attention on the subject of financial regulation. Policymakers and scholars are asking what role regulation played in creating the problems, and how the structure of financial services regulation should change to prevent similar financial crises in the future. Policymakers argue the U.S. needs an increased focus on systemic risk and a

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resolution authority for systemically risky institutions.¹ While the final outcome is still uncertain, it is clear that the structure of U.S. financial services regulation will change. Much of that change will address issues broader than or outside the scope of insurance regulation, but some of it will inevitably interact with insurance regulation. As is the case with other financial regulators, U.S. insurance regulators are assessing the lessons that can be learned from the performance of U.S. insurance regulation in the current economic environment.

Prior to recent years, the main criticism of the U.S. regulatory system involved the costs of dealing with multiple states. Critics argued that the state regulatory structure was inefficient, and that a single federal regulator would increase national uniformity, avoid the costs of duplicative and overlapping regulation, and provide a single voice for U.S. insurance regulation.² During the 1990s and 2000s, the NAIC and its members worked to increase uniformity, coordination and timeliness in processes such as company licensing, product approval and producer licensing. Efforts were made to increase coordination and consistency in market regulation. Progress has been made, but continued progress is needed.

Recent events serve as a reminder that efficiency is not the only important aspect of financial regulation. In the past two years, there has been a parade of financial regulators admitting they made mistakes in the way they supervised financial institutions and financial markets. The Office of Thrift Supervision (OTS) made a mistake in its supervision of the American International Group (AIG) holding company;³ the Securities and Exchange Commission (SEC) made a mistake when it created the Consolidated Supervised Entity (CSE) program, which relaxed the regulatory capital requirements for investment bank holding companies⁴ and in its supervision of the operations of Bernie Madoff. The failure to regulate credit default swaps may be seen as a massive policy failure that, at a minimum, was embraced by regulators. The financial difficulties of Fannie Mae

1. See, e.g., U.S. Department of the Treasury (2009).

2. See, e.g., Gasper (2002).

3. See, e.g., Polakoff (2009). Although AIG is often described as an insurance group, it is actually a large, complex financial institution with significant insurance operations. Because it owned a thrift, it was subject to holding company supervision by the Office of Thrift Supervision. The U.S. insurance regulators were the functional regulators of the insurance subsidiaries. The problems at AIG occurred largely in its Financial Products (FP) division, a noninsurance operation based out of London. AIG FP had written credit default swaps for European and U.S. banks. When asset prices fell, those banks made collateral calls, and AIG could not meet them. A secondary issue involved the securities lending operation of the life insurance company subsidiaries. The insurance regulators had identified the issue prior to AIG's failure and had been working with the company, with some success, to reduce the securities lending activities and exposure. The FP collateral calls and resulting reputational impact created a run on the securities lending operation that prevented the risk reduction from continuing. While this resulted in some losses at the insurance subsidiaries, the New York State Insurance Department has testified that it would not have rendered them insolvent. For a further discussion of AIG within the context of systemic risk, see Harrington (2009).

4. U.S. Securities and Exchange Commission (2008).

and Freddie Mac have raised questions about the adequacy of their supervision.⁵ The UK Financial Services Authority has concluded that it failed to adequately supervise the financial institutions it regulates.⁶ Banking supervisors around the world have vowed to improve their oversight of liquidity risk and off-balance-sheet vehicles. In the U.S., roughly 150 banks have failed since January 2008, and more are predicted to fail. The failures or bailouts of large institutions—from AIG to Bear Stearns to Lehman Brothers to Fannie Mae and Freddie Mac to Citigroup—have demonstrated the potentially systemic consequences of regulatory failures.

In comparison, the number of failures and bailouts in the insurance sector appear minimal, although even that sector has had its stresses. In particular, some mortgage guaranty and financial guaranty firms have gone into run-off, and some large life insurers were stressed by large accumulations of guarantees in variable annuity contracts.⁷ Securities lending operations in the AIG life insurance subsidiaries suffered losses (see footnote 3), and two life insurers received federal funds under the Treasury's Capital Purchase Program (CPP), a part of the Troubled Asset Relief Program (TARP) (in contrast to over 500 banks). While there are undoubtedly a number of reasons for the relative resilience of the insurance sector when compared to the banking sector (including, for example, business models and culture), differences in regulatory structure likely played a part.⁸

Ultimately, the main test of regulation's success is its effectiveness in achieving its objectives in protecting policyholders, depositors, investors, and the economy generally. The remainder of this article summarizes theories that are often used to explain regulatory failure and examines the unique structure of U.S. insurance regulation within the context of those theories.

5. In Warren Buffett's 2008 letter to shareholders, he opined: "So indecipherable were Freddie and Fannie that their federal regulator, OFHEO, whose more than 100 employees had no job except the oversight of these two institutions, totally missed their cooking of the books." The Housing Economic Recovery Act of 2008 created a new regulatory agency for the government-sponsored entities—the Federal Housing Finance Agency (FHFA).

6. Financial Services Authority (2009).

7. In December 2005, the NAIC adopted a new capital requirement for variable annuities, known as C-3 Phase 2, which addressed the risks embedded in these guarantees. The ability of life insurers to withstand the decline in equity prices in 2008 and 2009 was likely improved by this enhanced capital requirement.

8. It is not an accident, for example, that AIG's credit default swap activities occurred outside the insurance entities. Had these activities been undertaken within the insurance companies, they would have been subject to capital and reserving requirements.

Why Regulation Fails

The simplest explanation for regulatory failure is that regulators are human, and human beings make mistakes. Regulation is fallible, because human beings are fallible. While that is the most obvious explanation, scholars have developed other concepts related to regulatory failure. Two of these concepts are 1) regulatory forbearance and 2) regulatory capture.

Regulatory Forbearance

Regulatory forbearance refers to the failure to take prompt and stringent action in the face of a potentially troubled firm—that is, to delay regulatory intervention. When faced with a potentially troubled firm, regulators have many options and a certain amount of discretion. The future is never certain, and there is always a possibility, however small, that the company could pull through. Shutting down a company is not a pleasant experience, particularly if the company is a major part of the market, part of the community, perhaps politically connected. A failure on the regulator’s watch could negatively affect his or her reputation. If the regulator orders the company to increase capital levels or take other remedial action, the company may object, necessitating a commitment of regulatory resources to resolve the dispute. In short, taking action can be difficult, and there are disincentives to act. Regulatory forbearance is the logical result.

The problem with regulatory forbearance is that a failure to act in a timely manner can increase the ultimate size of the deficit when the institution does fail. When a firm is in danger of failing, there is a tendency to “bet the farm”—i.e., increase risk-taking in an attempt to resolve the problem. This is because the potential gains from the increased risk accrue to the benefit of the owners, while the losses are largely borne by others. (In the case of banks and insurers, losses are borne by the depositors and deposit insurance fund, and by the policyholders and insurance guaranty funds, respectively.) A number of academic studies have empirically confirmed this tendency toward increased risk-taking among troubled institutions, a concept that regulators intuitively understand.⁹ Regulatory

9. After studying almost 250 property/casualty insurers that failed between 1986 and 1999, Grace, Klein, and Phillips (2007) find strong support for the hypothesis that more highly leveraged insurers are more costly to resolve in bankruptcy, supporting the conclusion of increased risk-taking in insurers as capital levels decrease. They also find that guaranty fund losses are higher for insurers where a greater portion of policyholders have guaranty fund coverage.

forbearance has been identified as a major reason for the large losses during the savings and loan crisis of the 1980s and early 1990s.¹⁰

Regulatory Capture

The concept of regulatory capture is closely related to the concept of regulatory forbearance. It refers to the tendency for regulators to take the mindset of an interest group either because of the influence of the interest group or political interference. The typical example of regulatory capture involves capture by the regulated industry. A number of observers have opined that regulatory capture played a role in the current financial crisis.¹¹ The suspicion that the federal banking regulators were captured by the industry they regulate is one of the motivations for the creation of a Consumer Financial Protection Agency (CFPA).¹² Others have pointed to the SEC's dramatic reduction in the capital requirements of

10. The Federal Home Loan Bank Board, the regulator of the savings and loan institutions in the 1980s, responded to the savings and loan crisis by easing regulatory requirements, including minimum capital requirements and regulatory accounting rules. This permitted savings and loans to continue in business and to adopt increasingly risky business strategies in an effort to save themselves, thus increasing the ultimate losses suffered by the insurance fund (Benston and Kaufman, 1997). The savings and loan regulators were not the only ones subject to criticism during this time period. A 1985 staff report of the House Banking Committee criticized the Office of the Comptroller of the Currency's (OCC) and Federal Reserve's supervision of Continental Illinois Bank, which failed in 1984 (FDIC, 1997).

11. According to the World Bank (2009), "There is strong (though anecdotal) evidence that political interference and industry capture compromised the ability of supervisory agencies to take appropriate actions to avoid or minimize the crisis." The World Bank cites the following examples: weak institutional mandates and related resources (such as in the case of the Office of Federal Housing Enterprise Oversight, which supervised Fannie Mae and Freddie Mac); lack of new regulations on rapidly growing financial players and markets (the U.S. Federal Reserve in the case of over-the-counter derivatives); nonintrusive, "arm's length" supervision (the UK Financial Services Authority); loosening of existing regulatory restrictions (the U.S. Securities and Exchange Commission, which relaxed leverage ratio limits for broker-dealers in 2004); and general leniency in the oversight of politically popular financial sector activities (residential mortgage financing, including subprime lending) World Bank (2009). See also, e.g., Raskin (2009) and Kaufmann (2009). Raskin (2009) has argued that regulatory capture becomes more rather than less likely with a consolidated regulatory structure.

12. See, e.g., Keest (2009).

investment bank holding companies as an example of regulatory capture.¹³ The European Shadow Financial Regulators Committee has cautioned that Basel II reflects and promotes regulatory capture.¹⁴

The implications of regulatory fallibility, regulatory forbearance, and regulatory capture are significant for the design of a system of regulation. Any system that relies on the idea of a single omniscient regulator who can scan the market, see the problems, know what to do, and do it, will ultimately fail. The world is too complicated, and regulation is not that perfect. Regulators may fail to identify problems, they may fail to know the solutions, and even if they know what they should do, they may fail to take action. To be effective, a regulatory system needs to be designed with these realities in mind. In this context, the structure of U.S. insurance regulation, including the checks and balances and peer pressure that form essential elements of that structure, may be instructive. Ultimately, the question is, “Who watches the regulators?” In U.S. insurance regulation, the answer is, “The regulators watch each other.”

The Structure of Insurance Regulation in the United States

In the United States, insurance regulation is a state-based system. That is, each state is responsible for regulating the markets in its state. Each state has a chief insurance regulator (variously known as the commissioner, superintendent, or director of insurance) charged with enforcing that state’s regulatory laws.

In 1871, the state regulators established the National Association of Insurance Commissioners (NAIC) to provide a national forum in which to engage in cooperative activity. Through the years, the NAIC has come to play a significant

13. In 2004, the SEC allowed the five largest U.S. investment banks to reduce their capital requirements by enrolling in a voluntary program known as the Consolidated Supervised Entity (CSE) program. Under the CSE program, the SEC supervised broker-dealer holding companies on a consolidated basis, extending supervision to the unregulated affiliates of the broker-dealer and to the holding company itself. To become a CSE, the broker-dealer would apply to the SEC for an exemption from the normal capital rules (known as the net capital rule) and submit to consolidated supervision. Bear Stearns’ leverage ratio subsequently rose to 33-to-1. In March 2008, Bear Stearns, facing imminent collapse, was acquired by JP Morgan with the assistance of the Federal Reserve. Today, none of the five largest investment banks continue to be supervised as investment bank holding companies, having all been either acquired, placed into bankruptcy, or converted to bank holding companies. (Lehman declared bankruptcy, Merrill Lynch was acquired by the Bank of America (and has suffered huge losses), and Goldman Sachs and Morgan Stanley both converted to bank holding companies subject to Federal Reserve oversight.) In September 2008, SEC Chairman Christopher Cox announced the end of the CSE program and new plans for enhancing the oversight of broker-dealer subsidiaries of bank holding companies. See U.S. Securities and Exchange Commission Office of Inspector General (2008).

14. European Shadow Financial Regulatory Committee (2003).

role in insurance regulation in the U.S. Through their NAIC activities, the states coordinate their oversight of the U.S. insurance industry, share data and other information, and develop common solvency tools, reporting requirements, and model laws. As a result of the NAIC's Financial Regulation and Solvency Accreditation Program, solvency regulation is largely uniform in the U.S., and states undergo regular on-site reviews to ensure appropriate implementation of the regulatory framework. As described below, a key strength of the U.S. system is that it has evolved into a system composed of checks and balances that limit regulatory failures. These checks and balances include duplication, peer pressure, and diversity of perspective.

Duplication

The insurance fraud conducted by Martin Frankel during the 1990s provides an example of the value of duplicative regulatory oversight. During the 1990s, Frankel gained control of seven life insurance companies in five states and began to steal money from them. Unfortunately, several state regulators missed the fraud. Fortunately, the Mississippi Insurance Department became suspicious and brought the fraud to light. While insurance regulators clearly made errors, those errors were uncovered because of the duplication that exists in the system. The total amount stolen was approximately \$200 million, and no policyholders lost any funds.¹⁵

There is an important lesson from this series of regulatory failures, particularly when contrasted with the larger regulatory failure in the Bernie Madoff fraud. In that case, a failure by the SEC to detect the fraud permitted it to grow to over \$10 billion. While the emphasis in previous years was often on regulatory efficiency—i.e., streamlining regulation to avoid duplication and overlap—there is a value to duplication and overlap. All regulators make mistakes. The question is *what happens* when the regulator makes a mistake. As Nobel prize-winning economist Joseph Stiglitz stated in testimony before Congress: “It may also be optimal to have duplicative regulatory systems: The costs of a mistake overwhelm the extra costs of regulation.”

It is important, of course, that due consideration be given to the potential costs of duplication and an appropriate level of coordination to eliminate unnecessary costs. Over the years, the NAIC has come to serve that coordinating role in U.S. insurance regulation. Beginning in the 1990s, U.S. insurance regulators have developed a highly coordinated, integrated system of solvency regulation and supervision (in contrast to the way its critics often inaccurately describe it). Approximately 10 years ago, the NAIC designated a lead state regulator for every U.S. insurance group. The lead state regulator is responsible for coordinating with the other regulators on examinations and analysis, and for coordinating regulatory action when it is necessary. The structure is similar to recent international proposals for the creation of supervisory colleges.

15. For a description of the Martin Frankel fraud, see Government Accountability Office (2000).

Peer Review and Peer Pressure

Among the unique features of U.S. insurance regulation are the extensive systems of peer review and multistate oversight that exist today. These include the NAIC's Financial Analysis Division (FAD), Financial Analysis Working Group (FAWG), and the accreditation program.

- The NAIC's FAD is a centralized function that performs ongoing financial analysis of all nationally significant insurers.¹⁶ Any unusual findings are referred to the Financial Analysis Working Group. This analysis is in addition to the analysis conducted by the states themselves.¹⁷
- FAWG is a working group of 16 of the most experienced financial regulators in the system of U.S. insurance regulation. These regulators serve as a forum for collaboration and problem-solving with respect to potentially troubled insurers. Once the FAD or another regulator identifies a company in need of attention, FAWG will review the company, ask questions of the primary regulator, and often invite that regulator in to discuss the company. Those discussions may lead to further requests for information, to additional discussion, and even to recommended regulatory actions.¹⁸

16. The criteria for being considered nationally significant depend on the classification of the insurer. A property/casualty or life/health insurer is designated as nationally significant if its gross premiums (direct plus assumed) are greater than or equal to \$50 million in any of the past three years and it is licensed or writing business in five or more states. A property/casualty insurer is also considered nationally significant if its gross premiums are greater than or equal to \$30 million and it is licensed or writing business in 17 or more states. The percentage of the market covered by the nationally significant insurers is 85.1% for property/casualty insurers and 94.6% for life/health insurers, based on direct premiums written.

17. The NAIC maintains the world's most extensive database of insurance company financial information. The NAIC's central office uses that data, in conjunction with various analysis tools and other public and market-based information, to identify trends, benchmark companies against others, and otherwise identify potentially troubled companies. States also do their own analysis, using the NAIC's financial data, confidential information provided to the regulator, public information, the NAIC analysis tools, and their own internal tools.

18. The need for enhanced peer review processes has been highlighted by the current financial crisis. According to Sir Callum McCarthy (2009), the former chairman of the UK Financial Services Authority, "(A)t present, national supervisors do not challenge each other's decisions often or fiercely enough. ... We need a better process of robust challenge, with an enforcement process that involves at least a strong element of naming and shaming." He has proposed expanding the International Monetary Fund's Financial Sector Assessment Program process and creating formal peer review processes in the European Union. See also de Larosiere (2009): "The present processes and practices for challenging the decisions of a national supervisor have proven to be inadequate. ... The Group believes that an effective means of challenging the decisions of the home regulator is needed. ... Equally, the Group believes that an effective mechanism is needed to allow home supervisors to challenge decisions made by host supervisors." The NAIC's Financial Analysis Working Group process has existed for over 15 years and is a model of a multi-jurisdictional peer review process.

- The NAIC's accreditation program was established in 1990 to promote sound insurance company financial regulation in the states. Under the accreditation program, states undergo an on-site evaluation by an NAIC accreditation team every five years. The team reviews the state's laws and regulations, the financial analysis and financial examination functions, and the state's organizational and personnel practices to assist in determining a state's compliance with the accreditation standards.¹⁹ The evaluation includes a review of a sample of the state's examination and analysis files to determine whether red flags were identified and acted upon. Off-site reviews are conducted annually. In addition to determining whether the state meets the accreditation standards, the accreditation team will provide a management comment letter to the state that contains suggestions for improving its system of financial regulation. These reports are shared with other states, which make the final decision on whether the state's accreditation should be continued.

These processes are mostly collaborative and collegial. But they can also be pointed, and they are places where other states can question a state, encourage continuous improvement, and, if necessary, pressure the domestic regulator to act. The domestic regulator knows that the ability of his or her insurers to do business in other states is dependent on their continuing to be licensed by those states. Furthermore, other regulators could order their own examinations of those insurers. The potential for other regulators to take action provides an incentive for the domestic regulator to be responsive to the concerns of other states. This peer pressure acts as a counterweight to the pressures on the regulator not to act—be it resistance by the company, political pressure in their own state, or anything else. In other words, it counters the problems of regulatory forbearance and regulatory capture.

For the system to gain maximum benefit from the peer review processes, there must be a culture of free-flowing information among supervisors, and a willingness to challenge and to be challenged. This culture does not develop overnight. It takes both incentives and a level of trust among supervisors. There must be a way of checking to make sure supervisors are sharing information as they should, and the accreditation team reviews provide that check. The FAD acts as another check that potentially troubled companies are identified, and the FAWG acts as a forum for other states to challenge the domestic regulators. Regulators that are not satisfied with the level of compliance of the domestic state need to have the ability to react. These multiple mechanisms for peer review work together to provide a coherent structure for coordination and cooperation.

19. For a complete description of the NAIC's accreditation program, see National Association of Insurance Commissioners (2009).

Diversity of Perspective and a Search for Compromise

In regulation, there is a constant need to balance regulatory costs and benefits. Overregulation can impose unnecessary costs on consumers. On the other hand, excessive deregulation can create unnecessary harm to consumers and taxpayers. Where that balance lies is not always easy to determine.²⁰ Because of the multitude of diverse perspectives in the U.S. regulatory system, it is less likely to tend toward the extreme. Rather, the search for compromise tends to produce centrist solutions. Thus, another advantage of the system is that it is highly unlikely that a dogmatic move toward excessive deregulation (or over-regulation) could occur in the state-based system.

Market Discipline and Moral Hazard

An often unnoticed advantage of a state regulatory system is the difficulty it has in accessing federal government funds, which decreases the likelihood of bailouts and the concomitant moral hazard problems that accompany a market expectation of bailouts.²¹ While the increased hurdles to accessing a federal safety net might be a disadvantage from the perspective of insurer management (and also from the perspective of individual regulators seeking to save a company), from the perspective of market discipline, it is clearly a strength. It is this author's personal opinion that, had the U.S. financial guaranty firms been federally regulated, they would likely have been bailed out by the federal government during 2008 or early 2009. Such a step could have introduced into the insurance market the same moral hazard problem that currently exists in banking—a problem that has not existed to date in U.S. insurance markets.²² Instead, U.S. insurance regulators were forced to negotiate settlements with the banks that resulted in the banks taking haircuts on

20. Former Federal Reserve Chairman Alan Greenspan has acknowledged his error in finding the balance: "Those of us who have looked to the self-interest of lending institutions to protect shareholder equity (myself especially) are in a state of shocked disbelief" Scannell and Reddy (2008).

21. While the state guaranty fund system provides a level of protection for individuals and small businesses in the event of insurer insolvency, the coverage is not designed to satisfy the needs of large policyholders.

22. Once unleashed, a "too big to fail" problem is very difficult to correct. Evidence suggests that, in spite of prior attempts to prevent future government bailouts in the banking sector, the problem is getting worse, not better. According to Alessandri and Haldane (2009), "At least over the past century, there is evidence of a ratchet in the scale and scope of state support of the banking system." As described in fn3, the AIG bailout was not precipitated by problems in the insurance subsidiaries. Rather, it was driven largely by the connections between AIG and other large U.S. and European financial institutions that arose through the unregulated Financial Products division. It is questionable whether financial assistance would have been provided had it been an insurance solvency problem. To the extent the market recognizes this distinction, the implications of the AIG bailout for moral hazard in the insurance sector are diminished. For a discussion of the dangers of federal bailouts in insurance and the implications for market discipline, see Harrington (2009).

their claims. This outcome would have been less likely had there been access to a federal safety net, giving the banks an incentive to hold firm for a settlement of 100 cents on the dollar.²³

Lessons from State Insurance Regulation

Prior to the current financial turmoil, there was a distinct trend toward supervisory deference to other countries and other supervisors. Examples include home state supervision under the EU's passport system and the trend toward mutual recognition to eliminate duplicative supervision. To some extent, this trend appears to be reversing, and the emphasis now is on supervisory coordination.²⁴ Proposals for the creation of supervisory colleges for globally significant financial institutions illustrate this new trend. U.S. insurance regulation offers some lessons for how to structure a system that maintains important checks and balances, but has a strong emphasis on coordination.

Building an effective system requires four elements, all aimed at building a system that emphasizes coordination and cooperation. First, regulators must have a level of confidence in each other. To do this, it is helpful to have mechanisms that independently verify regulatory and supervisory effectiveness in each jurisdiction. In U.S. insurance regulation, that is done by the NAIC's accreditation program. Internationally, the IMF's Financial Sector Assessment Program and the proposed G20 peer review process have been proposed for that role.

Second, there must be free sharing of information among supervisors. This is not easy to create, particularly given the tendencies for countries to protect their own domestic industries. This cultural and political barrier to building a globally collaborative supervisory system is likely to be the greatest one. Unless supervisors can reach a level of confidence and trust in each other, treat each other as equals, and be willing to challenge and be challenged, the system cannot meet

23. The case of the financial guaranty insurers, where banks were required to take haircuts, may be contrasted with the resolution outcome in the case of AIG, where the New York Federal Reserve paid the banks 100 cents on the dollar.

24. See, e.g., FSA (2009), p. 37. Speaking of the current structure of the EU passport model, with its reliance on supervision by the home country and limitations on host country authority, Lord Adair Turner wrote: "These current rules and arrangements are untenable for the future and must be changed through some combination of: (1) more European coordination in regulation, supervision and deposit insurance; and (2) more host country national powers in regulating and supervising the branches of banks based in other member states." The De Larosiere Group similarly concluded, "[A]n effective means of challenging the decisions of the home regulator is needed. ... [A] binding mediation mechanism is required to deal with such cross-border supervisory problems" (De Larosiere, 2009). The Level 3 supervisory groups (CEIOPS, CEBS and CESR), which heretofore had largely advisory roles, are being converted to regulatory authorities with significantly broader mandates. These include 1) coordinating the supervisory analyses of financial groups; 2) ensuring consistency in supervisory outcomes across financial groups; 3) participating and eventually mediating in supervisory colleges; 4) supervision of pan-European entities; and 5) developing common training for supervisors (Lannoo 2009).

its objectives. (The same lesson applies to the creation of a system of systemic risk regulation in the U.S.)

Third, there must be the ability for other countries to take action if they are dissatisfied with the actions taken by another supervisor. Ideally, this action would be coordinated and multilateral. Supervisory groups create a structure that facilitates such coordinated action. The important thing is that the threat of multilateral action provides an incentive to the home state supervisor to engage with other supervisors and to respond to their concerns.

Finally, there must be a credible mechanism for resolving situations where the assets are insufficient to fund all of the claims on those assets. The difficulties encountered in resolving Lehman and Fortis demonstrate the limitations in the current level of global cooperation and coordination. Effective cross-border cooperation cannot exist without confidence that resolution mechanisms will be fair to all countries with an interest in the outcome.²⁵

Lessons for State Insurance Regulation

While the relatively strong performance of insurance companies in the current financial crisis testifies to the strengths of the checks and balances in the U.S. system, U.S. regulators have identified targeted areas for further improvement. For example, U.S. insurance regulators are revisiting their reliance on rating agencies in their risk-based capital system, introducing new reporting and other requirements around securities lending, and increasing their attention to the potential impact of unregulated affiliates on the insurance companies.²⁶

Beyond those targeted improvements, there is a constant challenge to continuously improve the efficiency and coordination in the U.S. system. The downside of the checks and balances in the U.S. system is the additional cost of having multiple regulators and making companies deal with multiple regulators with potentially different regulatory standards and processes. In some cases, states' laws and processes differ because they reflect fundamental differences across states in their regulatory philosophy, market issues, or other state-specific considerations. Often, however, they differ simply because they arose independently, without coordination, at a time when insurance markets were more local. In that case, greater uniformity would reduce costs without reducing regulatory effectiveness, but inertia

25. For a discussion of the Lehman and Fortis cases, see Basel Committee on Banking Supervision (2009).

26. Given the diversity of the activities of groups that own insurance companies in the U.S. and the absence of authority over unregulated entities, U.S. insurance regulators have historically ring-fenced insurance companies that are part of a group. The AIG case—where the rating downgrade of the holding company negatively affected the reputation of the subsidiary (but solvent) insurers—highlighted the limitations of ring-fencing. As described earlier, U.S. insurance regulators have established strong mechanisms to coordinate among themselves, but there is a need to better coordinate with other regulators and to otherwise increase the understanding of potential group impacts on the insurance companies.

often prevents that from occurring. U.S. insurance regulators must be ever vigilant about the potential for inefficiency. A fundamental question for U.S. regulators is: “How can we improve efficiency without losing the inherent strength of our checks and balances where they matter?”

Beyond the questions about efficiency, there are issues raised about the system’s ability to interact with those outside U.S. insurance regulation. How can a state-based system present a single voice in Congress, or with its fellow financial regulators in the U.S., or with financial regulators in other countries? How can it present a coherent, coordinated, seamless system to those outside the U.S. insurance world? How can U.S. insurance regulators make it easier for those who aren’t familiar with the structure, but who have to interact with it? In an increasingly global world, these questions gain importance.

U.S. insurance regulation is not a static structure. Over the years, the system has evolved as the marketplace has evolved. At each step, coordination and consistency have increased, but always with an appreciation of the value of diversity and of the checks and balances that exist in the system. A number of improvements have been undertaken over the past 20 years. In the early 1990s, regulators significantly strengthened multi-state processes in solvency regulation. In the late 1990s, they pursued the creation of a national producer licensing system, and much progress has been made. In 2003, they announced the creation of an interstate compact to regulate life insurance and annuity contracts.²⁷ Regulators continue to identify areas in which greater efficiency and effectiveness are possible.

In February 2009, the NAIC adopted a set of principles for a nationwide system of insurance regulation. In those principles, the commissioners acknowledged the need for greater uniformity and reciprocity. They also described five principles that must be met by any national structure that promotes uniformity and reciprocity:

- There should be uniform standards where appropriate, but local or regional standards where necessary.
- States should have the responsibility for setting and enforcing standards.
- State regulators should have equal regulatory standing with other functional regulators when it comes to regulating holding company structures.
- The structure should provide mechanisms for collaboration and interaction with international and financial services regulators on matters that impact the U.S. insurance marketplace.
- The system should not prejudice states’ traditional and long-standing authority to impose taxes and fees.

27. As of August 2009, 36 states had joined the Interstate Insurance Product Regulation Compact. The interstate compact develops product standards that apply in member states and approves products that meet those standards. This enables insurance companies to file life insurance, annuity, disability income, and long-term care insurance products for approval in one place and market those products in multiple states.

Over the past eight months, U.S. insurance regulators have been considering alternative structures that would meet those objectives. While it is too early to know what the recommendation will be, there is intense interest in taking advantage of the current environment for regulatory reform to improve the existing system. It could involve congressional action. It could involve greater engagement with the U.S. Treasury. It could involve a new model for coordination with and among state legislators. Many options are possible. Whatever it is, it will be simply one more step in the ongoing evolution of the U.S. regulatory system, as U.S. insurance regulators continue to search for the optimal balance between the strength of the checks and balances and the elimination of unnecessary costs.

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