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Regulating Insurance After The Crisis

Robert E. Litan

The Initiative on Business and Public Policy provides analytical research and constructive recommendations on public policy issues affecting the business sector in the United States and around the world.

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EXECUTIVE SUMMARY

Despite a long-standing policy debate, insurance remains the only major financial industry not to be regulated at the federal level, a tradition dating from the 19th century. However, recent financial turmoil has fundamentally changed the terms of this important discussion.

Many contend that as opposed to as many 51 separate regulators, a single federal insurance regulator would: allow insurers to pass substantial savings on to their consumers; preempt market distorting state regulation of rates; attract the expert talent needed to supervise the increasingly complex industry products; improve competition between insurers and non-insurance financial institutions for insurance-like products; better position insurers to compete globally and; make national policy with respect to insurer solvency

However, state insurance regulators and some smaller insurers and insurance agents favor the current system, arguing that: they alone have the interest, expertise, and accessibility to consumers to handle best consumer complaints; insurance rates must be subject to oversight if not outright control to protect consumers; and state regulators have moved aggressively in recent years to improve their solvency regulation.

After weighing these arguments, I conclude in this essay that insurers and agents operating in multiple states should have the option to operate under a more streamlined regulatory system, and in particular to choose between being chartered and thus regulated by individual state regulators, or by a new federal insurance regulator. Congress has considered but not yet enacted legislation establishing this "optional federal charter" system, analogous (although not identical) to the regulatory system that has long governed the U.S. banking industry.

Further, the recent financial crisis and associated bail-out of AIG make it is clear that, in addition to the optional federal charter, the government should *require* federal solvency and consumer protection regulation of the largest insurers that are deemed to be "systemically important financial institutions." Clearly, if the federal government is potentially needed as a source of debt or equity funds for certain insurers, there is a strong case for having the federal authorities actively oversee the financial safety and soundness of at least those firms that may benefit from federal, and thus national taxpayer, assistance.

Introduction

As policymakers vigorously attempt to breathe life back into the nation's financial system, attention has also turned to reforming financial regulation so that something like the current crisis never happens again. Given the failure and ongoing record-setting rescue of the holding company of the nation's largest insurance company, AIG, any final reform package that is enacted should also update the nation's antiquated system of state insurance regulation. Insurance is the only major financial industry not to be regulated at the federal level, notwithstanding the fact that competition in many lines of insurance is not only national, but global in nature.

This regulatory anomaly has been increasingly subject to question. In recent years, predating the current crisis, Congress has been considering legislation that would authorize an "optional" federal charter (OFC) for insurers, just as commercial banks have had since national banks were authorized in 1863. The arguments on both sides of the so-called "OFC debate" – which has concentrated on the life and property-casualty insurance industries – are well known. I summarize them briefly below.[1]

But the main point of this essay is that the recent financial turmoil has fundamentally changed the terms of this debate. At this writing, a number of life insurers are under significant financial stress due to heavy losses in their asset portfolios. Although the property-casualty insurance industry is in better financial shape, there is a crisis in coastal America that is most acute in the homeowners' insurance market in the State of Florida. In Florida, a long standing absence of available capital has been exacerbated by local political pressures to suppress insurance rates below market, threatening the bankruptcy of that state's backup homeowner insurance plan. Should that occur, yet another federal bailout could well be in the cards.

Given the clear federal taxpayer exposure to the potential failure of large insurers – or those deemed to be "systemically important financial institutions (SIFIs)" – it is time that a federal regulator oversees all aspects of their operations to assure their continued solvency. Other insurers that choose federal solvency regulation, as under the OFC model, also should be allowed to do so.

In both cases, to provide effective oversight of insurer solvency, federal regulators must also be able to preempt state regulations inconsistent with that objective. In particular, allowing individual states to regulate the rates of insurers whose solvency is regulated by the federal government would create highly perverse incentives: in the name of "helping consumers," states could keep rates below actuarially appropriate levels, knowing that solvency is not their problem, but the federal government's. This outcome not only would tie the hands of federal regulators, but also expose the insurers they regulate as well as their customers to greater risks of insurer insolvency. It would also give insurers put in this position incentives to limit or abandon insurance underwriting in states that choose not to permit market forces to set insurance rates (as they do for virtually all other goods and services sold in our economy). Such an outcome clearly would not be in consumers' interest. For all these reasons, federal solvency oversight of any insurer should preempt state rate regulation.

At the same time, there must be a federal system of consumer protection – one for accepting and quickly resolving complaints – for policy holders of federally regulated insurers. The federal system can easily be funded by assessments on federally chartered insurers. Dividing consumer protection oversight authority between the states and federal government would create more bureaucracy, add additional costs, and reinforce regulatory gaps and inconsistencies.

1. Similar issues exist with respect to the health insurance industry, but I do not consider them here, as they are part of a larger debate over health insurance reform.

The Pros and Cons of a Federal Charter for Insurance

There are many anomalies in America's system of financial regulation, but surely one of the more notable ones is the longstanding regulation of insurers (life, property/casualty, and health) by state governments. The tradition dates from the 19th century and was backed by an 1868 Supreme Court ruling holding that insurance was not commerce and therefore not subject to federal regulation of "interstate commerce."[2] In 1944, the Supreme Court overruled its earlier position on insurance and attempted to end this fiction by declaring insurance to be interstate commerce and, therefore, subject to federal regulation.[3] Congress, however, quickly stepped in to perpetuate the fiction and protect the state regulation of insurance by enacting the McCarran-Ferguson Act of 1945.

State insurance regulation covers the waterfront. State insurance commissioners (some of them elected and others appointed) oversee the solvency of insurers, approve insurance forms, supervise insurers' conduct to protect consumers from unscrupulous practices, oversee the activities of insurance agents, and depending on the state and type of insurance, approve the rates that insurers charge. Each state insurance commissioner in which an insurer does business engages in all of these activities, except for solvency regulation, which is typically delegated to the insurer's state of domicile.

The state system of insurance regulation contrasts with that of banks, which can choose their primary regulator (state or federal), mutual funds (federal), and securities and commodities brokers (primarily federal). Furthermore, whereas the prices charged by these other financial institutions and virtually all other producers of goods and services in the U.S. economy are set by market forces, some states still continue to regulate insurers' premiums, notably for automobiles and residential properties, even though the markets for such insurance are unconcentrated and therefore fundamentally competitive. Indeed, heavy-handed imposition of state price controls can drive insurers out of such markets, as has occurred recently in the Florida homeowners' insurance market.[4]

State regulation of insurance is especially anomalous in light of the national, and for some products global, character of the industry. In each of the major segments of the industry, many providers are active in every state, alongside many other regional and state-specific insurers. Nonetheless, under the state regulatory system, insurers must obtain approvals *from each state* every time they offer a new product, change a form, or change their prices. Agents who sell insurance also must be licensed to do business in each of the states in which they do business.

Some insurers and agents operating in multiple states, understandably, would like at least to have the option to operate under a more streamlined regulatory system. One way this could be accomplished would be to permit insurers to choose between being chartered and thus regulated by individual state regulators, or a new federal insurance regulator. Congress has considered but not yet enacted legislation establishing this OFC system, analogous (although not identical) to the regulatory system that has long governed the U.S. banking industry.[5] (All banks, whether chartered by the states or the federal government, are also supervised for safety and soundness by one of four federal regulators. It is possible, in the wake of the current crisis, that

2. Paul v. Virginia, 75 U.S. 7 Wall. 168 168 (1869).
3. United States v. South-Eastern Underwriters, 322 U.S. 533 (1944).
4. See for example, Liam Pleven, "State Farm Won't Cover Properties in Florida," The Wall Street Journal, January 28, 2009, C1.
5. During the 110th Congress, for example, Senators Sununu and Johnson and Representatives Bean and Royce introduced the "National Insurance Act of 2007," S. 40/H.R. 3200.

Congress will consolidate the number of federal bank regulators).

An alternative way to streamline the current state regulatory system would be to allow the state regulator of the insurer's choosing to act as a national regulator. Such a concept was proposed by former Congressman Richard Baker and Michael Oxley in 2004, in draft legislation called the State Modernization and Regulatory Transparency Act, better known by its acronym the "SMART Act."[6] In effect, this "single passport" system is in place, on a much larger scale, for all financial institutions doing business within the European Union. It is also the model under which corporations are governed. Many, but not all, of the advantages of having a single insurance regulator that I outline shortly would apply to either the federal charter or single passport system. However, for reasons discussed in the next section, I concentrate here on the federal charter model and on an even more far-reaching idea, mandatory federal insurer oversight of at least some large insurers, either of which, in light of recent events, are superior to the single passport approach.

Arguments Favoring a Federal Charter

Academic scholars and various interested parties have identified several advantages of moving to a single insurance regulator, and a federal one in particular:

- Insurers subject to a single regulator would be able to gain approvals for changes in policy language and new products more quickly and at lower cost than is the case under a system which requires regulatory approvals in up to 51 different jurisdictions. Speedier and less costly insurance approvals would permit insurers to respond to consumers needs more expeditiously. Such a system would enable insurers to deliver their products at lower costs, while strengthening competition among insurers, which is also in consumers best interest.

- A federal regulator (or a suitable state regulator under a single passport system) would be able to preempt state regulation of rates, which distorts markets. Contrary to a perception in some quarters that the regulation of insurance rates benefits consumers, the most recent academic research amply documents otherwise. For example, states that have tightly regulated auto insurance rates have not lowered average premiums below what they otherwise would be, while distorting insurance rates for individual classes of consumers, forcing safer drivers to subsidize higher risk drivers. Furthermore, by artificially restraining premiums, state premium controls have caused many more higher-risk drivers in states where these controls are present to obtain their insurance from so-called "residual risk" markets or plans because insurers cannot profitably sell insurance to these drivers at the controlled premiums.[7]

- A federal regulator would be able to realize economies of scale in supervision in a way that no single state regulator, even one as well recognized as the insurance department in the State of New York, can achieve. In particular, a federal regulator is better positioned to attract the kind of sophisticated expertise that is required to oversee the increasingly complex business of insurance. That regulator, in turn, can better spread the cost of its personnel across many insurers than can any single state authority.

6. For a more recent version of this idea, see Henry Butler and Larry Ribstein, "The Single License Solution," Regulation, Vol. 31, No. 4, Winter 2008.
7. David Cummins, editor, *Deregulating Property-Liability Insurance: Restoring Competition and Increasing Market Efficiency* (Washington, D.C.: AEI-Brookings Joint Center on Regulatory Studies, 2002). See also Robert E. Litan and Philip O'Connor, "Consumer Benefits of an Optional Federal Charter: The Case of Auto Insurance", to be published in a forthcoming volume edited by Martin Grace and Robert Klein (Washington, D.C.: Brookings Institution Press and the American Enterprise Institute, 2009). This paper, along with others on the future of insurance regulation that were presented at a conference in July, 2008, is available at www.rmi.gsu.edu/insurance_regulation/rel_papers/conf_papers.html.

- A federal insurance regulator would put insurers on a more level playing field when competing with similar, or even close to identical products and services, which are offered by other financial services firms. Consider, for example, the annuity products offered by life insurers, which compete with bank savings accounts and certificates of deposits, and with mutual funds, or standby letters of credit that compete with surety bonds.[8] The fact that insurance companies must obtain approvals for their products in 51 different jurisdictions not only hampers them in competing with rival companies regulated only by a single authority, but deprives consumers of the benefits of more vigorous competition that greater regulatory parity would permit. Ideally, financial regulation should move in the direction of regulating like or similar products in a like or similar fashion, regardless of which type of entity offers them. The fragmentation of insurance regulation among the states makes this objective virtually impossible to achieve.

- As noted, insurance increasingly is a global business, with some U.S. companies (notably AIG) expanding abroad, and even more significant, many foreign insurers and reinsurers doing business or wanting to do business in the United States. Given the fact that other countries generally regulate insurance at the national level, U.S. insurers wanting to operate abroad therefore have the advantage of needing the approval of only a single foreign regulator. In contrast, foreign insurers doing business here, like their U.S.-based counterparts, must gain approvals from the regulators in each of the states in which they choose to operate. Because insurance regulation is fragmented at the state level with no federal regulatory authority in place, the United States has no federal agency with the interest and expertise to discuss and potentially negotiate insurance regulatory issues with foreign counterparts. A federal insurance regulator would rectify this problem (in a way that even a dominant state regulator, such as New York, under a single passport system would not).

- Finally, a federal regulator is best positioned to make national policy with respect to insurer solvency. In the wake of the financial crisis, the National Association of Insurance Commissioners (NAIC) in early December 2008 appeared receptive to proposals by the life insurance industry to relax state capital and reserve requirements. Whatever the merits of this particular policy idea – there are arguments on both sides – this is precisely the type of decision that should be taken by federal authorities. Although the NAIC's proposals influence state regulatory policy, they do not control it. On matters of such importance as the standards for insurer solvency, federal authorities stand in a better position than any individual state regulator to weigh the consequences of different regimes for the national economy. In particular, one expects federal authorities to take into account the impact of any set of standards on systemic risk. This is not the purview of any individual state regulatory authority, or even the NAIC, which represents the interests of all state insurance regulators, but not necessarily what is most appropriate to preserve the safety and soundness of the nation's overall financial system.

Arguments Against a Federal Charter

The foregoing arguments, up to now, have not been sufficiently persuasive to overcome the opposition to an OFC, which understandably comes from state regulators and, perhaps less obviously, from many smaller insurers and insurance agents. Several arguments have been advanced to support the state system:

8. This point has been frequently and well articulated by Peter Wallison. See his "Competitive Equity: An Optional Federal Charter for Insurance Companies," American Enterprise Institute, March 2006 (at www.aei.org).

- A federal regulator, or a single regulator from another state under a single passport system, might not have the same interest, expertise, and accessibility to consumers to handle consumer complaints as expeditiously and with as much interest and concern as is true under the current state system.

- A related concern, voiced by some consumer groups and a number of insurance commissioners, is that insurance rates must be subject to oversight if not outright control to protect consumers.

- State regulators, represented ably by the NAIC, have not been unmindful of the frictions that multiple state approvals cause for insurers and thus insurance markets more broadly. In particular, the NAIC announced an "action plan" in 2000 to bring greater uniformity to state regulation.[9]

- The NAIC has also taken steps since Congressional concerns were voiced in the 1980s and early 1990s about the adequacy of state regulation of insurer solvency to improve state solvency regulation. Thereafter the NAIC established an accreditation program to confirm that each of the states had the resources, legal authority, and appropriate standards (notably risk-based capital standards, modeled on similar standards that had been developed internationally for banks) to adequately regulate insurer solvency. Currently, all states and the District of Columbia, with the exception of New York (which has not passed one of the NAIC's model laws), have received this accreditation.[10]

Evaluation

I believe that the arguments opposing an OFC for insurers lack foundation, or collectively are outweighed by the benefits of a federal charter.

Perhaps the weakest argument is that state regulation of insurance rates remains necessary. There is no theoretical or empirical basis for this position. As already noted, insurance markets are structurally competitive and do not display the kind of concentration that would warrant price controls.

The most recent comprehensive study of insurance rate regulation to date dispels the notion that such regulation has benefited consumers.[11] I have confirmed this finding in a forthcoming paper that, among other things, finds that strict rate regulation tends to force higher risk auto insurance consumers to buy coverage from "residual" or "last resort" mechanisms typically at less-than-actuarially-appropriate rates that fail to discourage these higher-risk drives from driving more safely. This outcome leads to higher overall auto claims.[12]

Two states that have moved away from strict price controls over auto insurance premiums are New Jersey and South Carolina. Their experience demonstrates that consumers have not been harmed in the process, as perhaps some may have feared. To the contrary, consumers in both states generally have benefited.

The popular perception that tight regulation of auto insurance rates in California has benefited consumers in that state also is misplaced. On closer inspection, California rates stayed low initially for several years after rate regulation was tightened, largely because of safety improvements and changes in

9. National Association of Insurance Comissioners. "A Reinforced Commitment: Insurance Regulatory Modernization Action Plan." (Sept 2003). http://www.naic.org/documents/ topics_regulatory_modernization_plan.pdf
10. Department of the Treasury, *Blueprint for a Modernized Financial Regulatory Structure* (2008), p. 65.
11. Cummins (2002).
12. One recent study estimates that, as a result, auto insurance losses are 44 percent higher than what would be expected based on Massachusetts' demographic composition and its liability coverage. Richard Derrig and Sharon Tennyson, 2008, "The Impact of Rate Regulation on Claims: Evidence from Massachusetts Automobile Insurance," at http://ssrn.com/abstract=1115377.

the liability system, which meant rates should have declined in any event. Because any rates, whether higher or lower, required prior regulatory approval under Proposition 103, the California law actually had the effect of discouraging insurers from reducing rates to match declining claims costs. *If California instead had maintained its prior open, competitive market, auto insurance rates would have been even lower than they actually were.*[13]

Indeed, state insurance rate controls not only distort markets, but also can lead to financial peril. A classic, timely example is what has been happening to the Florida homeowners' insurance market, where record hurricane losses in 2004 and 2005 led insurers and leading catastrophe modelers to substantially increase their estimates for future losses and thus the need for premium increases. The state's regulators, however, have not allowed market forces to work, and have denied insurers' proposed rate increases. Many insurers have thus curtailed coverage and the state's largest homeowner carrier, State Farm, has announced that it will be halting all such coverage. As a result, the state-owned insurer, Citizens Property, has become the largest homeowner insurer (of last resort). But with subsidized rates at below market-clearing levels, Citizens is a financial disaster waiting to happen – when the next large hurricanes strike the state and exhaust Citizens' reserves and its reinsurance layer. Calls for a future federal rescue of Citizens will be inevitable.

Meanwhile, at a more mundane level, the work by the NAIC to harmonize different states' licensing rules and policy reforms remains very much a work in progress. The NAIC has been working toward uniformity since its creation in 1871. The NAIC's 2000 "action plan" was much too limited in scope (covering only the life insurance approval process), and even then it has not achieved uniformity. Moreover, the NAIC's efforts fundamentally do not change the fact that insurers operating in multiple states still must obtain approvals in each of the states any time they wish to offer a new product. Even with the best of intentions, the NAIC cannot realistically achieve uniformity because that would require uniform action by 50 state legislatures.

Finally, state regulators are not the only entities capable of addressing consumers' concerns. The Federal government has already risked $150 billion in taxpayers' money to address one insurer's threatened insolvency and could pledge additional tax dollars to prevent other insurers from failing. For a tiny fraction of this cost it could construct a gold plated insurance consumer assistance and complaint resolution operation, one that could easily be funded through fees paid by federally chartered companies and their sales forces, as outlined further below.

13. See both Cummins (2002) and Litan and O'Connor (2009).

The Financial Crisis and the Case for Federal Regulation of Some Insurers

Whatever one may think of the relative merits of an OFC for insurers, the subprime mortgage-generated financial crisis has and certainly should have fundamentally changed the nature of the debate, which so far has focused only on issues of efficiency in regulation and states' rights. For the reasons I now outline, I believe the weight of the argument has now shifted. In particular, whereas the focus of the debate up until now has been on whether insurers should have the *option* to be regulated at the federal level, the key challenge post-crisis is to implement a modernized, more effective system of insurance regulation. That system, in my view, should entail *compulsory* federal solvency and consumer protection regulation of the largest insurers that are deemed to be SIFIs, as discussed further below. Federal regulation should remain optional for other insurers. The current state system of insurance regulation should remain intact for insurers, agencies and producers that do not select the federal option.

Here are some other features of federal regulation that should apply:

Universality: Federal chartering and regulation should apply to all lines of insurance and reinsurance, other than health insurance, and should accommodate all corporate forms (i.e., stock, mutual, risk-exchange and fraternal companies).

Independence: The chartering, regulatory and supervisory authority for federal insurers, agencies and producers should be conducted by an office with sufficient independence, such as a bureau within the Treasury Department that operates independently like the Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision (OTS), or through a new financial solvency regulator.

Robust, Uniform and Exclusive Consumer Protection: Federally chartered insurers, agencies and producers should be subject to strong, uniform and exclusively federal consumer protection standards that ensure that consumers are treated fairly in all phases of an insurance transaction. The federal insurance chartering authority also should establish regional offices and comprehensive procedures for accepting and addressing consumer complaints.

Holding Company Regulation and Supervision: The federal chartering authority for federal insurers and federal agencies should have comprehensive power to supervise and regulate insurance holding companies and other affiliates of an insurer, brokerage or agency to ensure that holding companies and other affiliates do not jeopardize the solvency and integrity of federal insurers and brokers and agencies.

Rate and Form Regulation: Federally chartered insurers should be subject to a prior notice process for addressing policy forms, which does not delay the development and marketing of new products for consumers. Federal law should rely upon competitive market forces to establish premium rates for all forms of insurance.

BOX 1:

Implications of Bond Insurer Financial Difficulties for Federal Regulation

The recent financial troubles of the major previously "monoline" bond insurers reflects a failing of state regulation as well. For decades, there was little to question the financial soundness of the monolines, which concentrated primarily if not exclusively on insuring municipal bonds. In effect, the monolines were able to "rent" their AAA ratings and implicit endorsement of soundness by their state regulator to municipalities by charging them a premium for bearing the risk that their bonds might default. Currently, $2.3 trillion of municipal securities (about half of all "municipals" outstanding) are insured.

But in recent years, in their quest for larger profits from new markets, the monolines began insuring complex mortgage securities, including those backed at least in part by subprime mortgages. The insurers' near fatal mistake – as well as that of their state regulator – was to under-price the risk. In contrast to municipal bonds, as to which the insurers had decades of repayment experience in both good times and bad, the vast proportion of subprime-backed securities were issued, and insured, only during the past few years, a period of economic recovery. Thus, when subprime delinquencies began soaring in 2007, the monolines were surprised to find how heavily exposed they were to losses, and thus began facing a series of credit downgrades from the credit rating agencies (who had also badly miscalculated the risks of the securities).

If the monolines' ratings problems had been confined to their mortgage securities business, at least the damage to them and to the market would have been somewhat contained. But the financial danger faced by the monolines has spilled over into the municipal bond market, and thereby exposes state and local governments throughout the country to the risk of not being able to issue new bonds to finance their capital projects.

The one silver lining in all this is that the barriers to the formation of new municipal bond insurers are reasonably modest. Indeed, two new insurers have gone into the business in just the past year. Yet it still takes time for new entrants to attract the capital and thus the capacity to fill any void that might be left if one or more the exiting monolines were to fail. This is one of the reasons that Treasury at some point could be asked by various institutional investors and state and local governments to use some of the funds in the TARP to purchase municipal bonds, and why the Department could be asked to make equity investments in the bond insurers themselves.

Rationale For A New Regulatory Framework For The Insurance Industry

Clearly, the most important developments driving the recommendation to establish a system of mandatory federal regulation for systemically important insurers and optional federal regulation for other insurers are the recent bailouts undertaken or contemplated by the federal government of certain major insurers. In mid-September, the Federal Reserve felt it necessary to lend not once but twice to AIG to keep the world's largest property-casualty insurance conglomerate afloat. The Fed has recently also given AIG access to its new facility supporting the commercial paper market. In November, the Fed reworked its original rescue of AIG, pushing up the government's investment to a staggering $150 billion. At this writing, it is impossible for outsiders (maybe even insiders) to know how much more government assistance for AIG may be required.

In late October 2008, meanwhile, the Treasury Department took the surprising step of announcing that it was considering making equity injections from its Troubled Asset Repurchase Program (TARP) into a number of major life insurers, and that the insurers seemed amenable to partial government ownership. The Obama Administration's new Treasury Secretary, Timothy Geithner, has taken a different view, rejecting the idea of TARP capital infusions into life insurers at this point given the absence of a federal insurance regulator that could "stress test" such institutions. But Geithner also has indicated that the collapse of AIG, among other factors, has prompted the Administration to seriously consider federal charter proposals for the insurance industry.

Clearly, if the federal government is potentially needed as a source of debt or equity funds for certain insurers, there is a strong case for having the federal authorities actively oversee the financial safety and soundness of at least those firms that could benefit from federal, and thus national taxpayer, assistance. This transforms the debate over whether to allow insurers to *choose* their regulator (state or federal), and moves it to what criteria (discussed below) should be used to decide which insurance firms *must* be regulated by a federal supervisory authority.

Federal charter opponents have countered that the notion of federal regulation of insurers has been somehow discredited by the failures of bank regulators to have prevented so many banks from taking excessive risks, as well as by the apparent inability of the federal OTS, as the regulator of AIG's parent company, to have prevented the reckless sale of more than $400 billion in credit default swaps (CDS) which put the entire enterprise at risk.

These arguments are more than offset, in my view, by two other compelling considerations. One is that state regulators can act in ways that threaten the interests of federal taxpayers, as came close to happening in the AIG matter. Shortly before the Fed came to AIG's rescue, New York's Governor was putting pressure on the state's insurance department (which may have been equally willing to comply) to approve a $20 billion "bridge" loan from AIG's regulated insurers to the company's parent to help cover any liquidity shortfalls due to the parent's exposure to risk from writing an excessive amount of CDS contracts. Not only would such a loan have put the insurer and its customers at risk, but it was massively insufficient: the Fed not only had to come up with $87 billion in the initial rescue loan, but only several days later felt compelled to loan the company another $37.5 billion. This sequence of events underscores how federal intervention rescued not only AIG but also how the state regulator otherwise would have jeopardized the solvency of the insurers under its direct supervision.

Furthermore, recent disclosures about the risks of AIG's insurance operations – apart from its CDS activities – highlight critical failings in state insurance regulation. In particular, AIG ramped up over a nine year period a program of loaning securities in its insurance and retirement services subsidiaries to banks and broker-dealers, and invested the cash or collateral received for the loans increasingly in subprime securities. At its peak, the securities lending program grew to $94 billion. When the subprime mortgage crisis hit, AIG began to suffer mounting losses on the subprime securities it had bought, losses which have contributed to the rising cost of the federal bailout.

In short, recent events have made it unnecessary to resolve the seemingly never-ending debate over which level of government (state or federal) does a "better" job of regulating. If the federal government is to have a financial stake in the performance of certain insurers or financial instruments they may insure – which is now clearly the case – then it is axiomatic that some federal authority must have a say in how the financial condition of those entities is monitored and protected.

Federal Regulation and the Way Forward

In a separate essay, "Fixing Finance: A Roadmap for Financial Reform," I have outlined with Martin Baily a comprehensive set of financial reform suggestions.[14] At the heart of those recommendations are the SIFIs: the notion that any large financial institution that poses significant "systemic risk" – and thus the likelihood that federal aid to some creditors will be required if the institution is threatened with failure – requires solvency regulation by the federal government. This idea is not ours alone. It has been endorsed in recent reports by the Group of Thirty and by the Congressional Oversight Panel created in October 2008 to oversee the Troubled Asset Repurchase Program.[15]

To be sure, a federal solvency regulator – perhaps a separate "systemic risk" regulator – must define which firms, including large insurers, qualify as SIFIs, using such criteria as size, leverage, and degree of interconnection with the rest of the financial institution. This job admittedly will be a difficult one, but recent events have given the government no other choice. Meanwhile, as noted earlier, other insurers not qualifying as SIFIs should have the option to be federally regulated.

Federally-regulated insurers must also be held to strong federal consumer protections, which should supplant or preempt existing state protections. Ideally, as argued in "Fixing Finance," a separate federal agency, charged with overseeing consumer protection for all financial institutions, would oversee consumer protection for insurance purchased from federally regulated insurers. Alternatively, if insurance is to be regulated by a separate federal insurance regulatory body, that agency would enforce consumer rules. In either case, the agency charged with consumer protection should have state and regional offices, and establish comprehensive procedures for accepting and addressing consumer complaints.

For reasons that already should be clear, federal regulation should preempt state regulation of prices and forms. It would hurt consumers, and indeed could be financially dangerous, to allow the federal regulatory authority only to oversee an insurer's financial soundness while permitting the states to regulate the fundamental ways insurers do business. This kind of arrangement literally could invite states to impose costs on insurers, either in the form of constraining their rates or the policies and services they offer, knowing that some other authority, namely the federal regulator, is responsible for ensuring that the insurers remain viable, or if they fail, that the federal government (and thus taxpayers) could bear the costs of picking up the pieces.

Furthermore, where states constrain rates to be less than anticipated losses and a reasonable allowance for profit, insurers will have strong incentives to limit or abandon their underwriting in those states, as has recently occurred in Florida. This would reduce competition in those insurance markets, to the detriment of consumers living in the affected states. As already noted, given the competitive structures of both the life and property-casualty insurance industries, states can avoid these undesirable outcomes by allowing markets and competition to set rates, as they do for prices in virtually all other spheres of our economy.

14. Robert E. Litan and Martin Neil Baily, "Fixing Finance: A Roadmap for Reform," The Initiative on Business and Public Policy at Brookings' *Fixing Finance Series*, 2009-01, February 17, 2009. Available at http://www.brookings.edu/papers/2009/0217_finance_baily_litan.aspx
15. See Group of Thirty. "Financial Reform: A Framework for Financial Stability" (Washington D.C., Jan 2009) and Congressional Oversight Panel, "Special Report on Regulatory Reform" (Washington, D.C., Jan 2009).

Finally, a remaining question is how best to protect policy holders from insurer insolvencies. There is a strong argument for retaining the individual state guaranty funds, which generally protect policy holders of failed insurers for claims up to $300,000, even for federally regulated insurers. The state guaranty system has proved effective so far. There is no reason why it couldn't continue to be effective.

Nonetheless, federal policymakers may want to establish for policyholders of federally regulated insurers only a separate federal insurance guaranty fund operated in much the same way in which the state funds now operate (by assessing healthy insurers the cost of making good on guarantees of failed insurers, after the fact). In considering that option, however, policy makers must weigh the possibility that without large, systemically important insurers in the state systems, the state funds and/or the federal fund (even with ex post assessment system) may be unable to honor their commitments under extreme circumstances. If this risk is deemed sufficiently great, then retaining the current state guaranty system may be the preferred option.

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