Washington Update: Solving the Nation's Financial Mess

Do We Shoot the Pirates or Just Rearrange the Deck Chairs on the Titanic?

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Systemic Risk: The 800 Pound Gorilla

- Congressional leaders and the Obama Administration have made it clear that they intend to move legislation dealing with systemic risk in the nation’s financial markets.

- Although there is no universally agreed-upon definition of “systemic risk,” most in Congress seem to be in general agreement with the definition set out by NAIC CEO Terri Vaughan in her March, 2009 testimony before the House Financial Services Committee’s Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises.

- Dr. Vaughan testified “that an entity poses systemic risk when that entity’s activities have the ability to ripple through the broader financial system and trigger problems for other counterparties, such that extraordinary action is necessary to mitigate it.”

- Or, as the Government Accountability Office (GAO) put it in a recent report, systemic risk is “the risk that an event could broadly affect the entire financial system rather than just one or a few institutions.”

- Dr. Vaughan testified, and state insurance regulators have stressed repeatedly, that the insurance industry in general does not pose a systemic risk to the nation's financial markets to the extent we have seen in the banking and securities sectors.

- Insurance companies are more often the receivers or conduit of risk than the creators, since assumption of risk is their fundamental business.

The AIG Example

- Insurers’ exposure to systemic risk typically flows from linkages to the capital markets.

- A classic example is AIG, where the unregulated credit default swap (CDS) transactions impaired the holding company, resulting in a downgrade that has threatened policyholders’ confidence in the otherwise stable insurance subsidiaries.

- AIG’s insurance companies were also directly exposed to systemic risk through securities lending partnerships with other financial institutions.

- That resulted in a liquidity crunch when a massive deterioration in the value of traditionally conservative, fixed income securities resulted in AIG’s counterparties all attempting to exit the marketplace at roughly the same time.

- No company or regulator operates so conservatively as to withstand such a “run on the bank” scenario.

- What financial stability regulation can – and should – do is ensure that such scenarios are identified and mitigated at the outset before they become systemic.

Systemic Risk vs. Risk of Large Failures: Two Different Animals

- Risk of a large failure and systemic risk are not one in the same, and insurance can illustrate this difference.

- Most lines of insurance have numerous market participants and ample capacity to absorb the failure of even the biggest market participant.

- If the largest auto insurer in the U.S. were to fail, its policyholders would be quickly absorbed by other insurers.

- Policyholders would be further protected by the state guaranty fund system.

- This scenario would not pose systemic risk. The impact is isolated, does not ripple to other financial sectors and does not require extraordinary intervention to mitigate.

- We have urged Congress that any financial regulatory reform package it attempts to move should focus on truly systemic risk, and not create redundant mechanisms for dealing with isolated disruptions.

The OFC Myth: Trying Again to Make the Ghost Disappear

- Supporters of an optional federal charter (OFC) for insurers have not missed the opportunity to try and jump on a moving train.

- Seeing the probability of some type of systemic risk regulation being enacted, they have pulled out their well-worn arguments from past unsuccessful efforts and tried to apply them to the current financial crisis.

- They have attempted to use the AIG situation as a new clarion call for federal intervention in the insurance markets.

- That is in spite of the fact that AIG’s problems were **not** in its insurance subsidiaries, did **not** involve insurance products and were **not** subject to state insurance regulation.

- Congresswoman Melissa Bean (D-IL) and Congressman Ed Royce (R-CA) have reintroduced their OFC bill from the last Congress.

- This time, they have given the bill, H.R. 1880, the curious name the “National Insurance Consumer Protection Act.”

- It’s anything but.

- They have added a mysterious “systemic risk regulator” for insurers, with broad regulatory and enforcement powers.

- In an attempt to counteract the bill’s deregulatory bent, they would put a Division of Consumer Affairs in every state, thereby setting up a redundant and confusing mechanism for policyholders and claimants to get their problems and complaints resolved.

- But putting lipstick on this pig won’t make it smell any better.

- Sticking a proposal to allow insurers to choose **less** regulation, and choose who their regulator will be, into a package that is intended to provide **more** stability to the nation’s financial markets, and more comfort for consumers nationwide, is exactly the wrong way to go.

- That has been, and will continue to be, the NAIC’s consistent message to Congress and the Administration

More on the Plate: Other Legislation

- Nothing is easy on Capitol Hill, and nothing is more palpable than the tension between the House and Senate.

- As my old boss, former Ohio Republican Congressman Mike Oxley, was fond of saying (not his original quote, I am quite sure): "The Democrats are our **opposition**. The Senate is the **enemy**!"

- House Financial Services Committee Chairman Barney Frank (D-MA) has expressed his desire to move quickly on systemic risk regulation, then fill in with other financial legislation as events warrant.

- Senate Banking Committee Chairman Chris Dodd, on the other hand, sees his Committee getting “one bite at the apple” in addressing the nation’s financial crisis, and has recommended a go-slow, comprehensive approach that would reorganize the entire spectrum of financial services.

But Wait – There's More!

- Other financial services related legislation is percolating, with some bills having been introduced and some measures existing only in proposal form.

- The Treasury Department has set out a comprehensive proposal it calls the "**Resolution Authority for Systemically Significant Financial Companies Act of 2009,**" which would create a federal systemic risk regulator for certain firms based on "the financial system's interdependence with the firm, the firm's size, leverage (including off-balance sheet exposures) and degree of reliance on short-term funding."

- The systemic risk regulator would have authority to put such firms into conservatorship and receivership and provide “a prompt, corrective action regime that would allow the regulator to force protective actions as regulatory capital levels decline, similar to that of the FDIC with respect to its covered agencies.”

- The institutions to be covered under such authority would be “financial institutions that have the potential to pose systemic risks to our economy but that are not currently subject to the resolution authority of the FDIC.”

- The most likely candidate to assume this new systemic risk regulatory authority appears to be the Federal Reserve, although some have raised objections or warning flags about implementing such a fundamental change in the Fed’s traditional monetary policy role.

The OFC Phantom Rears Its Ugly Head

- Although there is no specific language on the matter in the Treasury’s proposal, Secretary Geithner, in his testimony laying out the Administration’s plan before the House Financial Services Committee, was asked how insurance should be treated under a revamped regulatory scheme.

- Consistent with the views of his predecessor in the Bush Administration, Henry Paulson, Geithner replied that “there’s a very good case for optional federal charter legislation to be introduced.”

“Information Please!” – Office of Insurance Information

- The Secretary also expressed support for quickly establishing an Office of Insurance Information (OII) to create more insurance expertise in the Treasury Department.

- NAIC endorsed the OII concept in the last Congress, after working with its sponsor, Capital Markets Subcommittee Chairman Paul Kanjorski (D-PA) and his staff to narrow the bill’s preemption provisions and ensure that it created no regulatory authority within Treasury.

The Fed Weighs In

- The Federal Reserve Board has recently weighed in with its own resolution authority proposal.

- The Fed's proposal applies only to "financial companies," which include insurance holding companies but <u>**not**</u> subsidiary insurers.

- The definition also appears to exclude operating insurance companies that are themselves holding companies.

- Insurance holding companies that are not operating insurers would be subject to resolution if they are systemically risky and in danger of default.

- Whether such holding companies are "systemically risky" would be determined by a series of suggested measurements, one of which would be $25 billion or more in assets.

- Treasury would select which federal agency would act as the conservator or receiver for an insurance holding company.

- The Fed proposal does not appear to enable the federal agency to drain assets from an insurance subsidiary.

- The agency would have the power to make loans or buy debt, purchase assets, assume or guarantee obligations or acquire equity interest in the holding company, a bridge financial company **<u>or any subsidiary</u>** (which would appear to include insurance subsidiaries).

- The federal agency would be able to terminate “burdensome contracts” to protect against punitive damages or damages for pain and suffering resulting from termination of the contracts.

- Compensatory damages would be allowed.

- A pre-funding mechanism (the "Systemic Resolution Trust Fund") would be set up to pay for "short-term funding of a covered financial company."

- The Trust Fund would then be authorized to borrow from the Treasury "such funds as are required to permit the orderly resolution of one or more covered financial companies."

- Assessments necessary to pre-fund the Trust fund or to pay off the long-term debt would be imposed on “financial companies” (including insurance holding companies that are not insurers), but excluding operating insurance companies.

- Much of the rest of the proposal is similar to Treasury’s. A significant difference, however, is that the Fed specified that it does not want to get into the question of a federal role for insurance.

Resolute on Resolution Authority

- House Financial Services Committee Chairman Frank has announced hearings on resolution authority legislation beginning this week and continuing into next, with the ultimate goal of having a bill out of his Committee by the Memorial Day Recess.

- …Where it will promptly land in the "Legislative Graveyard," the Senate Banking Committee, whose Chairman, Chris Dodd, continues to urge caution.

- As Dodd's poll numbers continue to plummet in a year he is up for reelection, however, this could be a bill he decides to move.

Waiting in the Wings

- We are monitoring a reinsurance tax bill, which is still developing.

- A Workers' Comp Study bill had been set for the House suspension (non-controversial, no amendments) calendar the week of April 20, but was pulled. We will monitor that situation as well.

- **Indexed Annuities**: Congressman Meeks (D-NY) is poised to introduce a bill to overturn SEC Rule 151A, published in January and set to take effect in January 2012.

- The rule essentially classifies indexed annuities as securities and puts them under SEC jurisdiction rather than state insurance regulation, which governs all other annuities products.

- NAIC has joined in a lawsuit challenging the SEC's authority in this regard, and is looking with interest at the Meeks proposal.

“Cats and Dogs” Abound

- **Financial Product Safety Commission**: Senators Durbin (D-IL) and Schumer (D-NY) have introduced a bill to establish a new regulator whose sole objective would be to help consumers use financial products, such as mortgages, credit cards and retirement accounts safely and efficiently.

- **Financial Accounting Oversight Board**: Congressman Perlmutter (D-CO) has introduced a bill to establish a Financial Accounting Oversight Board, which would include the President of the NAIC.

The Holdovers

- **<u>Nonresident Producer Licensing (NARAB II)</u>**: The House passed H.R. 5611, the National Association of Registered Agents and Brokers (NARAB) Reform Act of 2008 in the last Congress.

- The NARAB concept was established by the 1999 Gramm-Leach-Bliley Act (GLBA) to spur state reforms in producer licensing and uniformity, but was never triggered due to states meeting the GLBA reciprocity threshold within the prescribed time.

- NAIC supported H.R. 5611 as passed by the House.

- We worked closely with the producer community and are working closely with the Big I and adjuster community to make key changes to respond to perceived legal and market concerns, in anticipation of a new version of the bill being introduced in the near future.

- NAIC’s goal remains nonresident uniformity, and some producer groups feel this legislation is the only realistic way to achieve that objective.

- **Natural Catastrophe**: Bills are pending to establish a federal backstop for states in the event of a mega-disaster, similar to those considered in the last Congress.

- **Flood Insurance**: Congress extended the National Flood Insurance Program (NFIP) through the end of the current fiscal year as part of the recently-enacted Omnibus Appropriations bill.

- The measure did not contain certain changes advocated by House and Senate supporters regarding addition of optional wind coverage to NFIP, forgiveness of NFIP’s outstanding debt or establishment of a Blue Ribbon Commission to study natural catastrophes.

- NAIC opposed the Commission proposal as drafted, as it would explicitly have excluded state officials from participating on the Commission.

- **Surplus Lines**: We have been working with House staff to agree on language changes, and expect a new bill to be introduced soon.

- We are on the same page on the surplus lines provisions, but have expressed our opposition to attaching reinsurance reform proposals to the bill.

The Message

- Stay tuned.

- Things are changing by the day.

That’s All, Folks!