

Insurance Executive Review

Market Commentary on Current Developments within the P&C Insurance Industry

New Financial Market Regulation to Snare Insurance Companies

The question is not IF it will happen ... but WHEN it will happen!

During 2008 we wrote three newsletters* suggesting the involvement of the Federal Government in insurance regulation that up to now has been the exclusive domain of State regulators. The collapse of AIG was at the heart of the issue and remains the dominant headline cause for expanding federal oversight. The need to expand and centralize greater financial institution regulation is the concern with systemic risk containment that they and their market products could generate given the reality of the AIG example. Current financial market regulation not only leaves gaps (i.e. insurance holding companies) but entire segments (i.e. hedge funds) have minimal regulatory burdens. Filling in the gaps as well as expanding the reach of financial regulation is now on the front burner. We have been in favor of federal regulation applicable to insurers (and their holding companies) of commercial risks but less inclined to see any reason to change state regulation of insurers of personal lines risks.

Federal Proposal

At this writing the specifics of extending federal regulation to insurance is still to be drawn but Treasury has suggested certain conditions that would place insurers under federal regulatory jurisdiction. They have pointed to conditions of “financial systems interdependence”, insurer size, use of leverage (i.e. holding company debt or conditional capital), investments in credit risk instruments and source of financial system liquidity. These conditions would apply to other financial market participants as well, including hedge funds, private equity and other financial firms. For the insurance industry it might be aligned as follows:

- Commercial and personal lines insurers within the same group should be separated with dedicated capital allocation;
 - Commercial insurers including re-insurers would operate under a federal charter and along with their holding company (if any), would be subject to a new federal regulator within Treasury;
 - Personal Lines insurers would continue to be regulated by state regulators with focus on consumer protection, coverage availability and financial soundness;
 - Keep state premium tax revenues on personal lines entirely to states where business is written as the current substitute for state income tax while splitting commercial insurers premium tax between state and federal governments, reflecting the latter’s new regulatory role;
 - Maintain State Guaranty Funds to continue run-off all existing insolvencies and any new personal lines insurer that should become insolvent. Create an FDIC mechanism to fund and handle any commercial lines insurer that becomes impaired;
 - Need for Surplus Lines insurers would cease under a national federal charter system as freedom
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of form and rate would make such companies meaningless;

- Alien companies operating in the US would be under federal regulation in cooperation with foreign regulators.

*Newsletters in 2008 included Issue #5 "Here Come The Feds"; Issue #8 "Fed Vs. State Regulation"; and Issue # 11 "Federal or State Regulation" can be found on our website at www.crmarketstrategies.com

So while the Treasury officials are still formulating the specifics, members of Congress are also suggesting several variations of a federal role in insurance regulation. Meanwhile state insurance regulators are still clinging to the hope that their regulatory role will not diminish.

On April 29 eight industry trade groups came out in support of a single federal insurance regulator holding the view that it "would reduce costs and risks to consumers and the economy". They cite the need for such federal oversight given "the structural limitations of the state system" to regulate insurance which "has become a global, integrated business". Most importantly, they suggest it is the only way "to act upon market activity and business practices that may adversely impact the broader markets and economy in a timely and comprehensive fashion". In other words, state regulators don't now have nor could they ever have the authority and regulatory reach that a federal system could provide.

Benefits of Federal Regulation

There are a number of benefits that would be secured in a federally chartered commercial insurance market:

- Regulatory focus would shift away from a transaction oriented compliance to a financial and systemic risk exposure evaluation lowering product cost pass-through;
- Reduction of regulatory costs by consolidating the current 50 state jurisdictions/manpower dedicated to commercial lines business into a single federal agency;
- Commercial insurance market would become similar to the State and Federal charter banking system;
- Ability to look at financial leverage at holding companies including borrowing and conditional capital that leverages writing of insurance contracts;
- Place new capital market risk products such as Catastrophe Bonds under more direct supervision, oversight and control of single federal regulator;
- Ability to coordinate global operations of insurance firms operating here and abroad with foreign regulators;

Place the guaranty fund for insolvencies on a more acceptable FDIC type model favoring rehabilitation and merger rather than current multiple decades of liquidation costs and preference control by state of domicile;

Ability to create a US Insurance Exchange to help create private capital market risk capacity for property and casualty risks that could operate on an accepted nationwide basis something the former NY Insurance Exchange was unable to do.

Conclusion

The days of total state regulatory control of insurance appear to be numbered. We think the federal involvement in property casualty insurance when it comes, will be limited to commercial lines of in-

insurance including primary, surplus lines and reinsurance markets. The federal government has too much at stake to leave a large segment of the financial services market outside its jurisdiction. The insurance industry is known to be a part of the “shadow banking” business because of its large pool of funds for investment. The \$180 Billion bailout of AIG (previously known as the world’s largest insurer) becomes the poster-boy for the new federal oversight of commercial insurance. Now that 5 major insurance groups have been approved for TARP funding the elephant will soon be inside the tent! We still need specifics, so we will withhold our enthusiasm for a national regulator of commercial property casualty insurance until more details are known.



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