Featured Article

Blueprint for Insurance Reform: the Paulson Plan

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In its "Blueprint for a Modernized Regulatory Structure," issued on March 31, 2008, the U.S. Department of the Treasury outlines the "optimal regulatory structure" for the regulation of banking products, securities and futures, and adds a federal regulatory structure for insurance products. With the benefit of hindsight and decades of experience with various forms of regulation, Treasury, helmed by Secretary Henry M. Paulson, Jr., seeks to create a new system by eliminating and merging existing federal agencies and regulators and creating new ones. Most notably for the insurance industry, the Blueprint calls for the establishment of an optional federal insurance charter.

Overview of The Blueprint

Treasury views the current financial regulatory landscape as essentially a patchwork of initiatives created in response to specific crises. The goal of the Blueprint is a more thoughtful, comprehensive approach that would operate efficiently and would also address the types of products and risks which currently exist in the financial markets. The Blueprint recommends certain "short term" changes, including expanding the role of the President's Working Group on Financial Markets. The Working Group includes the heads of Treasury, the Federal Reserve, the Securities Exchange Commission and Commodities Futures Trading Commission, to which the Blueprint would add the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision. In addition, the Blueprint recommends the creation of a new federal commission to address gaps in mortgage origination oversight, as well as enhancing the Federal Reserve's provision of liquidity, and access to lending through its discount window, to both depository and non-depository institutions.

The "intermediate term" changes recommended in the Blueprint include elimination of the federal thrift charter, (and, consequently, the OTS), based on the diminishing importance of thrifts as a source of mortgage funding, and implementing federal regulation of payment and settlement systems for the transfer of funds from financial institutions. The Blueprint further proposes establishing an optional federal charter for insurance companies, thus allowing insurance companies to opt for federal, rather than state, regulation. Other recommended intermediate term changes include the creation of a new federal agency within Treasury to address international insurance issues, including collateral required from reinsurers domiciled outside the U.S., as a precursor to the regulatory regime that would be needed to support an optional federal charter; modernizing SEC regulation, followed by a merger of the CFTC and the SEC, and determining the appropriate federal supervisor of state-chartered banks (FDIC versus the Federal Reserve).

Long term goals for reform include adopting an "objectives-based," versus "rules-based," regulatory approach that would address failures in particular markets, establishing a charter for all depository institutions with federal deposit insurance (and creation of a new agency to act as a receiver in the event of failure of such institutions), and creating the following distinct regulators:

- "Market Stability" regulator (the Federal Reserve) responsible for monitoring overall conditions of financial market stability that could impact the economy, as well as implementing monetary policy, providing liquidity to the financial system, and collecting information from financial institutions and disclosing and sharing such information in order to collaborate with other regulators on taking corrective action when necessary in the interest of financial market stability.

- "Prudential Financial" regulator responsible for the financial regulation of financial institutions, including establishing and monitoring capital adequacy, investment limits and other solvency related requirements.

- "Business Conduct" regulator to handle "consumer protection issues" across all types of financial institutions.

- "Corporate Finance" regulator who would assume the SEC's current authority regarding corporate oversight (such as corporate disclosures and governance) and accounting oversight.

Some Notable Insurance Industry Omissions

While the optional federal charter is the Blueprint's most obvious insurance-related provision, the Blueprint is also notable for the omission of insurance from certain key initiatives. First, despite the recognition of the insurance industry as a major component of the financial services industry, the Blueprint does not include an insurance representative among the proposed additions to the President's Working Group. Treasury describes the President's Working Group as "the most useful interagency coordination tool for financial services regulation" and (as noted above) considerably expands the Group to include regulators of all types of financial institutions. U.S. Treasury Department, Office of Public Affairs, Fact Sheet:

Treasury Releases Blueprint for a Stronger Regulatory Structure.

It is therefore surprising that insurance representatives (even newly created federal insurance regulators) were not included in the Group. Second, while the Blueprint emphasizes the importance of providing non-depository institutions with access to discount window lending, it does not address the availability of such an option in the context of the insurance industry. Considering Treasury's view that the insurance industry is critical to overall market stability, it is unclear why the Blueprint does not include the insurance industry in its discussion of access to liquidity options provided by the Federal Reserve. Finally, while the Blueprint stresses the importance of a federal backstop in the event of a crisis (seemingly unrelated to access to Treasury-provided liquidity), it also reiterates Treasury's opposition to the creation of a national catastrophe fund as a backstop to catastrophic losses in the insurance context. As support, the Blueprint (in a footnote) merely states that providing the federal insurance charter option will "go a long way towards eliminating the root cause of the problem behind the desire for a backstop fund," without elaboration. *Blueprint* at 128, FN 109.

Optional Federal Charter and Federal Insurance Institutions

The Blueprint advocates offering insurers the option to be regulated at the national level, or to continue regulation under the current state system. Federal legislation would address the mechanics of obtaining a federal charter, and licensing, regulation and supervision for federally chartered insurers, reinsurers and insurance producers (insurance agents and brokers). While a federal charter would be available to insurance producers, the Blueprint focuses on insurance companies.

Federally chartered insurers would be regulated by a newly created agency within the Treasury called the Office of National Insurance. Insurers with federal charters would remain subject to "some continued compliance" with state laws, such as state tax laws, compulsory workers' compensation and individual auto insurance requirements, and participation in mandatory residual risk mechanisms and guaranty funds. *Blueprint* at 10. Rate regulation was intentionally excluded from those areas of regulation left to the states. In the Blueprint, Treasury bluntly declares, "[w]hile numerous arguments have been made to justify. . .rate regulation, they are unpersuasive" and notes that some states have already eliminated rate regulation. *Blueprint* at 129. While the Blueprint calls for federal regulation of solvency issues and a "comprehensive scheme for the receivership for federally chartered insurers," such a scheme would require federally chartered insurers to participate in *state* guaranty funds (unless an insurer is chartered as a federal insurance institution, as discussed below). *Blueprint* at 130.

As support for the federal charter option, Treasury cites the lack of uniformity across state insurance regulation, leading to inefficiencies and undue regulatory burden that limits the domestic insurance industry's ability to compete nationally and internationally. According to Treasury, burdensome regulation also results in diminished quality of services and choices (and higher prices) for insurance consumers. Of course, many state insurance regulators (as well as some insurers and trade groups) oppose the federal charter approach, arguing that state regulation is superior to federal oversight, particularly with respect to consumer issues. State regulators have asserted that federal regulation has not been particularly effective, noting Hurricane Katrina-related issues and the continuing credit crisis and sub-prime fallout. The most vocal support of an optional federal charter has come from the life insurance industry, which believes it is at a disadvantage in competing with banks and other financial institutions that are regulated at the federal level, on a centralized basis.

Finally, the Blueprint would establish a federal insurance institution (FII) charter for insurers offering "retail consumer products with some type of government guarantee." *Blueprint* at 166. While the exact scope of this proposal is not entirely clear, the products listed in the Blueprint include personal automobile and homeowner insurance, and commercial property and liability insurance sold to small businesses. Such products are often covered by state guaranty funds, subject to certain monetary and other limits; presumably, a FII would only be permitted to issue products that are currently covered by state insurance guaranty funds. While a FII charter would likely be "optional" (like the OFC) for insurers, the Blueprint does not address the interplay between the FII charter and an OFC. The Blueprint contemplates that products issued by FIIs would either remain covered by state guaranty funds or a newly created federal insurance guaranty fund (FIGC) that would, similar to state insurance guaranty funds, impose limits upon the amount of coverage recoverable by policyholders in the event of an FII's insolvency. The Blueprint recommends that if a FIGC is established, the FDIC be reconstituted as the Federal Guarantee Corporation to oversee not only the deposit insurance fund, but also the FIGC.

Office of Insurance Oversight

Recognizing that federal insurance charters are controversial and that efforts to pass legislation in the U.S. Congress, such as The National Insurance Act of 2007, have thus far failed, Treasury recommends the creation of a second insurance-related agency, the Office of Insurance Oversight (OIO), within the Treasury while the charter issue is considered. The directives of this agency are not specified in the Blueprint. While the OIO would be granted the authority to "recognize international regulatory bodies" for specific insurance purposes, the Blueprint does not detail what is meant by "recognition" of a foreign regulator. *Blueprint* at 11. However, the Blueprint clearly states the need for one insurance regulator to represent U.S. regulation when working with foreign regulators and suggests the National Association of Insurance Commissioners (NAIC) has assumed such role by default. Treasury believes the NAIC has thus far failed to achieve uniformity required to address international insurance issues. The OIO would assume this role and preempt state laws or regulatory actions that are inconsistent with international insurance policy goals established by the OIO. The Blueprint does not specify what constitutes an "international insurance issue," but does make clear that it includes consideration of changes to reinsurance collateral requirements applicable to insurers domiciled outside the U.S. Should Congress authorize the OIO before the NAIC and individual states reach a resolution on reinsurance collateral reform, the dynamics of the current debate concerning reinsurance collateral will change significantly. The Blueprint also calls for the OIO to advise Treasury on insurance issues that most affect financial markets, such as financial guaranty insurance, private mortgage insurance and natural catastrophe insurance.

Additional Considerations for the Insurance Industry

The sweeping changes included in the Blueprint could have a dramatic impact on the insurance industry. In addition to the optional federal charter for insurers, the Blueprint would alter the regulatory environment for commercial banks, investment banks and hedge funds. These financial services industry participants are key partners (and frequent competitors) of insurers and will undoubtedly influence the market in which insurers operate.

As expected, hearings have been scheduled to educate federal legislators regarding the Blueprint. On April 16, 2008, representatives from Treasury, insurance industry groups and state insurance regulators testified regarding the Blueprint before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises. The chair of the Subcommittee (Paul Kanjorski, D-PA) has introduced a bill, H.R. 5840, that would create an Office of Insurance Information (OII) to establish federal policy regarding "international insurance matters" and "ensure that [s]tate insurance laws are consistent with agreements relating to such Federal policy. . . ." H.R. 5840, 110th Cong. (2008).

Treasury Secretary Paulson has called for a "thoughtful discussion" of the issues and has acknowledged that the implementation of the Blueprint would likely take several years. U.S. Department of the Treasury, Remarks by Secretary Henry M. Paulson, Jr. on Blueprint for Regulatory Reform (March 31, 2008). Many factors will affect the success and timing of the Blueprint, including the upcoming presidential election and continuing credit crisis. It remains to be seen whether the Blueprint will evolve from an academic debate into a real possibility for reform.

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