

# CAPITOL

## Federal Agencies Grab for Control of the Insurance Industry

BY STEVEN A. MORELLI

This was supposed to be the year to straighten out financial and insurance regulation. The politicians and bureaucrats surveying the tangled pileup that was the U.S. economy said, "Never again."

So rose the hopes of those preaching the virtues of federal regulation and liberating efficiency for insurance. Then the dream collided with reality. Now, instead of having one streamlined regulator, some fear the system might be further fractured, with different arms of the federal government controlling pieces of the insurance

business to the point that producers and carriers wouldn't know who was primarily responsible for what.

It's a frustration Gary E. Hughes sees first hand as the American Council of Life Insurers (ACLI) executive vice president and general counsel.

"We've been fighting for some years now to have a more effective system of regulation, uniformity and consistency," Hughes said. "The frustrating thing with what's on the table now and what is being proposed is that it's all moving in the opposite direction. Instead of getting consolidation, simplification and uniformity,

we are getting more proposals from and for more regulators.

The insurance business already has more

regulators today than everybody else."

At the core of the issue is the struggle over state versus federal regulation. Momentum seemed to build toward national regulation earlier this year, pushed by American International Group's struggles.

But everybody gleaned a different lesson from AIG. Those favoring a federal system said the experience showed the need for a transparent system and one authority to oversee the industry. They see the current system of regulation as one run from Victorian, pigeonhole desks in a desktop

# OFFENSE

computer world.

Others backing the state-based system said the insurance segments of AIG performed just fine; it was the part of the company that the federal government already supervised that went awry. Healthy and robust were state-supervised subsidiaries such as American General, while AIG's Financial Products Corp. was indulging in risky investing largely within the federally regulated equities markets.

Now regulatory reform seems to be setting up a place in between these positions, pleasing neither. That was confirmed by President Barack Obama's Financial Regulatory Reform report.

## The Office of National Insurance

People favoring state-based regulation saw support for the system in the Financial Regulatory Reform report, but that white paper did not contain a ringing endorsement. Those pushing for a federal system were not completely sure what the report meant for them either.

Organizations such as the National Association of

Insurance Commissioners (NAIC) seized on general statements that seem to support the state-based system, but many points in the paper undermine that.

"For over 135 years, insurance has primarily been regulated by the states, which has led to a lack of uniformity and reduced competition across state and international boundaries, resulting in inefficiency, reduced product innovation and higher costs to consumers," according to the report.

The document all but requires establishment of an Office of National Insurance (ONI), an entity within the Treasury Department that would keep an eye on the insurance industry for the federal government.

The ONI would also identify "problems or gaps" that could lead to a future crisis. In federal legislation proposed or about to be proposed, the ONI would pre-empt state regulation in these instances, particularly when the office says that an international agreement requires uniformity.

The NAIC was open to the ONI, although the National Conference of Insurance Legislators (NCOIL) recoiled, saying it was on a "slippery slope" toward federal regulation. But that was a slope that many in the industry were looking for. It was at least a start to creating an optional federal charter (OFC).

## The Optional Federal Charter

The OFC in itself is a half step to federal reform, allowing companies and producers to choose between being regulated at the state or federal level.

The Obama reform report indicates a willingness to take the full step to the OFC, if not further. One of the reform plan's chief aims is uniformity; it calls the current system "highly fragmented, inconsistent and inefficient."

The report says the answer is "Increased national uniformity through either a federal charter or effective action by the states." In the document's only mention

*Continued >>*

**"Insurance is a major component of the financial system. In 2008, the insurance industry had \$5.7 trillion in assets, compared with \$15.8 trillion in the banking sector. There are 2.3 million jobs in the insurance industry, making up almost a third of all financial sector jobs."**

— Financial Regulatory Reform report issued by the Obama administration

of the federal charter, there is no “optional.” And the document reveals no overwhelming expectation of “effective action by the states.”

Hughes of ACLI said the Treasury Department “thought long and hard” about adding more on a federal regulator in the report but decided against it.

“But some people there said they would not object if Congress went in

to work with, unlike the rest of the financial services industry, which has a federal regulator such as the SEC. The Fed would also not be concerned with insurance company solvency and the exclusions and exceptions that insurers worked out with states. Its main concern would be the company’s impact on the overall economy. That would not help streamline the system

be able to define what products should look like: “We propose that the regulator be authorized to define standards for ‘plain vanilla’ products that are simpler and have straightforward pricing. The CFPA should be authorized to require all providers and intermediaries to offer these products prominently, alongside whatever other lawful products they choose to offer.” And it would control conduct: “Where efforts to improve transparency and simplicity prove inadequate to prevent unfair treatment and abuse, we propose that the CFPA be authorized to place tailored restrictions on product terms and provider practices, if the benefits outweigh the costs. Moreover, we propose to authorize the Agency to impose appropriate duties of care on financial intermediaries.”

**“We have the states regulating insurance; we have the states regulating securities; we have the feds regulating some other things. Now we’re going to have the feds regulating products. We’re not going in the right direction.”**

that direction,” Hughes said. “I think they [Treasury] certainly left the door open to taking the ONI and making it the foundation of an actual functional regulator.”

### **The Federal Reserve**

The ONI as described in the Obama report would also be expected to identify another creature that frightens some observers – the company that’s Too Big to Fail. Here is the part that does that: “The ONI should also recommend to the Federal Reserve any insurance companies that the Office believes should be supervised as Tier 1 FHCs.”

Tier 1 FHCs are Tier 1 Financial Holding Companies “whose combination of size, leverage and interconnectiveness could pose a threat to financial stability if [they] failed.” The Federal Reserve would be required to hold these companies to a higher standard and undoubtedly do everything possible to prevent them from failing.

This is one of the new regulatory arms that have insurers concerned. The problem is that the Fed would not have a functional insurance regulator

for efficient insurance business for companies, producers or consumers. In fact, it would be tossing another layer of bureaucracy onto the sector.

It could also be detrimental to the rest of the industry because consumers and investors might gravitate to too-big-too-fail companies and away from those deemed small enough to fail. But the Fed is only one of a few new potential regulators for carriers and producers.

### **The Consumer Financial Protection Agency**

Obama has proposed creating a Consumer Financial Protection Agency (CFPA), which is supposed to give consumers recognition at the administrative level. With considerable lobbying by insurance groups, the plan so far excludes insurance, except for credit, mortgage and title coverage. But some are not so sure it will stay that way, and many are still pushing to include insurance in the mix.

The CFPA’s involvement would be troublesome because this agency would have massive clout over products and conduct. The Obama report said it would

### **The SEC and FINRA**

A more immediate concern is a recent fiduciary proposal by the Financial Industry Regulatory Authority (FINRA). Proposed Rule 09-25 is meant to consolidate and tighten rules on suitability and know-your-customer regulations. Although the rules involve securities, FINRA in its call for comments considered including insurance.

“FINRA also seeks comment on whether it should propose expanding suitability obligations to all recommendations of investment products, services and strategies made in connection with a firm’s business, regardless of whether the recommendations involve securities,” the agency said.

This set off alarm bells that FINRA would be bringing insurance under its tent by way of broker/dealers. The National Association for Fixed Annuities (NAFA), which is already opposing Securities and Exchange Commission (SEC) Rule 151A to regulate indexed annuities, believes FINRA, the SEC’s enforcement arm, is reeling in the rest of the insurance industry.

“The notice is a clear attempt to take

Continued >>

control on all product recommendations including life, long-term care, health, property and casualty insurance, savings accounts, fixed annuities, etc.," NAFA said in a notice to its members. "And it isn't just product recommendations. It is product, service and strategies. So a suggestion of, say, where to bank conceivably might require suitability review."

Others are also concerned about the rule's implications, not just because of its possible reach but also because of its current ambiguities as to what constitutes suitability and standard of care, a phrase used in the Obama regulatory reform plan.

Tom Korb, vice president of policy and public affairs at the Association for Advanced Life Underwriting (AALU), is keeping an eye on the evolving definition.

"We want to be sure there are workable standards that are good for clients, good for producers and good industrywide," Korb said. "The Obama blueprint authorizes the SEC and FINRA to increase the standard of care to the fiduciary level. It's really getting down to what 'standard of care' means. What should you disclose to the client? Is it appropriate products that further the client's objectives? Is it the best possible product individually? Those things make a big difference, and it's very important that those be right."

### Whose Standard of Care?

Even though the SEC endured a stream of criticism after the financial meltdown and a torrent after the staggering Bernard Madoff scam came to light, the Obama administration is suggesting even greater power for the agency. The reform report appears to be the basis, or at least an endorsement, of FINRA's new suitability rule. The Obama reform report would hand the SEC a significant mandate.

"The SEC should be permitted to align duties for intermediaries across financial products," the report says.

"Standards of care for all broker/dealers when providing investment advice about securities to retail investors should be raised to the fiduciary standard to align the legal framework with investment advisors. In addition, the SEC should be empowered to examine and ban forms of compensation that encourage intermediaries to put investors into products that are profitable to the intermediary but are not in the investors' best interest."

Although insurance products are not supposed to be part of the financial

he understands why people would be worried about a new regulator.

"The concern when you get into things like the Obama call for a national office is that the tendency of the regulator is to just gin up the enforcement activity to prove that they're doing a good job," Sullivan said.

But he says federal regulation is definitely on the way and he is one of the people dreaming that it could mean greater efficiency and a modern insurance marketplace. Companies might actually get to run free in an open

**"The federal government doesn't do price-setting schemes. It's obvious insurance is not a monopoly, so there's no need to set prices like we used to with utilities when utilities had a franchise on all of the electricity in a given area. There's competition like crazy in the insurance business."**

reform, few see how the SEC and FINRA would be able to follow this directive without getting into insurance products carried by wholesalers and their advisors. And the prospect of FINRA moving into this territory worries ACLI.

"I don't think the SEC has been a problem," Hughes said. "With FINRA, on the other hand, I honestly see a bias against insurance products. We have to fight very hard to get fair treatment. It's not the greatest thing in the world when you have regulators that don't think highly of your products. If you looked at the speeches the head of FINRA has given over the years, you certainly got the feeling that the agency is biased against insurance products."

That head of FINRA, Mary Schapiro, now heads the SEC.

### A Bumpy Ride Ahead

Kevin Sullivan, who was once the Nevada insurance commissioner, says

market, really compete and benefit consumers, he said.

We will all find out in the next few months if that will happen. Few expected significant action on the many federal proposals before the August break, mostly because of the distractions of health care reform. But the reform-minded Congress is likely to turn the momentum on financial regulation for the rest of the year, with insurance interests fighting for the dream of an unfettered market and against the nightmare of redundant regulation. **FINN**

*Steven A. Morelli is senior editor for InsuranceNewsNet Magazine. He has more than 20 years of experience as a reporter and editor for newspapers, magazines and insurance periodicals. He was also vice president of communications for an insurance agents' association. Steve can be reached at [smorelli@insurancenewsnet.com](mailto:smorelli@insurancenewsnet.com).*

