

The Proposed Office of National Insurance: Organization, Functions, Size, and Cost

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About the Authors

Eugene Ludwig

Mr. Ludwig is founder and Chief Executive Officer of Promontory Financial Group, LLC. Immediately prior to founding Promontory, Mr. Ludwig was Vice Chairman and Senior Control Officer of Bankers Trust/Deutsche Bank. From 1993 to 1998, he served as Comptroller of the Currency of the United States. During his time as Comptroller, Mr. Ludwig also was an active Chairman of the Federal Financial Institutions Examination Council, and he revitalized the work of the President's Working Group on Financial Markets. Prior to becoming Comptroller in 1993, Mr. Ludwig was a partner in the law firm of Covington & Burling in Washington, specializing in financial services regulation. Mr. Ludwig has written numerous articles on banking and finance for scholarly journals and publications and has been a guest lecturer at Yale and Harvard law schools and Georgetown University's International Law Institute.

Linda Lamel

Ms. Lamel is a Consultant at Promontory Financial Group, LLC and a professor at Brooklyn Law School. She previously served as Executive Director of the Risk and Insurance Management Society, President of The College of Insurance, and Deputy Superintendent of the New York State Department of Insurance. She has also held private sector positions as CEO of Claims Online and Vice-President of TIAA-CREF's group insurance operation.

James Kamihachi

Mr. Kamihachi is a Senior Principal at Promontory Financial Group, LLC. He is the former Senior Deputy Comptroller for Economic and Policy Analysis at the Office of the Comptroller of the Currency. Earlier, he served as Chief of the Regulatory Analysis Branch at the Office of Management and Budget and Deputy Director of the Economic Analysis Division at the Environmental Protection Agency.

Sam Tymms

Ms. Tymms is a Managing Director at Promontory Financial Group (UK) Limited. She has worked extensively at the UK Financial Services Authority and its predecessor organizations, holding enforcement and supervision roles. Prior to joining Promontory, she ran the FSA department that regulated the major retail insurance groups, many of them global. At the FSA's inception in 1998, Ms. Tymms was responsible for developing the supervision strategy and approach for the integrated regulator, as well as training supervisors in implementation of this strategy.

B.J. Sanford

Mr. Sanford is a Director at Promontory Financial Group, LLC. Prior to joining Promontory, he was an attorney at the law firm of Covington & Burling, where he specialized in financial services regulation.

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Executive Summary

The National Insurance Act of 2007, S. 40 and H.R. 3200, (“the Act”) would create an optional federal insurance charter overseen by a new federal agency, the Office of National Insurance (ONI). To understand better the implications of the Act and the anticipated operations of the ONI, the Financial Services Roundtable, the American Council of Life Insurers, and the American Insurance Association have asked Promontory Financial Group to prepare this study describing the likely organization and functions of the ONI and estimating its size and budget.

In conducting this study, we have reviewed thousands of pages of reports and other data from state insurance regulators, federal financial regulators, the UK Financial Services Authority, and the National Association of Insurance Commissioners, as well as previous studies concerning insurance regulation and the optional federal charter. We have also drawn on the experience of our project team, comprised of former insurance and banking regulators and other financial regulation experts.

Our summary conclusions follow:

1. With respect to functions that involve direct supervision of regulated firms (e.g., financial regulation, market conduct, product regulation, licensing), the scope of the ONI’s responsibilities resembles that of state insurance regulators. This resemblance would enable the ONI to build on the foundation of state frameworks and experience. However, as an agency with a national purview operating under a different statutory framework, it will execute some of its responsibilities in a manner different from its state counterparts. Most notably:
 - The Act authorizes the ONI to delegate many functions to Self-Regulatory Organizations (SROs) where such organizations can achieve the agency’s regulatory

objectives more efficiently or effectively. There is reason to believe that producer licensing is one such function. Given the large numbers and geographic dispersion of producers, a dispersed and flexible SRO should be better positioned to regulate producers efficiently than a centralized national government agency. Moreover, problems raised by the financial condition and market conduct of producers generally do not present the level of systemic risk posed by similar problems at insurance carriers.

- The ONI would exercise its product regulation powers through a streamlined and uniform process that differs from existing state new product approval procedures, which some have criticized as slow and labor-intensive. Under the Act, life insurers would file new policy forms and certify that they comply with ONI-issued product standards. Property and casualty insurers would be required to submit an annual list of policy forms to the ONI, and either submit copies of the forms (under the House bill) or make such copies available for inspection (under the Senate bill). In contrast to the practice in many states, the Act does not provide for rate regulation or pre-approval of policy forms by the ONI, and it prohibits the ONI from requiring insurers to use any “particular rate, rating element, price, or form.”
2. With respect to executive, administrative, analytical, and policy functions, there is reason to believe the ONI would resemble comparable federal financial regulators more than existing state insurance regulators. The ONI will be a federal agency, headquartered in Washington, D.C. and generally subject to the statutes and regulations that govern the management of federal agencies. Its administrative infrastructure and management culture therefore will likely be based on the federal model. Moreover, given the ONI’s status as a national

regulator, as well as its unique international role, the staffing of the analytical and policy functions will likely bear less relationship to the staffing of those functions at state insurance regulators than it does to that of the federal agencies that supervise sophisticated and internationally active firms in other financial sectors.

3. The experience of the dual banking system suggests that many firms will choose to remain in the existing state regulatory system, rather than convert to a federal charter or license. Firms that remain in the state system would be motivated, among other things, by satisfaction with their current regulator, avoiding the cost and effort of converting and the higher assessments likely to be imposed by a federal regulator, and maintaining relatively easy access to top administrative and legislative policy makers at the state level. Converting firms, on the other hand, would likely be attracted by the perceived value of uniform national rules, the absence of government rate regulation and pre-approval of policy forms, perceived differences in technical knowledge and specialization between state and federal regulators, and the prestige of the federal charter (particularly internationally). Since we cannot predict the conversion rate with precision, we ran our size and cost model based on two different conversion assumptions that roughly relate to the ratio between federal and state banking institutions: a Base Case in which 25% of regulated persons convert, and a High Conversion Case in which 50% of regulated persons convert.

- If the dual banking system is a guide, this range probably reflects the state-federal balance that will emerge with a national charter option. The state-federal balance has shifted numerous times over the nearly century-and-a-half-long history of the dual banking system. As of the date of this study, approximately 39% of insured depository institutions had federal charters.

- The Act requires national insurers to continue to pay state premium taxes, which ensures a continued source of revenue for the states regardless of the conversion rate.
4. The Act would not impose any material financial burden on the federal government or U.S. taxpayers, nor would it require the creation of an unmanageably large federal bureaucracy.
- The ONI would be funded by assessments on regulated persons in a manner similar to the funding of the Office of the Comptroller of the Currency (OCC). While startup costs would be borrowed from the Treasury, they would be repaid with interest over 30 years.
 - Our Base Case model indicates that the ONI would be one of the smaller agencies in terms of both size and budget among federal financial regulators with comparable missions, even before taking into account the economies of scale discussed below. Under this scenario, the ONI would employ about 2,390 full-time equivalents (FTEs) and have a budget of approximately \$465 million. In the High Conversion Case, the ONI would be roughly comparable in size and budget to its peer federal regulators, with 4,030 FTEs and a budget of approximately \$700 million.
 - By comparison, the State regulatory system is staffed with more than 14,000 FTEs and costs more than \$1.6 billion annually. This includes the State insurance regulators, which employ 13,632 FTEs and have an aggregate budget of \$1.54 billion. It also includes the National Association of Insurance Commissioners (NAIC), which provides important support and assistance to State insurance departments. The NAIC's 2007 budget was \$64.3 million, and it employed 424.5 FTEs. It should

be noted that these costs do not account for the substantial amounts that insurers spend on a routine basis to respond to requests from state regulators to hire independent contractors, which perform special analyses for the benefit of state regulators.

- Our cost and size model may overestimate the number of FTEs the ONI would require because it cannot fully account for the efficiency gains the ONI could realize when it examines and licenses very large firms. The conversion incentives described above, combined with the experience of the dual banking system, suggest that size is not a determinative factor in charter choice, and that companies of all sizes may have reason to choose a national charter. That said, based on these same factors, it is reasonable to expect that most of the largest insurers would join the federal system. Each firm, regardless of size, has a single set of financial statements, procedures, and similar documents for examiners to review and assess. Moreover, many elements of on-site examinations are performed on a sample basis, which permits examiners to extrapolate conclusions about a large firm using a smaller total number of files than they would be required to review for a large number of smaller firms. Personnel requirements attributable to the complexity and systemic risk presented by larger insurance firms may offset scale efficiencies to some extent. Still, it is reasonable to expect that the ONI will realize at least some savings from these economies of scale in the regulation of larger firms, mostly in the examination and licensing functions.
5. The ONI may have a substantial advantage over all but the largest state regulators in engaging the staff necessary to supervise the sophisticated and complex activities of the largest insurers. The number and scale of ONI-regulated institutions should provide a stable

and sufficient source of funding to justify the cost of maintaining a critical mass of specialized professionals, as well as sufficient salaries to attract and retain qualified individuals. The ONI will likely be large enough to afford divisions with specialized talents, such as in the capital markets area, that are attractive to top professionals because of the professional interaction and development such larger offices can bring. The ONI can also concentrate these teams in areas of the country where there is a critical mass of insurance and other financial activity. Moreover, with a larger number of institutions engaging in complex activities, the ONI would have a greater exposure to innovative products and activities, which, in turn, should make employment at such a regulator more attractive from a professional development perspective.

6. In addition to its advantage in recruiting and retaining top specialists, the ONI would be in a position to maximize the returns on their expertise. The national scope of the ONI's examination and report collection activities would provide it with a window into insurance firms of every region, size, business line, and level of complexity. This window should permit the ONI's supervisory and analytical staff to identify emerging regional and national issues more readily than state insurance departments, whose direct experience of the insurance market is necessarily narrower. The ONI staff would also be better positioned to apply industry-wide solutions to such emerging issues. The agency would have authority over a wide range of insurance firms operating in every domestic market, while its additional authority over insurance holding companies could give it the leverage necessary to influence the practices of the largest insurers across all of their subsidiaries. The ONI would also be in a position to deploy quickly nationwide any innovative regulatory practices it learns from peer regulators in the United States and abroad.

7. Contrary to fears some have expressed, the establishment of an optional federal charter seems unlikely to lead to a “race to the bottom” in market conduct standards as the new regulator competes for charters.
- Congress will retain a number of tools that would permit it to influence ONI policy and practices and ensure against a deterioration of market conduct standards. Ongoing oversight by Congress and its financial services committees, as well as pressure from key legislators, can often have significant influence on agency policy and behavior, leading to increased attention to consumer protection. The Act thus gives the Congress leverage that it presently lacks to address insurance market conduct issues and to force action to address new problems. Of course, Congress always has the option of establishing minimum standards by legislation as well.
 - In fact, the interplay between consumer-oriented legislators and regulators on the state and federal level can at times result in a “race to the top” as each jurisdiction raises the bar for best practices in market conduct regulation. Consumer protection provisions incubated in state “laboratories” frequently appear in new federal legislation. Similarly, states often enact their own versions of federal consumer protection laws. Where it materializes, this phenomenon tends to limit (although not eliminate) the divergence of substantive state and federal consumer protection standards applicable to similarly situated financial institutions.
 - Our size and cost model indicates that the ONI could staff its market conduct and consumer affairs functions in a manner comparable to existing large state insurance departments while maintaining a manageable scale. Indeed, the FTE and budget figures projected by the model assume that the ONI would employ the same number

of market conduct and consumer affairs FTEs per dollar of premium volume as the benchmark state insurance regulators. Thus, the ONI should remain comparable in size and cost to its peer federal regulators were it to perform its market conduct and consumer affairs functions in the same way as large states do today. In practice, this level of resource expenditure should actually increase the level of protection afforded to consumers nationwide. This is because our benchmark states devote more resources to the market conduct and consumer affairs functions than the typical state insurance department. As a result, the model assumes that the ONI would devote approximately 33% and 50% more FTEs per dollar of premium volume to consumer affairs and market conduct regulation, respectively, than the average state insurance department presently devotes. The impact of this discrepancy would be even greater to the extent that economies of scale and innovative practices enable the ONI to be more effective with the same amount of resources.

8. The international authority the Act grants the ONI would be an advancement for U.S. insurance regulation and would likely positively transform the way the United States relates to the international insurance regulatory community. Although state regulators do currently cooperate with foreign insurance regulators, their lack of sovereign status and fragmentation necessarily limits their effectiveness. As a national regulator, the ONI could carry the requisite weight and authority to negotiate and collaborate in international insurance forums as a peer to regulators from other jurisdictions.

Introduction

Insurance regulation in the United States has historically been the province of state government. Insurance companies have existed in the United States since colonial times. Property and casualty insurers were among the first insurers to organize in the eighteenth century, while life insurance companies followed suit around the middle of the nineteenth century. At first these companies were largely unregulated, but by the second half of the nineteenth century, several states had created insurance boards.

In 1869, the Supreme Court held that the business of insurance does not constitute interstate commerce, leaving the states free to regulate insurance without federal intervention.¹ With the Supreme Court's blessing, insurance regulation proliferated at the state level. The National Association of Insurance Commissioners (NAIC) was formed shortly thereafter in an effort to coordinate the regulation of insurers doing business in more than one state. New York passed the first comprehensive state insurance law in 1892.

State insurance regulation suffered a momentary setback in 1944 when the Supreme Court reversed its earlier holding and determined that the business of insurance could indeed constitute interstate commerce.² However, Congress moved quickly to vitiate the result of this ruling by enacting the McCarran-Ferguson Insurance Regulation Act ("McCarran-Ferguson Act") the following year.³ While implicitly acknowledging that insurance did constitute interstate commerce, the McCarran-Ferguson Act exempted the business of insurance from federal laws unless such laws specifically applied to insurance. Although the McCarran-Ferguson Act was amended in minor respects over the years, it remains the basis for state regulation of insurance.

¹ *Paul v. Virginia*, 8 Wall. 168, 19 L. Ed. 357 (1869).

² *U.S. v. South-Eastern Underwriters Ass'n.*, 322 U.S. 533 (1944).

³ *McCarran-Ferguson Act*. Public Law 79-15 (1945).

Despite the policy of state regulation explicit in the McCarran-Ferguson Act, Congress has periodically authorized a federal role in some aspects of insurance regulation. For example, the National Flood Insurance Act created a federally funded flood insurance program overseen by the Federal Emergency Management Agency.⁴ The Employee Retirement Income Security Act established minimum standards for many employer-sponsored pension and health plans under the supervision of the Department of Labor.⁵ Following the terrorist attacks of September 11, 2001, Congress passed and twice reauthorized the Terrorism Risk Insurance Act, which created a federal “backstop” for commercial property and casualty insurance claims related to acts of terrorism.⁶ Congress has recently expressed interest in similar backstops for natural disasters known as catastrophe funds.⁷

Periodically, crises in the insurance markets have renewed interest in more comprehensive federal regulation of insurance. The most recent example of such a crisis is the rapid deterioration of monoline bond insurers in the wake of the recent credit crisis. The central role played by these bond insurers in the international financial markets has raised concern about whether it is appropriate for a handful of state regulators to be setting national policy on matters critical to the global financial infrastructure. Like other crises that have preceded it, the fragility of the bond insurance industry suggested to policymakers that there may be benefits to raising standards and bringing uniformity and coherence to a historically-fragmented regulatory system. Indeed, this notion has long been discussed with regard to financial regulation, including in the Blueprint for a

⁴ *Housing and Urban Development Act*. Public Law 90-448 (1968).

⁵ *Employee Retirement Income Security Act*. Public Law 93-406 (September 2, 1974).

⁶ *Terrorist Risk Insurance Act*. Public Law 107-297 (November 26, 2002); *Terrorism Risk Insurance Extension Act*. Public Law 109-144 (January 4, 2005); *Terrorism Risk Insurance Revision and Extension Act*. Public Law 110-160 (December 26, 2007).

⁷ On November 8, 2007, the House passed the Homeowners' Defense Act of 2007 (H.R. 3355), which would create a national catastrophe fund.

Modernized Financial Regulatory Structure released by the Treasury Department on March 31, 2008 after extensive consideration by policy makers from the Treasury and other financial regulatory agencies. The Blueprint suggested that a uniform and coherent national regulatory and supervisory framework would improve many aspects of financial regulation.

Consistent with this sentiment, even before the monoline bond insurance crisis and the publication of the Treasury Blueprint, the National Insurance Act was reintroduced in the 110th Congress. Sponsored by Senators Sununu (R-NH) and Johnson (D-SD) in the Senate and Representatives Bean (D-IL) and Royce (R-CA) in the House, the Act establishes a federal insurance regulator to supervise federally chartered insurers and agencies and federally licensed producers and reinsurers.⁸ Often described as creating an “optional federal charter” or “OFC,” the Act does not eliminate state regulation. Rather, it creates a parallel but alternative system of regulation for those firms and individuals opting into it. The Act locates the new Office of National Insurance in the Department of Treasury under the direction of a Commissioner appointed by the President. It endows the ONI with the power to charter, license, and regulate those insurance firms that choose to operate under the federal system.

Much has been written regarding the advantages and disadvantages of the optional federal charter and the substantive insurance regulatory issues raised by various OFC proposals. However, beyond the framework provided by the Act itself, few have given thorough consideration to what a national insurance regulator would look like. What would be its structure and functions? How would these resemble or differ from state insurance regulators and other federal financial regulators?

⁸ The House bill (H.R. 3200) and Senate bill (S.40) are very similar, but not identical. The study notes the rare instances in which a difference between the bills is material to the discussion.

How many employees would it have? How much would it cost? This study addresses those questions.

The study is divided into five sections. Section I provides an overview of the organization and functions of existing state insurance regulators. Understanding the structure of existing regulators is essential to understanding the probable organization and functions of the ONI because the creation of a federal charter would not change fundamentally many of the basic elements of insurance regulation. (There are exceptions, most notably rate regulation, form approval, and the employment of SROs, which are explained in more detail in subsequent sections.) Readers familiar with state insurance regulation may skip Section I and proceed directly to Section II.

Section II provides an overview of the ONI as established by the Act. It focuses on the provisions of the Act that define the ONI as an agency – its powers, functions, and organization – rather than issues of substantive insurance regulation that have been thoroughly considered by others. Although the Act may not be enacted in its current form, our attempt to construct a model of the ONI required a fixed foundation, and the Act appeared to be the best starting point for our analysis.

It is, however, only a starting point. The Act provides for, in varying levels of detail, the most important regulatory powers of the ONI, as well as a handful of mandatory organizational components. However, consistent with legislation establishing other financial regulators, it does not set forth every detail required to construct a model of the ONI or to describe every component of the new agency. The organization and functions of state insurance regulators described in Section I offer one possible roadmap. Federal financial regulators with comparable missions, as well as national insurance regulators outside the United States, furnish different models.

Section III examines the organization and functions of three federal financial regulators that are comparable, to varying degrees, to the ONI – the Federal Deposit Insurance Corporation (FDIC), the Securities and Exchange Commission (SEC), and the Office of the Comptroller of the Currency (OCC). It evaluates the similarities and differences between each of these agencies and the ONI, a comparison that is both enlightening in itself and useful for constructing the ONI size and cost model. Section III also examines the insurance regulation function of the United Kingdom’s Financial Services Authority (FSA). Although the FSA’s status as an integrated insurance, banking, and securities regulator limits its usefulness in understanding the ONI’s organization, its experience as a national regulator of a highly sophisticated insurance market serves as an important model for the new U.S. agency. The FSA also offers a glimpse into how the ONI might operate within an integrated U.S. financial regulator, an idea that some have proposed.

Section IV is the analytical heart of the study. Drawing on the previous three sections, as well as publicly available data about the budgets and personnel of state and federal regulators, we constructed a model to estimate the size and cost of the ONI under two different conversion scenarios. Section IV describes the model’s assumptions, methodology, and results.

There are a number of qualitative features of the proposed ONI that the foregoing analysis does not fully capture. Although these features do not bear directly on the organization, size, and cost of the ONI, they shed significant light for anyone trying to understand the nature of the new agency. Section V rounds out the portrait of the ONI by discussing three of these features. The section first discusses the relative advantage the new national regulator would have over state regulators in engaging the staff necessary to supervise the sophisticated and complex activities of the largest insurers and to identify emerging regional and national issues. It then considers how ONI consumer protection efforts might resemble or differ from those of state regulators. Finally, it

assesses the effect that the creation of a national insurance regulator might have on relationships with foreign insurance regulators and on U.S. influence and standing in international forums.

The goal of this study is to provide the reader with a more concrete vision of the organization, functions, size, and cost of the proposed ONI than could be obtained simply from reading the Act. Of course, however grounded in quantitative and qualitative data, such exercises are necessarily conjectural and rest on a large number of assumptions. We have taken pains to ensure that our assumptions are, at the very least, both reasonable and clearly stated. Accordingly, whether or not all of the assumptions materialize as predicted (and some no doubt will not), we are comfortable that the study provides a solid framework within which the reader can consider the consequences of the various policy options.

I. Overview of State Insurance Regulatory Agencies

In order to construct an accurate picture of the proposed ONI, one must first understand how the states presently regulate insurance. Traditionally, state insurance regulators have attempted to achieve three major objectives: insurer solvency, a fair and competitive marketplace, and consumer protection. This section provides an overview of the major functions of state insurance regulatory agencies. It creates a context for the discussion in the next section of the federal agency created by the Act.

Financial Regulation

According to the 2006 NAIC Insurance Department Resources Report, financial regulation consumes the single largest share of insurance department budgeted expenses. The principal means of financial regulation is the acquisition and analysis of financial and market information about insurers. As a condition of licensing to do business in a state, insurers must meet certain financial requirements. Insurers are then required to file quarterly and annual financial forms based on a

system of accounting (known as “statutory accounting”) designed to measure claims-paying ability and liquidation value in case of insolvency. Insurers must also file audited financial statements and attested actuarial opinions.

The regulatory agency employs financial analysts to review the financial filings. Insurance regulators also obtain financial information through field examinations of insurers, typically conducted every three to five years or as needed. From time-to-time, state regulators will ask insurers to retain outside consultants to perform independent reviews of the firm for the benefit of the regulator. The regulated parties pay for these studies.

Since determining the solvency of insurers requires estimates and forecasts, state insurance departments also depend on the work of actuaries, who may be either agency employees or external consultants. Regulatory actuaries analyze the reserves established by insurers to determine that they will have adequate resources to pay claims and that they are not assuming excessive risk. If the insurance department determines that the reserves, capital, and surplus are not adequate, it can label an insurer “impaired” and require that insurer to take corrective action. In such cases of “administrative supervision,” financial analysts with expertise in the type of insurer involved monitor the insurer’s progress and condition.

Insurance department staff also examine the investments of an insurer. Statutes and regulations prescribe which investments can be counted toward required statutory capital and surplus. Recently, in some lines, insurance regulators have shifted toward risk-based capital requirements that seek to align investments with specific products and their claim potential. This has required regulators to have personnel with stronger investment expertise and, in some cases, extended the time for review.

Financial regulation is applied in varying degrees to out-of-state and non-U.S. companies as well. Generally, the company's domiciliary regulator takes the lead in financial examinations, although examiners from other states can and do participate in such exams.

Company Licensing

Insurance companies must be licensed separately in each state in order to write business in the state. The license requirements apply both to companies that are domiciled in the state and to those that are "foreign" – that is, not domiciled in the state – and "alien" – that is, organized outside the United States. State licensing is available for the full range of insurance entities and lines of business. States employ licensing analysts to review and approve company license applications.

State regulators must also review and approve mergers, acquisitions, and consolidations of insurers. The principal objective of the approval process is to ensure that the surviving entity is solvent and that the transaction does not diminish the solvency of any other insurer involved. If an entity seeks to acquire an insurer, the regulator assesses whether the acquiring entity has adequate resources to make the acquisition and is not leveraging assets to an extent that would impair the insurer's financial condition. Regulators also monitor major transactions within a holding company system to ensure that the insurer is not being stripped of its assets. In some instances, an insurer cannot complete a transaction within a holding company system without the permission of the insurance department.

Product and Rate Regulation

State regulators generally exercise at least some level of review or approval authority over policy forms. In the case of property and casualty insurers, they also often regulate premium rates. In some cases, insurers must simply file rates and forms before using them; in other cases, both must be approved in advance.

According to its proponents, product and rate review serves both a financial solvency and consumer protection function. The theory behind solvency review is that policy forms determine the risk an insurer is assuming, while rates determine whether the insurer is being adequately compensated for those risks. The consumer protection review, principally a concern in personal lines, pulls somewhat in the opposite direction. There, regulators seek to ensure that the forms provide the coverage that consumers would reasonably expect (or that public policy dictates, such as with auto insurance), and that the rates are reasonably affordable. One can also detect in the product and rate review function the vestiges of traditional justifications of rate regulation, such as prevention of “ruinous competition” and the control of market power. These factors play only a minor part in contemporary federal financial regulation, where they are addressed largely through antitrust enforcement.

Market Conduct Regulation

The objective for market conduct regulation is to ensure that insurers and producers refrain from deceptive or unfair conduct in marketing, underwriting, and claims. Regulators monitor marketing and sales materials and perform market conduct examinations, although such examinations generally are not scheduled on any regular interval. Market conduct examinations may be performed alone or in conjunction with a financial examination, and with or without participation by other states.

Consumer Affairs

In addition to market conduct regulation, insurance departments invest resources in protecting and assisting individual consumers. Separate consumer affairs functions handle individual complaints against insurers and producers and seek resolution short of litigation. They also respond to inquiries about licensees and products. In addition, insurance departments with sufficient

resources provide buying guides, public education materials and forums, and advocacy (e.g. a voice on proposed legislation and handling of appeals for health care claims). Although the consumer affairs function is sometimes considered the principal source of personnel requirements, the states report that they devote a greater number of FTEs to financial regulation.⁹

Antifraud

State regulators can also investigate allegations of criminal or civil fraud and take remedial enforcement action. Some states do not have separate fraud divisions and must rely on insurers to report fraud. In states with robust fraud divisions, however, fraud investigation and enforcement consumes a significant amount of department resources.

Enforcement

The NAIC and many states have adopted model acts dealing with unfair trade practices and unfair claims practices. Regulators invoke unfair trade practices statutes to take action against insurers that misrepresent their products or unfairly discriminate against insureds. Unfair claims practices statutes give the regulator authority to punish insurers who do not meet their obligations in the handling of claims. Such enforcement actions often require extensive investigation by the insurance department.

Producers

In addition to regulating insurers, states license producers and other intermediaries.¹⁰ These individuals and companies must meet licensing requirements and pay required fees in each state in

⁹ National Association of Insurance Commissioners. *2006 Insurance Department Resources Report*. (2007).

¹⁰ These may include agents, brokers, surplus lines brokers who work with non-admitted insurers, reinsurance intermediaries who facilitate reinsurance arrangements, managing general agents who exercise more authority than other agents, third party administrators who provide services to

which they sell and deliver policies or otherwise provide services. A producer that commits misconduct is subject to investigation, penalties and fines, and license revocation or suspension. States often provide a hearing process before a license is revoked or suspended, and such determinations are subject to judicial review.

Reinsurance

Insurers can improve their statutory balance sheet through reinsurance. Regulators review reinsurance arrangements to ensure that the reinsurer is likely to meet the financial obligation it has undertaken, that there has been a true transfer of risk to the reinsurer, and that any security for the reinsurance (e.g. letter of credit) is credible. Regulators also evaluate other techniques insurers use to enhance their financial condition, such as portfolio transfers or swaps. Sometimes the reinsurance or liability transfers occur between companies that are part of a holding company system. In those instances, regulators review the nature of the transactions in an effort to ensure that the insurer seeking to achieve financial benefit is, in fact, receiving that benefit, and that the transaction does not compromise its financial condition.

Supervision, Rehabilitation, and Liquidation

If a regulator (or the NAIC through its solvency monitoring system) determines that an insurer does not meet financial requirements, the domiciliary insurance regulator may place the insurer in administrative supervision (discussed above), rehabilitation, or liquidation. In all three situations, the insurance department gains control over essential management and operations of the insurer. If the insurer is under administrative supervision, the oversight is generally handled by the staff of the insurance department, with or without additional consultants. Rehabilitation and

insurers or self-insureds, and adjustors who work for insurers or the public. New York also licenses consultants who provide advice on the purchase of insurance.

liquidation are generally handled outside of the state insurance department by an entity appointed by the department (often a law firm, accounting firm, or specialty run-off company). Only New York maintains its own Liquidation Bureau, which handles most of the work for insolvent insurers. The Bureau is not part of the Insurance Department but reports to the Superintendent on Insurance, who is the appointed receiver. Other large states employ varying combinations of employees and contractors for this function.

Insolvency Protection

Once the regulator as liquidator takes over the insolvent insurer, it marshals the assets of the company and makes payments to the insureds and creditors. Each state has guaranty associations, which are non-profit organizations established by state law to pay claims that cannot be paid by the insolvent insurer. There are separate associations for different types of insurers. Except in New York, guaranty associations assess companies that write business in the state for the cost of the insolvency after it has occurred. New York has a pre-assessment fund for property and casualty insurers that is required to be kept in reserve at all times.

II. Organization of Functions of the ONI

This Section provides an overview of the ONI as established by the Act, with an emphasis on provisions that set forth the agency's powers, functions, and organization.

Structure and Funding

The ONI is to be led by a single Commissioner, who would be appointed to a five-year term by the President, subject to Senate confirmation. In addition to its headquarters in Washington, D.C., the agency is to have at least six regional offices, and may establish additional offices within or outside the United States. The Act grants the ONI pay authority comparable to other federal financial regulatory agencies, exempting it from General Schedule pay rates. The ONI would be

funded through assessments and fees imposed on regulated persons in a manner similar to the OCC. (It would borrow its initial funding from the Treasury, to be repaid with interest over 30 years.) Federally chartered national insurers would continue to pay state insurance premium taxes in addition to their ONI assessment.

Powers and Duties

Chartering, Licensing, and Structure. The Act grants the ONI the power to charter national insurers and agencies; license producers, foreign insurers, and reinsurers; and register certain insurance holding companies.

National Insurers and Agencies. The Act authorizes the ONI to organize, incorporate, charter, and regulate national insurers and national agencies. National charters would be available to both life and property and casualty insurers. However, the ONI would not charter or regulate health insurance companies. The ONI would have authority to approve the conversion of state insurers and agencies to a federal charter, as well as the conversion of insurers from mutual to stock form. The ONI would also be responsible for reviewing and approving mergers, acquisitions, and bulk transfers of policies involving national insurers and agencies.

Producers. The ONI would have the authority to issue federal producer licenses for any line of business within the scope of the agency's regulatory authority. The agency would define the lines of insurance covered by the license and specify any educational and examination requirements. A federally licensed producer could sell and solicit insurance in any state and could engage in claims adjustment and settlement, risk management, employee benefits advice, retirement planning, and other insurance-related consulting activities. National insurers and agencies would have a duty to supervise the sales and marketing practices of the individuals they employ, subject to examination by the ONI (or, as discussed below, an SRO). If a federally licensed producer is not supervised by a

national insurer or agency, then the producer would be subject to direct supervision by the ONI or an SRO. The Act also requires the ONI to create an electronic database of information on federally licensed insurance producers that would be available to state regulators.

Foreign Insurers. The Act authorizes the ONI to license U.S. branches of non-U.S. insurers. Such branches would be required to keep trust deposits in a U.S. bank for the benefit of the U.S. insureds of the company. They would be treated similarly to national insurers with respect to compliance with solvency standards and required trusteed surplus. A U.S. branch of a non-U.S. insurer could domesticate through merger with a national insurer, subject to the ONI's approval.

Reinsurers. Under the Act, the ONI could grant authority to write reinsurance to national, state-chartered, or foreign insurers. Before licensing, the ONI would conduct an examination and/or investigation of the applicant. If the applicant is not a U.S. insurer or U.S. branch of a non-U.S. insurer, it would have to meet certain conditions to assure jurisdiction and enforcement of judgments over the applicant should it become a licensee. A licensed reinsurer must submit an annual report of its financial condition to the ONI. The ONI may also require annual reports on the condition of any trust fund that has been required as security for a reinsurance transaction. The ONI would set standards on the circumstances in which a ceding company can take credit for reinsurance it has purchased. The Act prohibits states from interfering in the standards or requirements for these ceding transactions.

Holding Companies. Holding company systems that include at least one national insurer would be required to register with the ONI under the Act. The ONI would promulgate regulations concerning registration and termination of registration, and may provide for exemptions to such registration. The ONI would also create standards for transactions within a holding company system. In addition, a national insurer would be required to notify the ONI if it wishes to pay an

extraordinary dividend or distribution. Finally, the ONI would have exclusive jurisdiction over reinsurance pooling agreements that involve a national property and casualty insurer and affiliated state entities.

Regulation and Examination of Federally Chartered or Licensed Firms. The Act authorizes the ONI to issue regulations applicable to federally chartered or licensed firms and to conduct examinations of such firms. The agency would also possess product regulation powers, which would be exercised through a more streamlined process than currently employed by state regulators.

Regulations. The ONI would be responsible for creating a comprehensive regulatory scheme to govern the activities of regulated persons. This includes rules on accounting principles, auditing standards, investment standards, risk-based capital standards, valuation standards, nonforfeiture benefits, actuarial opinions, and market conduct. The Act provides that, within two years of the confirmation of the first ONI Commissioner, the ONI would adopt NAIC model acts and standards in a wide range of areas as interim rules. The ONI generally would have only limited authority to modify such rules for five years following their adoption. After the five-year transitional period ends, however, the ONI would, with certain exceptions, have authority to amend its rules as it deems appropriate.

Product Regulation. The ONI would exercise its product regulation powers through a streamlined process that differs from the product and rate approval procedures currently utilized by most state regulators, which some have criticized as excessively slow and labor-intensive. Life insurers would file new policy forms and certify that they comply with published ONI product standards. They would also be able to obtain interpretive rulings concerning their products' compliance with such standards. Property and casualty insurers would be required to submit an

annual list of standardized policy forms. The House bill also requires them to submit copies of such forms to the ONI, while the Senate bill mandates that they keep such copies available for inspection. The Act does not provide for rate regulation or pre-approval of policy forms by the ONI, and it prohibits the ONI from requiring insurers to use any “particular rate, rating element, price, or form.”

Examinations. Supervision of national insurers and agencies would include on-site examinations to ensure compliance with ONI regulations and with other federal laws, such as the Bank Secrecy Act. The Act requires examination of a national insurer at least every three years, and provides for special examinations as needed. National agencies would be examined if the ONI receives a complaint or finds evidence that they are violating applicable laws or regulations. The ONI may also examine the activities of insurer or agency affiliates that “may have a materially adverse effect on the operations, management, or financial condition of the national insurer or national agency.” The ONI is authorized to use reports generated by the affiliate, audited financial statements, and publicly available information for such an examination. It must use reports by the affiliate’s functional regulator to the extent possible.

Enforcement, Fraud, and Litigation. The Act grants the ONI the power to bring enforcement actions against regulated persons, investigate and prevent insurance fraud, and conduct litigation in its own name.

Enforcement. The ONI’s enforcement powers under the Act mirror those granted to federal banking agencies by the Federal Deposit Insurance Act. The Act authorizes the ONI to bring enforcement actions on a broad range of grounds. The authority includes the power to take depositions, issue subpoenas, order pre-judgment attachment, conduct hearings, and impose penalties. The ONI would have the power to revoke, suspend, or restrict a national charter or

license, and may, under certain conditions, issue an industry-wide prohibition order against an individual working for a national insurer, agency, or affiliate. The ONI could also impose civil money penalties, with a per day maximum of \$1,000,000.

Fraud. The Senate bill grants the ONI the authority to investigate allegations of insurance fraud.¹¹ Claim forms and applications issued to insureds must carry a warning about fraud, and regulated persons must report any suspected fraud to the ONI. The ONI would possess enforcement authority in cases of fraud that supplements the ordinary enforcement authority granted by the Act.

Litigation. Like other federal financial regulators, the ONI would have independent litigation authority in all federal and state courts other than the U.S. Supreme Court.

Cooperation with Other Agencies. The Act authorizes the ONI to consult with state insurance regulators at its discretion. It also requires the ONI to notify the appropriate state regulators within 30 days of taking any revocation, suspension, restriction, or receivership action against a national insurer or agency. States will retain their authority to tax nationally chartered companies.

As discussed more fully in Section V, below, the international authority granted to the ONI would mark a significant change for U.S. participation in international insurance forums and in the relationship between U.S. and foreign insurance regulators. The Act authorizes the ONI to enter into international agreements affecting global markets to promote fair and open competition. The ONI may also work with foreign regulators to develop international regulatory standards and mutual

¹¹ The Senate bill would grant the ONI authority to investigate fraud by or against a national insurer or agency, a federally licensed producer, or other federally licensed firm. The House bill extends the ONI's authority to cover state-licensed firms as well.

recognition agreements. The Act envisions that the ONI will consult and cooperate with the President and the U.S. Trade Representative in exercising this authority. The Act also grants the ONI the authority to assist foreign governments in their enforcement activities and to seek their help when needed.

Receivership. Under the Act, the Commissioner of the ONI would become the receiver for a national insurer in need of rehabilitation or liquidation. The appointment of the Commissioner as receiver would trigger the responsibilities of state guaranty associations in the same manner as if a state court had issued a liquidation order. As receiver of a national insurer, the Commissioner would have all the powers of the officers, directors, and managers of the company and could exercise any corporate powers under the company's by-laws. In addition, the Commissioner could collect and marshal assets and hold hearings. The Act requires the Commissioner to adopt regulations based on the Uniform Receivership Law of the Interstate Insurance Receivership Compact Commission and to follow the provisions of the NAIC's guaranty association model act.

Insolvency Protection. As with state insurance law, the Act provides for guaranty associations to protect policyholders in the event of the insolvency of an insurer. National insurers would be required to participate in existing state guaranty associations in the states where they do business, provided the guaranty association is deemed "qualified" by the ONI. In order to be deemed "qualified," the state association must admit both state and national insurers and have a board with representatives of different classes of insurers (e.g. type of charter, size, lines of business).

The Act also provides for the establishment of a National Insurance Guaranty Corporation (NIGC) under the supervision of the ONI. Any insurer operating in a state without a qualified guaranty association would be required to participate in the NIGC with respect to that state. The

NIGC would be a non-profit organization and would not be backed by the full faith and credit of the United States. When needed, the NIGC would be financed through assessments on participating national insurers. If, at any time, there is excess funding of the NIGC, the organization can return the surplus to its members.

Statutory Organizational Components

The Act creates three organizational components that the ONI would be required to include. First, the Act requires creation of a Division of Insurance Fraud to execute the agency's fraud-related responsibilities. It also creates a Division of Consumer Affairs that is charged with supporting the implementation and enforcement of market conduct regulations. Finally, the Office of Ombudsman would function as a liaison between the ONI and any adversely affected regulated person. The Ombudsman would have the power to seek a stay of certain ONI decisions or actions and would report to the Commissioner on weaknesses in policies and procedures within the ONI.

The Act also authorizes the involvement of SROs in many aspects of the ONI's regulatory mission. The ONI may delegate to SROs any power except: the authority to issue the rules, regulations, orders, and interpretations necessary to carry out the ONI's responsibilities under the Act; powers related to the organization and chartering of national insurers or agencies;¹² the power to preempt state law; powers relating to mergers, acquisitions, consolidations, and bulk transfers involving national insurers or agencies; powers relating to the domestication of foreign insurers; powers relating to conversion of stock or mutual insurers; and the regulation of holding companies. SROs must register with the Commissioner and be subject to ONI supervision and regulation.

¹² The Act distinguishes between the act of chartering a national agency, which the ONI may not delegate, and the licensing of producers (including national agencies and others), which it may.

III. Organization and Functions of Comparable National Regulators

The previous section outlined the general framework established by the Act for the ONI's organization and functions. The examination of state insurance regulators in Section I provides some of the information required to paint the details in a portrait of the new agency. Other details, however, may come from federal financial regulators with missions comparable to the ONI's, as well as national insurance regulators outside the United States. This section examines the organization and functions of the OCC, SEC, and FDIC, and evaluates the similarities and differences between each of these agencies and the ONI. For a further comparative perspective, this Section also examines the insurance regulation function of the FSA.

Office of the Comptroller of the Currency

Established in 1863 as a bureau within the Treasury Department, the OCC's mission is to ensure the safety and soundness of the national banking system. To that end, it charters, regulates, and supervises all national banks. It is responsible for more than 1,600 institutions holding over \$7 trillion in assets.¹³ The agency's principal objectives are to ensure the safety and soundness of national banks and their compliance with consumer and other applicable laws and regulations.

Supervision. The OCC is primarily a supervisory agency, with 2,061 national bank examiners representing over 67% of its total workforce.¹⁴ At the largest national banks, staff from the Large Bank Supervision department maintain a continuous physical presence, monitoring the banks' operations for safety and soundness, compliance, and systemic risk. At all of its supervised banks, the OCC employs a risk-based supervisory approach in its examinations, which occur every

¹³ Office of the Comptroller of the Currency. *Fiscal Year 2007 Annual Report*, 9.

¹⁴ *Ibid.*

12 to 18 months. In fiscal year 2007, the OCC conducted 1,287 safety and soundness examinations and another 897 specialty examinations.¹⁵

Although its mission is domestic in scope, the OCC nevertheless plays an important role in banking regulation internationally due to its responsibilities as supervisor of the federal branches and agencies of foreign banks and the international presence of large national banks. The OCC analyzes international risks to national banks, formulates international banking policy in consultation with its foreign counterparts and the Federal Reserve Board, and negotiates information-sharing agreements with foreign supervisors. The OCC recently announced the creation of a new international bank supervision group to focus on the foreign activities of national banks.¹⁶

Compliance and Consumer Affairs. The OCC promotes “fair access and fair treatment” of consumers through its supervisory process, its outreach program, and its Customer Assistance Group (CAG). As part of the agency’s supervisory program, the OCC staff evaluates compliance with applicable legal requirements. The OCC also collaborates with the Federal Reserve Board in its consumer protection rulemaking process.¹⁷ The OCC supplements these efforts with its own public information initiatives, which provide information to consumers on topics such as mortgages, gift cards, and fraudulent cashiers’ checks.

The CAG interfaces directly with consumers to address their complaints. Reporting directly to the OCC’s Ombudsman, the CAG in 2007 processed more than 67,000 cases, which resulted in

¹⁵ *Ibid.*

¹⁶ Office of the Comptroller of the Currency, “OCC Names Delora Jee Head of New International Supervision Group; Michael L. Brosnan Rejoins OCC as Large Bank Deputy Comptroller,” OCC News Release (April 2, 2008).

¹⁷ Both the FDIC and the OCC generally lack rulemaking authority under consumer protection laws. This authority is reserved for the Federal Reserve Board.

reimbursements to consumers of approximately \$8 million.¹⁸ The OCC analyzes the complaint data it receives and generates reports specific to individual banks. These reports can then be used by bank examiners when conducting examinations at those banks.

Enforcement. The OCC often chooses to assert its influence through the supervisory process and informal enforcement actions. However, in certain cases, supervisory review may lead to formal enforcement actions, which may include civil money penalties. In fiscal year 2007, the OCC instituted 53 enforcement actions against national banks and 248 actions against institution-affiliated parties.¹⁹

Major Similarities to the ONI. Many of the ONI's responsibilities and powers resemble those of the OCC. Both the OCC and the ONI would regulate some of the largest and most complex institutions, and therefore require a highly capable examination staff. Also, like the OCC, the ONI would have the power to charter institutions. The licensing, enforcement, and examination powers that the Act grants the ONI resemble those granted to the OCC under the National Bank Act, the Federal Deposit Insurance Act, and other statutes.

Major Differences from the ONI. Neither the OCC nor any other federal banking agency licenses intermediaries comparable to agents and other producers. As discussed in Section IV, it is not clear whether a federal agency could perform such a licensing function efficiently without the assistance of an SRO. In contrast to the ONI, which would be authorized to delegate regulatory functions to SROs, no domestic bank regulator relies on SROs in any capacity.

¹⁸ Office of the Comptroller of the Currency. *Fiscal Year 2007 Annual Report*, 56.

¹⁹ *Ibid.*, 21.

Securities and Exchange Commission

The goals of the SEC are to protect investors; maintain fair, orderly, and efficient securities markets; and facilitate capital formation. The SEC carries out these functions principally through its four divisions: Enforcement, Trading and Markets, Corporation Finance, and Investment Management.

Investor Protection. Many consider the SEC's regulatory style to be enforcement-oriented. Indeed, the Division of Enforcement is the largest division of the SEC, with 1,111 FTEs representing approximately 32% of the total SEC workforce in fiscal year 2007.²⁰ Through this Division, the SEC conducts investigations of potential securities law violations and brings civil actions in federal court or before administrative law judges. The SEC relies on its own examinations, market surveillance activities, investor tips and complaints, SROs, industry sources, and media reports to identify enforcement targets. In fiscal year 2007, the SEC initiated 776 investigations, 262 civil actions, and 394 administrative proceedings.²¹ These enforcement proceedings covered issues such as financial fraud, backdating of stock options, insider trading, broker-dealer violations, and mutual fund frauds. They do not include additional investigations and proceedings conducted by securities industry SROs.

The SEC's Office of Compliance Inspections and Examinations (OCIE) assists the Division of Enforcement in its mission by conducting examinations of SROs, broker-dealers, transfer agents, investment companies, and investment advisers to uncover securities law violations. Certain

²⁰ U.S. Securities and Exchange Commission. *In Brief FY 2009 Congressional Justification*. (February 2008), 1.

²¹ U.S. Securities and Exchange Commission. *2007 Performance and Accountability Report*, 25.

egregious violations are then referred to the Division of Enforcement. In fiscal year 2007, the OCIE conducted more than 2,400 examinations, mostly of investment advisers and broker-dealers.²²

Securities Markets. The Division of Trading and Markets oversees market participants and reviews the rulemakings of SROs such as the Financial Industry Regulatory Authority (FINRA) and the Public Company Accounting Oversight Board (PCAOB). Unlike bank regulators, the SEC relies extensively on SROs for regulatory capacity and oversight. FINRA is a critical component in the SEC's efforts to regulate market conduct and examine securities firms, and the PCAOB oversees registered accounting firms. The Division of Investment Management complements the oversight of the Division of Trading and Markets by regulating investment companies and investment advisers.

Financial Disclosure. The Divisions of Corporation Finance and Investment Management are largely responsible for ensuring that investors have accurate and timely information with which to make informed investment decisions. Together, these divisions reviewed the disclosures of over 36% of all reporting companies in fiscal year 2007 and of a higher percentage of initial registration statements.²³ The SEC maintains a publicly available electronic database, known as EDGAR, containing all disclosure documents filed with the agency. In fiscal year 2007, there were 802 million searches for filings in this database.²⁴

Major Similarities to the ONI. The SEC offers the most useful model among the larger federal financial regulators for estimating the size and cost of many aspects of the ONI. This is not

²² *Ibid.*, 26.

²³ *Ibid.*, 38.

²⁴ U.S. Securities and Exchange Commission. *In Brief FY 2009 Congressional Justification*. (February 2008), 4.

because the nature and style of federal insurance regulation would resemble that of federal securities regulation – to the contrary, as explained below, we would expect them to be quite different. However, the SEC’s market regulation function does resemble the ONI in the scope of its regulatory mission and the nature (although not the size) of its regulated community. Like the ONI, the SEC must oversee the regulation of sophisticated global financial institutions, a larger number of small and medium sized institutions, and a considerable number of geographically dispersed intermediaries. Moreover, the regulatory regime for which the SEC is responsible includes not only financial and market conduct regulation of financial institutions, but also examination, licensing, and enforcement with respect to individual securities professionals across the United States. In order to execute its mission, the SEC relies on a robust SRO structure, without which the agency likely would be substantially larger and perhaps less efficient. These characteristics, shared by the SEC and the ONI, distinguish both agencies from bank regulatory agencies such as the OCC and FDIC. (Of course, the SEC’s purview is much broader than the ONI’s. The SEC regulates securities exchanges, securities brokers and dealers, investment advisers, and mutual funds, as well as the securities offerings and accounting practices of publicly held companies, while the ONI’s purview would be limited to members of the insurance industry that are federally chartered or licensed.)

Major Difference from the ONI. As would be expected from the difference in the agencies’ respective regulatory approaches, the SEC’s examination group is much smaller than that of the FDIC or OCC. In this respect, one would expect the ONI to resemble the bank regulators far more closely than it does the SEC. Consistent with the practice of state insurance regulators, the ONI would likely devote more resources to proactive supervision and fewer resources to reactive enforcement than does the SEC. Indeed, the Act specifically requires the ONI to examine insurers every three years.

Federal Deposit Insurance Corporation

Created in 1933 in response to sweeping bank failures, the FDIC is designed to preserve and promote public confidence in the U.S. banking system. It pursues this mission through three core functions, reflected in its three primary divisions: Insurance and Research, Supervision and Consumer Protection, and Resolutions and Receiverships.

Insurance. The goal of the FDIC's insurance function is to protect insured depositors from loss while avoiding taxpayer liability. To accomplish this goal, the FDIC provides depositors with access to insured funds at failed institutions, identifies and responds to risks to the Deposit Insurance Fund (DIF), and manages the overall health of the DIF. Managing the risk to the DIF entails an assessment of each insured institution's overall risk through information obtained in the FDIC's or other agencies' examinations.

The FDIC can charge all insured depository institutions premiums to fund the DIF. These premiums are assessed based on the specific risk posed by the insured depository institution to the DIF: riskier institutions pay a higher rate to maintain their deposit insurance than less risky institutions of comparable size. The FDIC can also adjust DIF targets based on general economic conditions, such as the overall health of the banking industry. As of December 31, 2007, the DIF had approximately \$52.4 billion representing 1.22% of estimated insured deposits.²⁵

Supervision and Consumer Protection. The FDIC is the primary federal regulator for the approximately 5,257 state-chartered banks that are not members of the Federal Reserve System.²⁶ The FDIC is the back-up examiner for all other banks and thrifts that have federal deposit

²⁵ Federal Deposit Insurance Corporation. *Fourth Quarter 2007 CFO Report to the Board*. (February 6, 2008).

²⁶ Federal Deposit Insurance Corporation. *Annual Report 2007*, 16.

insurance. The FDIC is responsible for ensuring the safe and sound operation of the state-chartered banks that it supervises, as well as their compliance with consumer protection laws. The Division of Supervision and Consumer Protection, which houses these functions, had 2,557 employees at the end of 2007, comprising approximately 56% of total FDIC employees.²⁷ It is by far the largest division within the FDIC.

To carry out its supervisory objectives, the FDIC conducts on-site examinations of state non-member banks. These examinations are conducted on a 12- to 18-month cycle, with the state regulator and the FDIC performing every other examination. The examinations cover overall financial condition, management practices and policies, and compliance with applicable laws and regulations. Depending upon the severity of the problems identified during its examination and the institution's regulatory capital position, the FDIC may be required by law to take supervisory action to address them. In 2007, the FDIC conducted 2,258 safety and soundness examinations.²⁸

In addition to safety and soundness examinations, the FDIC conducted a combined 1,773 Community Reinvestment Act and targeted compliance examinations in 2007.²⁹ It received and responded to 11,624 consumer complaints and 6,977 inquiries.³⁰ The FDIC also conducts outreach and education programs to help consumers obtain information about their rights and the disclosures due them under consumer protection and fair lending laws.

Resolutions and Receiverships. The FDIC's resolutions function is charged with recovering assets for a failed institution's creditors and maximizing net return toward an orderly and

²⁷ *Ibid.*, 121.

²⁸ *Ibid.*, 16.

²⁹ *Ibid.*, 16.

³⁰ *Ibid.*, 26.

timely termination. In 2007, three FDIC-insured institutions with total assets of \$2.34 billion failed.³¹ The FDIC is currently planning to hire as many as 138 new employees in its Division of Resolutions and Receiverships to prepare for a projected rise in bank failures.³²

Major Similarities to the ONI. The ONI will serve as administrative receiver in the event of failure of a national insurer, and its powers as receiver will be similar to the FDIC's. Like the DIF, the NIGC would provide pre-defined benefits to policyholders following insolvency of a national insurer to the extent not provided by qualified state guaranty associations. Unlike the DIF, however, the NIGC will only be funded as needed to provide benefits or guarantee policies following an insolvency.

Both the FDIC and the ONI would have a substantial report collection function. The FDIC processes Call Reports on behalf of all bank regulators and maintains an "Institution Directory" on its website to serve as a public interface. The ONI would likely gather similar information on federally regulated insurance firms. Moreover, the ONI is specifically charged with maintaining a database with information about licensed insurance producers and creating an electronic communication network to facilitate the exchange of such information with state insurance regulators.

Major Differences from the ONI. The FDIC and ONI differ significantly with respect to the size and sophistication of the financial institutions subject to their primary supervision. The majority of the institutions under direct FDIC supervision are small and do not engage in sophisticated capital markets activities. On the other hand, in addition to numerous smaller

³¹ *Ibid.*, 29-30.

³² Michael R. Crittenden. "FDIC Seeks Hires, Braces for Troubles." Wall St Journal, March 26, 2008, A2.

institutions, we would expect the ONI to regulate some of the largest and most complex insurers, whose operations would span both state and international borders.

One additional difference between the FDIC and the ONI is worth noting in this context. In bank regulation, at least one federal regulator is always responsible for any federally insured depository institution, whether the institution operates under a federal or state charter. In contrast, the division of regulatory authority between the states and the federal regulator envisioned in the Act is mutually exclusive: insurers and producers will either be regulated by state insurance regulators or the ONI, but not both (although there are some exceptions to the mutual exclusivity of state and federal regulation designed to maintain the proper functioning of the state system).

UK Financial Services Authority

Prior to 2001, financial regulation in the United Kingdom was undertaken by nine separate regulatory bodies and organized around sectors (e.g., banking, insurance, securities), as it is in the United States. The Government first announced the intention to overhaul the regulation of the financial services industry in 1997, and the next four and a half years were spent consolidating the nine separate bodies into the newly created Financial Services Authority. On December 1, 2001, the FSA finally obtained its new legislative powers under the Financial Services and Markets Act of 2000. On a number of occasions since December 2001, Parliament has extended the FSA's regulatory responsibilities. The FSA is now responsible for both financial and market conduct regulation of all insurance companies, brokers, and intermediaries.³³

The structure of the FSA, revised in 2004, consists of three units: Retail Markets, Wholesale & Institutional Markets, and Regulatory Services. The retail unit includes three supervisory divisions

³³ This includes those who offer financing and insurance products to consumers, such as car dealers, home appliance outlets, and, in the near future, travel agents selling travel insurance.

(Small Firms Division, Retail Firms Division, and Major Retail Groups Division), a Treating Customers Fairly Division, a Financial Capability Division (responsible for consumer financial education), and a Policy and Themes Division. The wholesale unit includes a Markets Division, Wholesale Firms Division, Wholesale and Prudential Policy Division, and Financial Crime and Intelligence Division. The Regulatory Services unit handles applications for initial or extended authorizations and for waivers from specific requirements, as well as analyzing returns submitted by firms.

In 2004, the FSA introduced Sector Teams who work across the organization to assist senior management with risk identification in specific market sectors. Covering eight sectors,³⁴ the Sector Teams have responsibility for ensuring sufficient depth of knowledge about particular sectors and for representing the organization when dealing with interested stakeholders, including in international forums.

Supervision. The FSA's assessment of the inherent risk a firm presents to its objectives determines the allocation of regulatory resources and the intensity of the supervisory relationship. Since the agency acquired additional regulatory responsibility for general insurance intermediaries in January 2005, approximately 90% of the firms regulated by the FSA (about 26,000) have been defined as "low impact." Insurance companies, brokers, and intermediaries defined as low impact do not have a dedicated supervisory contact. Instead, firms submit periodic returns that are subject to automated monitoring. Any exceptions generate an alert that is investigated further. When a low-impact firm wishes to contact the FSA, it is directed to a contact center, which responds to queries and escalates issues where appropriate.

³⁴ Banking, Capital Markets, Asset Management, Insurance, Retail Intermediaries, Financial Stability & Business Continuity, Consumers and Financial Crime.

To ensure that low-impact firms are subject to sufficient supervisory oversight, the supervision division undertakes considerable cross-sector thematic work. This may be undertaken on a proactive basis, where a Sector Team or policy division identifies an industry trend and wishes to understand the implications, or on a reactive basis. Examples of topics examined in such efforts include the appropriate segregation of client funds held by brokers and intermediaries, contract certainty in the wholesale insurance markets, reviews of actuarial assumptions, and the adequacy of claims handling.

Medium-impact firms are assigned a dedicated supervisory contact at the FSA responsible for managing the relationship. Organized around specific sectors within the divisions, a supervisor will typically be responsible for between four and six firms. The aim is to build an effective working relationship with the firm and develop a detailed knowledge of its business, strategy, and the risks it poses to the FSA's objectives.³⁵

Firms considered to be high impact are subject to a much closer regulatory relationship, with an appreciably higher level of resources devoted to their supervision. Typically, the supervision team of a large firm consists of between three and eight people, with more senior members of staff responsible for managing the regulatory relationship. Supervisors responsible for large firms are expected to have a thorough understanding of the firms' business, systems, and controls and should be able to identify the risks that exist. Judgments about these risks are continually reviewed based on new information the FSA receives. This may arise from regular dialogue with the senior management of the firm and other regulatory agencies (including international regulators), consumer complaints, and similar sources.

³⁵ The four statutory objectives of the FSA are: market confidence, public awareness, consumer protection, and the reduction of financial crime. These are supported by a set of Principles of Good Regulation that the FSA must follow when performing its duties.

All medium- and high-impact firms are subject to a regulatory review cycle of between six and 48 months, concluding with an onsite visit by the supervisory team to determine the risk the firm poses to the FSA's objectives. If the FSA wishes to investigate further a specific concern following an assessment, it can require a firm to commission, at its own expense, a report by an independent outside party. This is only requested where the FSA believes it does not have the skills or resources to undertake the work and does not consider the firm able to perform the review with sufficient expertise or objectivity. The reports are typically prepared by an accounting, legal, or consulting firm.

The FSA also leads and participates in international supervisory colleges, whose aim is to coordinate the supervision of international financial conglomerates. The college meetings establish a forum for global regulatory agencies to meet and discuss common issues with groups or advise on particular concerns or business developments.

Treating Customers Fairly (TCF). All regulated firms are expected to comply with eleven "Principles for Businesses" published in the FSA's Handbook. The Principles are "a general statement of the fundamental obligations of firms under the regulatory system,"³⁶ and are achieving increasing prominence as the FSA moves to a more principles-based approach to regulation. The sixth Principle is a requirement that firms "must pay due respect to its customers' requirements and treat them fairly." The FSA's retail policy agenda is requiring firms to demonstrate how they are meeting this obligation. By December 2008, firms are required to have in place measures, typically in the form of management information, to show how they are treating their customers fairly. Firms who fail to meet the deadline risk enforcement action.

³⁶ UK Financial Services Authority. *Principles for Businesses*. FSA Handbook Release 035 (October 2004), 1.1.2.G.

The appropriate supervision team is principally responsible for assessing the adequacy of firms' compliance with TCF. The TCF Division acts as a specialist team that supports the supervisors in making that judgment in a rigorous way. It also designs review programs and publishes policy studies, case studies, and update papers.

Supervisory Support. The FSA has a number of specialist functions that assist supervisors in discharging their responsibilities and work to ensure a consistent approach to supervision across the agency.

Policy Divisions. The Policy divisions are responsible for interpreting the FSA's Handbook detailing authorized firms' regulatory obligations, formulating policy in response to market or product developments, and working with European and other international bodies to represent the UK position.

Themes Teams. A "Themes Team" is responsible for monitoring the overall retail market (as opposed to Sector Teams, which look at specific types of business or activity). Themes Teams work with both supervisors and Sector Teams to identify emerging risks and assess the potential impact on the FSA's statutory objectives. For example, past Themes Teams have assessed the quality of advice offered by individual financial advisors, the implications of the development of wrap platforms, preparations for the implementation of new pensions legislation by pension providers, and improprieties in the sale of mortgage endowments.

Actuaries. Actuaries assist supervisory staff in reviewing an insurance company's capital reserves and actuarial models. Embedded in areas responsible for supervising insurance companies, they provide input into the regulatory assessments of firms, review submissions (including financial reports), and participate in interviews with firms where appropriate. The actuaries also provide *ad hoc* assistance with firm inquiries related to technical actuarial matters and maintain close

relationships with the professional actuarial bodies, particularly with respect to standard setting and developing trends.

Risk Review Team. The Risk Review Team consists of quantitative and information technology specialists who assist in technical reviews of firms, including insurers where necessary. Such teams have particular skills in considering exotic market instruments and in model approvals. Much of the day-to-day work of Risk Review Teams relates to banks.

International Relations. The International Relations department works closely with the Policy divisions to represent the FSA in European and international regulatory forums. The department is also involved in establishing Memoranda of Understanding with other regulatory agencies.

Enforcement. The organization of the FSA's Enforcement Division reflects the broader structure of the agency. The division has dedicated wholesale and retail departments and is overseen by a director reporting to the CEO. The division, which consists primarily of attorneys, provides some in-house legal advice to the other divisions on enforcement matters. It also acts as contact point for making and receiving requests from enforcement departments of other regulators.

Financial Ombudsman Service. Responsibility for investigating and resolving consumer complaints against authorized firms does not sit with the FSA, but with a separate, albeit closely linked, body – the Financial Ombudsman Service (FOS). The FOS accepts referrals where consumers are contesting the findings of internal reviews undertaken by firms in the first instance. The service to consumers is free, while firms are charged a £400 fee regardless of whether the FOS finds for them or against them. Customers must have exhausted the complaints procedures at the firm before turning to the FOS.

Financial Services Compensation Scheme. The Financial Services Compensation Scheme (FSCS) acts as a compensation fund of last resort for consumers whose financial services provider is no longer solvent. Funded by levies against authorized firms in each sector, the FSCS only pays compensation for financial loss. If an insurer did become insolvent, the FSCS's role would be to pay claims if the insurer had insufficient funds to do so and to repay premiums.

Lessons for the ONI. The FSA's status as an integrated insurance, banking, and securities regulator limits its usefulness in modeling the structure, size, and budget of the ONI as proposed by the Act. Nevertheless, this brief overview of the FSA is helpful to anyone trying to evaluate the practical consequences of the creation of an optional federal insurance charter because it offers a glimpse into how the ONI might operate within an integrated national financial regulator. That is more than an academic exercise. Proposals for regulatory consolidation have gained new momentum in the wake of the credit crisis, and any federal insurance regulator would likely be included in such consolidation. Indeed, federal regulation of insurance was a component of the overall Blueprint for a Modernized Financial Regulatory Structure released by the Treasury Department on March 31, 2008.

The jury may still be out on the effects of cross-sector synergies on the quality of financial regulation, particularly in light of recent well-publicized crises in UK financial institutions, most notably Northern Rock. What is clearer, however, is that integration of the ONI into a consolidated national financial regulator might achieve at least some economies of scope. As may be gleaned from the descriptions of state and federal financial regulators above, sector specialization among U.S. regulators results in duplication of a number of policy functions that perhaps could be effectively combined, including those addressing such cross-sector issues as consumer disclosure,

economic capital, and risk assessment. These economies would be in addition to those achieved by combining the duplicative executive and administrative infrastructures.

Even absent the creation of an integrated regulator, adoption of certain FSA practices could enable the ONI to cope more easily with the challenge of regulating insurance on a national scale. The potential seems greatest in the areas of market conduct regulation and consumer affairs. First, the ONI could evaluate the initial results of the FSA's TCF initiative and, if successful, consider adopting all or part of this principles-based technique to supplement its market conduct regulation function. The ONI could also deploy "Themes Teams" to examine and address comprehensively market conduct issues that cut across a large number of regulated firms, such as complex annuity sales practices and the availability of property insurance in coastal areas. Finally, the ONI could encourage regulated firms to improve treatment of customers by charging them a fee when failures in the firms' internal processes lead customers to contact the ONI's consumer affairs function for assistance.

IV. Size and Cost of the ONI

The foregoing outline of the organization and functions of the ONI, together with the analysis of comparable state, federal, and foreign regulators, provides the context for our attempt to estimate the new agency's size and cost. We have constructed a model to make such a projection. This section describes the model's assumptions, methodology, and results.

Cost Calculations and Assumptions

ONI Functions. The model estimates the size and cost of ten functions we believe the ONI will perform. Five of these functions are "direct" functions – that is, they involve front-line supervision and enforcement activities. The other five are "indirect," in that they include

administrative, support, analytical, and similar functions that generally are not directly involved in day-to-day supervision of regulated parties.

The direct functions are:

- Financial Regulation (including receivership and guaranty association supervision)
- Market Conduct
- Enforcement and Anti-Fraud
- Consumer Affairs
- Licensing

The indirect functions are:

- Executive (including the Inspector General and the Ombudsman)
- Legal (excluding enforcement)
- Administration
- Information Technology
- Other Programs Offices (including Actuarial Policy, International Activities, Economic Analysis, and Outreach)

As discussed in Section II, the Act authorizes the ONI to delegate a number of regulatory functions to SROs. One model for such delegation is the SEC, which has delegated large portions of its responsibility for licensing and regulating market professionals to FINRA. Given the large number and geographic dispersion of producers, one could fairly argue that flexible SROs with substantial presences in local markets should be able to regulate them more efficiently than the ONI. Moreover, problems raised by the financial condition and market conduct of producers do not generally present the level of systemic risk posed by similar problems at insurance carriers.

Given the compelling case for delegation of producer licensing and the ease with which such costs can be isolated using available data, we assumed that the ONI would delegate producer licensing to an SRO and excluded that function from our model. The Act also authorizes the ONI to delegate other functions, including many aspects of financial and market conduct regulation of insurers. If the ONI elected to delegate further responsibilities, its operating costs and size would be smaller than what we have estimated. However, the available data are not sufficiently detailed to permit us to assess the impact of such delegation quantitatively.

Model Structure. For each of the ten functions, the model breaks down individual costs into line items such as salaries and benefits, travel, rent and facilities (including equipment), other overhead, and contract services. Each function is assigned an FTE number equal to the estimated number of full-time employees required to perform the function. Each line item is assigned a cost coefficient equal to the estimated cost per FTE represented by the line item. The model sums the cost coefficients for each function and multiplies it by the number of FTEs, producing an estimated total cost for the function. The sum of these costs represents the total agency budget.³⁷

Explanation of Data Sources. We drew state FTE and salary data, premium income statistics, and data on regulated parties from the 2006 NAIC Insurance Department Resources Report. Reports dating back to 1998 were available to us, and we used them to determine if there was anything anomalous about the figures in the 2006 Report. We did not spot any major anomalies with respect to FTEs and salaries across the reports, with the exception of certain issues in the 2006 data for Texas and Florida, which we discuss below.

³⁷ The model estimates the steady-state operating costs for the ONI. It ignores one-time start-up costs, such as procuring space, purchasing furniture, building an IT infrastructure, and conducting the initial recruiting and hiring effort.

We drew federal costs from publicly available budget data for the FDIC, the OCC, and the SEC. Among the federal financial services regulators with missions comparable to the ONI, only the SEC has a so-called “appropriated” budget (meaning that its budget is specifically appropriated by the Congress). Perhaps as a result, its budget data is presented in far more detail in public documents and therefore served as a more useful basis for estimating the cost of “federal” elements of the ONI budget.

Estimation of FTEs. We use two different methodologies for estimating FTEs, depending on whether the estimate involves a direct or indirect function. For the five direct functions, the model uses FTE data for the California, New York, and Texas state insurance departments. These states’ FTE figures are weighted by premium volume and then adjusted to reflect the scale of the national regulator, as more fully described below. The use of state data for direct functions rests on the assumption that tasks performed by the ONI’s supervisory, consumer affairs, licensing, and enforcement personnel will more closely resemble those performed by state insurance regulators than those performed by federal banking or securities regulators. This assumption is particularly strong in the first few years of the ONI’s operations, as the agency likely will initially be staffed primarily by former state insurance regulators enforcing a regulatory regime based almost entirely on NAIC model acts and standards.

There are two exceptions to this general rule: First, we reduced the direct function FTEs by the amount of premium volume reported for health insurance.³⁸ As discussed in Section II, the ONI would not regulate health insurance. Second, we excluded from the direct functions any FTEs attributable to product and rate review. Given the nature and scope of product regulation

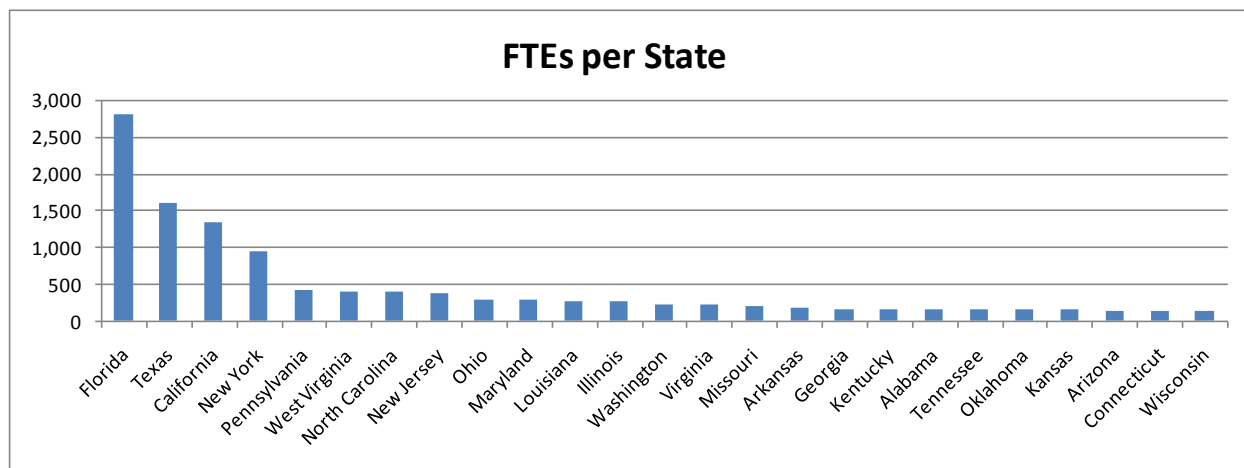
³⁸ The California Insurance Department does not regulate health insurance.

envisioned by the Act, we do not expect the ONI to devote any material level of resources to routine product and rate review. Rather, we expect the ONI's product review function to focus primarily on such policy and research matters as devising life and annuity product standards, responding to interpretive letter requests, and serving as a resource for the financial and market conduct regulation functions. While the resource requirements for such activities would surely grow larger as the regulated community grows, we would not expect them to vary directly with the number of regulated firms because they permit substantial economies of scale. For example, it is reasonable to assume that the ONI would develop only one set of standards per life insurance product type, regardless of the number of firms that join the federal system.

We believe using state FTE data for indirect functions would be misleading. The ONI will be a federal agency, headquartered in Washington, D.C. and generally subject to the statutes and regulations that govern the management of federal agencies. Its administrative infrastructure and management culture therefore will likely be based on the federal model. Moreover, given the ONI's status as a national regulator, as well as its unique international role, the staffing of the analytical and policy functions will likely bear less relationship to the staffing of those functions at state insurance regulators than it does to that of the federal agencies that supervise geographically diverse, complex, and internationally active firms in other financial sectors. Accordingly, we based FTE estimates for indirect functions on the SEC, whose available budget data was sufficiently specific to permit function-by-function calculations.

Choice of Comparison States. Among the state insurance departments, a few agencies stand out in terms of their size. The NAIC data show that the four largest state insurance departments – Florida, Texas, California, and New York – have far more employees than do other state insurance departments. Together, these four states account for approximately 50% of all FTEs reported by

state insurance regulators and average 1,671 FTEs each. By comparison, all the other state insurance departments average 145 FTEs.



We based our calculations of the ONI’s personnel and budget on the figures reported for the larger states, for a number of reasons. First, one could reasonably assume that differences in scale cause large and small regulatory agencies to operate differently. Small agencies must be staffed with more generalists and contract out more technical work. Also, FTE and salary figures at small agencies are more vulnerable to idiosyncratic factors in agency management or in particular states’ regulated markets. Indeed, our review of the data suggests that such factors affected the allocation of FTEs among functions. We believe it is reasonable to assume that FTE distribution at the ONI – a relatively large regulator – would most closely reflect the distribution at other large agencies.

We further excluded Florida data from the model because of the peculiar structure of insurance regulation in Florida. The Florida Office of Insurance Regulation is administered by a Commissioner appointed by the state’s Financial Services Commission. However, the Office is administratively housed within the Florida Department of Financial Services (FLDFS), which is administered by an elected Chief Financial Officer. The FLDFS supports the Office of Insurance Regulation in the areas of information technology, budgeting, personnel, and accounting. In

addition, some consumer functions are performed by a separate Division of Consumer Services within the FLDFS, while some enforcement functions are performed by the Investigations Unit of the FLDFS's Agent and Agency Services Division. This fragmentation of the insurance regulatory function suggested to us that the FTE and salary data reported by Florida in 2006 may not be comparable to those of California, New York, and Texas, and may not serve as an accurate guide for the more integrated and self-sufficient ONI.

We also note that the distribution of FTEs among functions in the Texas data is affected by the decision of the Texas Legislature to combine the Texas Worker's Compensation Commission with the Texas Department of Insurance. In addition, Texas categorizes over 676 FTEs as "other staff," while California and New York combined only report 88 FTEs as "other." We were concerned that the Texas figure would distort the output of the model, so we elected to exclude all FTEs categorized as "other staff" from our model. Our assumption is that if these staff were performing one of the direct functions, Texas would record the FTEs in one of those cost categories. To the extent that our exclusion leads us to understate the Texas direct FTEs, the impact will be partially offset by the fact the Texas FTEs receive less weight in our calculations since Texas has the lowest volume of premium income of the three states. To the extent these staff are performing administrative or other indirect functions, they should be accounted for in our estimates for indirect FTEs.

Weighting and Scaling. The three states together regulate insurers and producers that account for roughly 25 percent of non-health insurance domestic premium income. Estimating how the ONI's size and cost would grow if it were to supervise a larger regulated community requires determining a basis for scaling the state data. We identified this basis by examining the relationship between FTEs in each state and a number of factors: state insurance department budget, number of

insurers, premium volume, and state populations. Our correlation analysis indicated that FTEs' strongest relationship is with premium volume.³⁹ We therefore use premium volume to weight and scale the state FTE data.

For indirect functions, the model assumes that the ratio of direct-to-indirect FTEs at the ONI would be comparable to that of the SEC. This is consistent with our previously stated assumption that the size of the indirect functions at the ONI would resemble those at peer federal financial regulators. The SEC's direct FTE count falls between the direct FTE projections in the ONI Base Case and High Conversion Case scenarios. It is reasonable to expect that the number of FTEs employed in indirect functions will not be particularly sensitive to the number of regulated firms within the range of potential conversion rates we considered. Moreover, no matter how many firms choose a federal license, there must be some minimum number of indirect FTEs required to support an agency of any significant scale. In light of the foregoing, we decided that the most elegant solution is to use the SEC's indirect FTE counts for both conversion scenarios. This approach has the additional advantage of capturing the economies of scale likely to accrue in indirect functions as the size of the regulated community grows, with overhead expenses constituting a higher percentage of total costs in the Base Case and a smaller percentage of total costs in the High Conversion Case.

Estimation of Cost Coefficients. After projecting the number of FTEs the ONI would require in each function, we estimated cost coefficients for each of the various line items in the projected ONI budget.

³⁹ The correlation coefficients for each factor were as follows: number of insurers – 59%, population – 73%, agency budget – 56%, and premium volume – 78%.

Salaries and Benefits. As discussed in Section II, above, the Act grants the ONI flexible pay authority comparable to the authority possessed by several other federal financial regulators. In order to attract top quality people from the ranks of current insurance regulators (the most obvious initial labor source), the ONI will have to offer competitive compensation that will likely exceed the average pay scales presently in use by state regulators. Ideally, we would have preferred to estimate the salaries by applying a “federal premium” calculated based on the relationship between the pay of federal and state banking and securities regulators for the functions reported in the NAIC data. Unfortunately, we found no suitable, rigorous pay studies that systematically compare state and federal pay at financial regulators. In our experience, government pay comparisons involve knotty methodological problems that cannot be overcome without substantial internal data (reflecting, for example, the often-skewed distribution of employees within pay grades). Given these problems, we do not believe we can confidently calculate a federal premium using available data.

We overcome this problem by making the conservative assumption that ONI pay will be comparable to that of the New York State Department of Insurance, as reported in the NAIC data. According to the NAIC data, salaries paid by the New York State Department of Insurance are by far the highest of any insurance regulator and appear, at least superficially, roughly comparable to those paid by federal financial regulators. We expect the ONI would be able to pay somewhat less than New York in regions of the country with lower costs of living and state government pay, such that our New York-based cost estimate may overstate the total salary expense that the ONI will incur.

For some jobs, New York does not provide specific salary data. Where available, we used the salary cost from the other two states, which we adjusted upward by 30 percent. (The adjustment reflects a finding by a 2006 salary survey conducted by the state of California that its salaries lagged

the salaries for benchmark public sector jobs in California by 15 to 30 percent.⁴⁰) No state provided salary data for the generic “Support Staff” positions reported across the various functions. For those positions, we simply assumed that employees were paid \$30,000 per year. Since both categories generally involved lower-paid junior or support positions, neither of these simplifying assumptions should have a material effect on the total budget figure the model projects.

We also added the cost of federal benefits to the state salary data by increasing pay for each position by 20%. This reflects the average ratio of salary-to-benefits costs experienced by the SEC.

Contract Services. We assume that the ONI’s contracting practices will be similar to comparable federal financial regulators. The NAIC data indicate that use of contract services varies greatly among state regulators and does not appear to be correlated to agency size or other agency-specific factors that we could identify. This suggests that there are factors driving outsourcing decisions that are not specific to the nature and scope of the regulated insurance market (or even perhaps to financial regulation in general). In this respect, one could fairly argue that the ONI, embedded in the Treasury Department and influenced by federal management culture and practices, would most likely exhibit federal outsourcing patterns.

We estimated contracting costs in the Base Case by calculating the amount that the SEC spends per FTE. However, more than half of this amount was for maintenance services, which we would not expect to grow proportionally as the number of regulated firms increases. Therefore, when we scale up the contracted services expenses to accommodate a higher rate of conversions, we only increase the amounts for advisory and other services.

⁴⁰ State of California Department of Personnel Administration. *Total Compensation Survey*. (April 2006), 3.

Travel. Travel costs are not separately reported in the NAIC data, and there are no directly comparable federal data available. In the absence of comparable data, we used the travel costs per FTE indicated by the SEC budget data. We believe the ONI's travel costs would in fact be higher than the SEC's because of the ONI's emphasis on on-site examinations. However, this difference is not necessarily material. A sensitivity analysis indicates that even doubling the travel expense figure would increase total ONI costs by only 1.5%.

Facilities and Equipment. We use SEC cost data with regard to renting space, acquiring furniture and fixtures, and purchasing IT systems. The ONI, like the SEC, would be subject to federal procurement rules, and we assume its costs for space and equipment per FTE would be comparable.

Rate of Conversion to the Federal System. The scale of the ONI will be heavily influenced by the number of firms that choose to operate under federal charters and licenses. The history of the dual banking system suggests that a number of factors will affect a firm's preference for one charter type over another. Size is not necessarily determinative in this area. The banking experience indicates that a federal charter can be an attractive alternative to the state charter for institutions of all sizes. Today, while most of the very largest commercial banks have national charters, the majority of national banks are smaller community banks.

Among the factors that could lead insurance firms to choose one regulator or another are the following:

- *The anticipated value of uniform national rules.* It is reasonable to expect that national uniformity would lower costs of duplicative regulation and increase speed to market of new and revised products for companies that operate in multiple states. Therefore,

companies that operate across state lines or seek to do so in the future would likely be attracted to the federal charter.

- *The streamlined product approval process and absence of rate regulation.* Some firms may be attracted to the ONI's more streamlined product approval process, described above, and to the absence of rate regulation under the federal framework.
- *The size of federal assessments.* The experience of bank regulators is that federal assessments and fees are at least twice as expensive as state assessments (although a major reason for the difference is that every other examination of state banks is performed by the Federal Reserve or the FDIC, and state banks do not pay for those examinations). In our experience, smaller institutions tend to be more sensitive to the difference in examination fees than larger institutions because the fees represent a larger portion of their total expenses. This factor may be even more important in the insurance context because federally regulated carriers would continue to be subject to state premium taxes, in addition to the assessments the ONI imposes.
- *The perceived difference in technical knowledge.* In our experience, many larger institutions believe that federal specialist examiners are more knowledgeable about best practices and highly complex financial transactions because they are exposed to a greater number of sophisticated institutions.
- *The prestige of a federal charter.* Some banks believe a federal charter carries more prestige abroad and that foreign regulators will give more credence to federal examinations. Institutions with a greater international presence or that engage in complex transactions would therefore be expected to prefer federal regulation.

- *Satisfaction with current regulator.* It is costly and time-consuming to change charters. Accordingly, it is reasonable to expect a measure of inertia that would lead many institutions to maintain a relationship with their current regulator.
- *Relationships with top decision makers.* In banking, state-regulated institutions tend to have a close relationship with and easy access to the top levels of the state regulators' management structure, while senior federal regulators may seem more remote and unapproachable. Similarly, state legislatures tend to be more responsive to individual state-regulated institutions than Congress is to federally regulated ones. Institutions that value these relationships and the comfort and flexibility they can afford will likely continue to value the state charter.

As of the date of this study, approximately 39% of insured depository institutions operated under federal charters. Because it is difficult to predict with precision which firms will convert, we calculate the size and cost of the ONI under two different conversion rate scenarios that relate to the banking industry ratio cited above.

- *Base Case:* Assumes that 25% of insurance carriers – and a commensurate number of producers, reinsurers, and other regulated persons – join the federal system.
- *High Conversion Case:* Assumes that 50% of insurance carriers – and a commensurate number of producers, reinsurers, and other regulated persons – join the federal system.

Results

Before taking into account the potential economies of scale discussed below, our model predicts the Base Case ONI would employ about 2,390 FTEs and have a budget of approximately \$465 million per year (see Exhibit A). In the High Conversion Case, our model predicts the ONI

would employ 4,030 FTEs and have an annual budget of approximately \$700 million (see Exhibit B). The table below compares these numbers with the size and budget of several comparable federal financial regulators and with the aggregate size and budget of the state insurance regulatory system.

Comparison of Costs (\$000)		
AGENCY	BUDGET/COST	FTEs
ONI (at 25%)	\$465,000	2,390
ONI (at 50%)	\$700,000	4,030
OCC (FY2009 projected)	\$810,872	3,139
SEC (FY2009 projected)	\$913,000	3,473
FDIC (FY2008 approved)	\$1,141,804	4,180
STATE SYSTEM (FY2006)	\$1,600,000	14,000
State FTE data are 2006 actual		

It is notable that, according to these estimates, the ONI budget would be disproportionately small given its size and the budgets of comparable federal regulators. The principal reason for this disparity is that the model assumes that the ONI's salary and benefits costs per FTE are lower. This is despite the fact that the model uses New York's costs, which are the highest of all the states and appear to be roughly comparable to federal pay scales. The most likely explanation for this difference is that the model assumes every employee would be paid at the mid-point of the salary range for her or his position type, on the assumption that most of the ONI's personnel will be new

federal employees with experience levels appropriate for their positions. On the other hand, existing federal regulatory agencies tend to have a large number of long-tenured staff members who are paid at the high end of the salary range for their position.⁴¹

Economies of Scale

There are reasons to believe that our cost and size model overestimates the number of FTEs the ONI would require because it does not take into account potential economies of scale in the direct regulation functions. While there is insufficient data to capture these economies quantitatively, their impact on the total ONI personnel and budget requirements could be substantial. The true FTE and budget numbers for the ONI, therefore, may well be somewhat smaller than the FTE and budget figures described above.

Specifically, the cost and size model assumes that the size distribution of converting firms mirrors the distribution of the regulated community in California, New York, and Texas. Admittedly, the conversion incentives described above, combined with the experience of the dual banking system, suggest that size is not a determinative factor in charter choice, and that companies of all sizes may have reason to choose a national charter. That said, based on these same factors, it is reasonable to expect that most of the largest insurers would join the federal system.⁴² The ONI will be able to regulate large firms with fewer FTEs than is indicated by the weighted average level of resources utilized by these states to regulate the average insurer. This is because each firm,

⁴¹ The Congressional Budget Office reports that in 2005, on average, permanent full-time federal workers were 47 years old and had 16 years of service. Between 1975 and 2005, the average age of federal workers rose from 42 to 47, and that shift was “mirrored by an increase in the average length of service.” Congress of the United States Congressional Budget Office. *Characteristics and Pay of Federal Civilian Employees*. (March 2007), 3-5.

⁴² According to the FDIC Institution Directory, 20 of the 25 largest insured depository institutions by asset size have federal charters.

regardless of size, has a single set of financial statements, procedures, and similar documents for examiners to review and assess. Moreover, many elements of on-site examinations are performed on a sample basis, which permits examiners to extrapolate conclusions about a large firm using a smaller percentage of files than they would be required to review for a large number of smaller firms.

The experience of the banking regulators supports this proposition. For example, Bair, et al. provide OCC data that, taken together, suggest that the OCC employs less than 20 percent of the examiner FTEs per dollar of assets in a bank with more than \$10 billion in assets than it expends at a bank with assets of less than \$1 billion.⁴³ Our view is that this calculation overstates the efficiencies, and that personnel requirements attributable to the complexity and systemic risk presented by larger firms would offset such efficiencies to some extent. Still, it is reasonable to expect that the ONI will realize at least some savings from these economies of scale, mostly in the examination and licensing functions.

All things being equal, the savings from economies of scale also should be partially offset by the size of the ONI's complaint handling component. However, here too one could fairly expect savings in comparison to the personnel and funds expended by state regulators, mostly because there is reason to believe the ONI would receive fewer customer complaints per dollar of premium income than state regulators. Past studies have found that the frequency and rigor of market conduct examinations differ markedly among different state insurance regulators.⁴⁴ One would expect more consistent and rigorous federal market conduct examinations to reduce the number of

⁴³ Sheila Bair et al. *Consumer Ramifications of an Optional Federal Charter for Life Insurers*. (Amherst, Mass.: University of Massachusetts-Amherst, Isenberg School of Management, March 2004), 161.

⁴⁴ *Ibid.*, 16-17, 30-31.

complaints concerning federally regulated firms to some degree. In addition, the survey conducted by Bair, et al. indicated that complaint volume is highly concentrated in small companies.⁴⁵ Given the experience of the dual banking system, although the ONI would regulate companies of all sizes, many of the largest firms would likely convert to a federal charter. Finally, the ONI's frequent interactions with peer national regulators in the United States and abroad may facilitate deployment of innovative consumer protection practices, such as FSA practices discussed in Section III.

V. Regulatory Quality Issues

The previous sections have described the proposed ONI's statutory structure and responsibilities, analyzed the organization and functions of comparable agencies, and calculated the size and cost of the ONI under various scenarios and assumptions. Through this exercise, the study has drawn a reasonably complete outline of the new agency. However, there are at least three significant qualitative features of the proposed ONI that the previous analysis does not adequately capture. Although these features generally do not bear directly on the organization, size, and cost of the ONI, they shed significant light for anyone trying to envision the operations of the new agency.

Staffing

Like other financial services firms, U.S. insurers and reinsurers are increasingly engaged in a variety of complex financial activities. Effective oversight of insurers and reinsurers requires staff with specialized skills in fields such as capital markets, derivatives, complex annuities, risk management, and international matters. It seems reasonable to expect that, for most (although not all) state regulators, there would rarely be a sufficient number of supervised firms engaged in complex activities to justify the cost of maintaining a critical mass of full-time professional staff

⁴⁵ *Ibid.*, 30.

members in these areas. One could also expect state regulators to face inherent geographic limitations in recruiting staff with the necessary expertise that are either already resident or willing to relocate to their states, as only a handful of major cities possess financial markets deep and sophisticated enough to support a substantial specialized labor pool.

A national regulator should be better positioned to overcome the specialization, financial, and geographic obstacles facing all but the largest state regulators in staffing. A national regulator can maintain regional offices in major financial centers to ensure a ready talent pool of professionals on which to draw. The number and scale of federally regulated institutions provide a stable and sufficient source of regulatory funding that could justify the cost of maintaining a critical mass of specialized professionals and sufficient salaries to attract and retain qualified individuals. The greater prestige of a national regulator could serve as a further inducement to potential recruits. With a larger number of institutions engaging in complex activities, a federal regulator would have a greater exposure to innovations that, in turn, would make employment at such a regulator more attractive from a professional development perspective.

The experience of the banking regulators supports these predictions. With a few notable exceptions, most state bank regulators cannot maintain sufficient capital markets, economic analysis, and international affairs staffs to regulate large, sophisticated institutions effectively. The OCC, on the other hand, has the scale to maintain a much larger and more specialized staff in these areas. The OCC's Large Bank Supervision department contains a body of examiners with experience and expertise supervising the nation's and world's largest and most complex institutions. The International and Economic Affairs department contains specialized teams focused on risk analysis, economic analysis and forecasting, statistical analysis, and international banking and finance issues. The OCC's frequent contact with foreign supervisors gives it additional perspective that is put to use

on the domestic front. The Office of the Chief National Bank Examiner works with all the major regulatory agencies around the world to develop better approaches to supervising and regulating complex financial activities. The Securities and Corporate Practices section of the Chief Counsel's office keeps abreast of legal and policy issues relating to complex capital markets transactions. In consultation with other relevant offices, the Chief Counsel has produced a steady flow of interpretive letters providing guidance to national banks in areas ranging from reinsurance to cutting-edge derivatives products that bank clients are requesting.⁴⁶

In addition to its advantage in recruiting and retaining top specialists, the ONI would be in a position to maximize the returns on their expertise. The national scope of the ONI's examination and report collection activities would provide it with a window into insurance firms of every region, size, business line, and complexity. This window should permit the ONI's supervisory and analytical staff to identify emerging regional and national issues more readily than state insurance departments, whose direct experience of the insurance market is necessarily narrower. The ONI staff would also be better positioned to apply industry-wide solutions to such emerging issues. The agency would have authority over a wide range of insurance firms operating in every domestic market, while its additional authority over insurance holding companies could give it the leverage necessary to influence the practices of the largest insurers across all of their subsidiaries. The ONI would also be in a position to deploy quickly nationwide any innovative regulatory practices it learns from peer regulators in the United States and abroad.

⁴⁶ Office of the Comptroller of the Currency. *Activities Permissible for a National Bank, Cumulative*, Third Quarter 2006.

Consumer Protection

Under the Act, nationally chartered or licensed firms would be subject to more uniform and regular market conduct regulation than companies regulated by the various state insurance departments. Although the promulgation of NAIC model legislation and regulations promotes some consistency in substantive standards across states, substantial variation remains in both the standards and their application. Moreover, as noted above, states vary widely in the frequency, intensity, and scope of market conduct examinations. By establishing a single set of rules and examination standards, the ONI would ensure that customers of ONI-regulated firms receive the same level of protection regardless of their state of residence.

Of course, uniformity is no guarantee of quality. Some have argued that the establishment of an optional federal charter would lead to a “race to the bottom” in which the ONI would weaken market conduct standards in order to attract charters and licensees. We think this is unlikely, for a number of reasons.

First, Congress will retain a number of tools that would permit it to influence ONI policy and practices and ensure against a deterioration of market conduct standards. Ongoing oversight by Congress and its financial services committees, as well as pressure from key legislators, can often have significant influence on agency policy and behavior, leading to increased attention to consumer protection. The Act thus gives the Congress leverage that it presently lacks to address insurance market conduct issues and to force action to address new problems. Of course, Congress always has the option of establishing minimum standards by legislation as well.

Indeed, the interplay between consumer-oriented legislators and regulators on the state and federal level can at times result in a “race to the top” as each jurisdiction raises the bar for best practices in market conduct regulation. Consumer protection provisions incubated in state

“laboratories” frequently appear in new federal legislation, as in several recent mortgage reform proposals. Similarly, states often enact their own versions of federal consumer laws, including so-called “mini” versions of the Truth in Lending Act and the Federal Trade Commission Act. Where it materializes, this phenomenon tends to limit (although not eliminate) the divergence of substantive state and federal consumer protection standards applicable to similarly situated financial institutions.

Finally, our size and cost model indicates that the ONI could staff its market conduct and consumer affairs functions in a manner comparable to existing large state insurance departments while maintaining a manageable scale. Indeed, the FTE and budget figures projected by the model assume that the ONI would employ the same number of market conduct and consumer affairs FTEs per dollar of premium volume as the benchmark state insurance regulators. Thus, the ONI should remain comparable in size and cost to its peer federal regulators were it to perform its market conduct and consumer affairs functions in the same way as large states do today.

In practice, this level of resource expenditure should actually increase the level of protection afforded to consumers nationwide. This is because our benchmark states (California, New York, and Texas) devote more resources to the market conduct and consumer affairs functions than the typical state insurance department. As a result, the model assumes that the ONI would devote approximately 33% and 50% more FTEs per dollar of premium volume to consumer affairs and market conduct regulation, respectively, than the average state insurance department presently devotes. The impact of this discrepancy would be even greater to the extent that economies of scale and innovative practices enable the ONI to be more effective with the same amount of resources.

International Cooperation

As noted above, the Act authorizes the ONI to work with foreign regulators to develop international regulatory standards and mutual recognition agreements, in collaboration with the President and the U.S. Trade Representative. This international authority would be unprecedented for a U.S. insurance regulator and transform the way the United States relates to the international insurance regulatory community.

Although state regulators do currently cooperate with foreign insurance regulators, their fragmentation and lack of sovereign status necessarily limit their effectiveness. This contrasts sharply with other areas of international financial regulation, in which the United States has played a major role. For example, in banking regulation, the president of the Federal Reserve Bank of New York served as the Chairman of the Basel Committee, and the Comptroller of the Currency is a member of the Committee. In securities regulation, the SEC has been active in supporting IOSCO, the international securities regulator. On the other hand, as Howard Davies, former Chairman of the UK FSA, said this year, “the U.S. is unable to take the lead globally in developing insurance standards – a leadership gap from which we all suffer.”⁴⁷

Comments from Davies and others suggest that the weight and authority the ONI would carry would be welcomed in the international insurance regulatory community, particularly as insurers and reinsurers engage in increasingly complex financial transactions.⁴⁸ One could fairly expect this contribution to aid in policy development as insurance supervision internationally continues to evolve, in meeting the regulatory and capital challenges new developments and

⁴⁷ Howard Davies, “Sharks Circle Paulson’s Aussie plan.” *Financial Times*, April 1, 2008.

⁴⁸ Howard Davies, “COMMENT: A word of advice to Hank Paulson.” *Financial Times*, July 5, 2006.

products present, in considering the changing nature of the market (such as the regulatory response to aging), and in sharing best practices across the globe.

Conclusion

Our analysis of the structure and functions of the ONI paints a familiar portrait: the agency would most likely resemble a hybrid of existing large state insurance departments and comparable federal financial regulators. Under the Act, the ONI would need to carry out most of the basic functions of direct regulation that state insurance departments perform today. At the same time, the ONI would resemble comparable federal regulators in its important international role and access to extensive analytical resources. In addition, since the ONI would be a federal agency, its administrative infrastructure and contracting practices would likely conform to federal patterns.

Most notable, however, are our unremarkable findings concerning the ONI's size and cost. Our model predicts that, under either conversion scenario, the ONI's budget and headcount would be roughly similar to those of comparable federal financial regulators. They would also be roughly proportional to the costs of the state system given the projected size of the regulated community.⁴⁹ These results were remarkably stable. Although changes to our fundamental assumptions could shift the figures to some extent, we found no set of reasonable assumptions that yielded projections far outside this range.

Moreover, a number of factors suggest that the ONI could introduce efficiencies and other improvements into the insurance regulatory system, whether by reducing costs or increasing quality. The ONI might reduce costs by delegating to SROs functions that such organizations could perform more efficiently, by taking advantage of economies of scale presented in the regulation of

⁴⁹ The model actually predicts that the ONI would be somewhat more efficient, but we hesitate to draw conclusions from that result given the model's imprecision.

larger insurers, and by approaching consumer protection in a more consistent and systematic manner. There are also reasons to believe that the ONI would engage in more effective international cooperation efforts, maintain a critical mass of highly trained financial specialists, and apply consistently strong market conduct standards – all for roughly the same cost as the present system, and possibly less.

This study does not attempt to address comprehensively the arguments for an optional federal insurance charter or for preserving the existing state system. It does, however, seek to enrich the debate by turning the ONI from a shadowy abstraction to a more concrete and comprehensible concept. Admittedly, such efforts are necessarily conjectural and imprecise. Still, we hope our analysis can serve as a useful basis for policy decision-making on this issue.

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Exhibit A

ONI Size and Cost – Base Case

	Indirect Costs			Direct Costs					
	Executive & Administration	Legal	Other Program Costs	Financial Regulation	Market Conduct	Enforcement/ Anti-Fraud	Consumer Affairs	Licensing	
Costs									
Salaries and Benefits	\$ 62,683,742	\$ 22,794,088	\$ 34,191,132	\$ 40,310,795	\$ 15,356,535	\$ 41,811,052	\$ 36,949,390	\$ 2,237,664	
Contract Services	\$ 16,587,761	\$ 4,804,731	\$ 6,940,167	\$ 16,767,196	\$ 7,247,853	\$ 20,116,395	\$ 16,885,139	\$ 1,649,599	
Travel	\$ 1,231,722	\$ 356,775	\$ 515,341	\$ 1,245,046	\$ 538,188	\$ 1,493,740	\$ 1,253,803	\$ 122,491	
Equipment	\$ 4,111,233	\$ 1,190,840	\$ 1,720,102	\$ 4,155,706	\$ 1,796,362	\$ 4,985,796	\$ 4,184,938	\$ 408,849	
Rent	\$ 14,062,640	\$ 4,073,316	\$ 5,883,679	\$ 14,214,759	\$ 6,144,527	\$ 17,054,116	\$ 14,314,748	\$ 1,398,484	
Other Expenses	\$ 1,886,594	\$ 546,462	\$ 789,334	\$ 1,907,002	\$ 824,328	\$ 2,287,920	\$ 1,920,416	\$ 187,616	
FTEs	435.00	126.00	182.00	439.71	190.07	527.54	442.80	43.26	
							Total FTEs	2,386	
							Total Cost	\$ 464,140,111	

Exhibit B

ONI Size and Cost – High Conversion Case

	Indirect Costs			Direct Costs					
	Executive & Administration	Legal	Other Program Costs	Financial Regulation	Market Conduct	Enforcement/ Anti-Fraud	Consumer Affairs	Licensing	
Costs									
Salaries and Benefits	\$ 62,683,742	\$ 22,794,088	\$ 34,191,132	\$ 80,621,590	\$ 30,713,069	\$ 83,622,104	\$ 73,898,779	\$ 4,475,328	
Contract Services	\$ 16,587,761	\$ 4,804,731	\$ 6,940,167	\$ 21,719,473	\$ 9,388,544	\$ 26,057,875	\$ 21,872,251	\$ 2,136,816	
Travel	\$ 1,231,722	\$ 356,775	\$ 515,341	\$ 2,490,091	\$ 1,076,376	\$ 2,987,480	\$ 2,507,607	\$ 244,981	
Equipment	\$ 4,111,233	\$ 1,190,840	\$ 1,720,102	\$ 8,311,411	\$ 3,592,723	\$ 9,971,592	\$ 8,369,875	\$ 817,698	
Rent	\$ 14,062,640	\$ 4,073,316	\$ 5,883,679	\$ 28,429,518	\$ 12,289,054	\$ 34,108,233	\$ 28,629,496	\$ 2,796,967	
Other Expenses	\$ 1,886,594	\$ 546,462	\$ 789,334	\$ 3,814,004	\$ 1,648,656	\$ 4,575,841	\$ 3,840,833	\$ 375,231	
FTEs	435.00	126.00	182.00	879.41	380.14	1055.07	885.60	86.52	
							Total FTEs	4,030	
							Total Cost	\$ 699,753,158	