

**Convergence in Financial Services Markets:
Likely Effects on Insurance Regulation**

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Abstract

Convergence among the principal members of the financial services industry—banks, securities firms and insurance companies—is occurring through conglomeration into diversified financial services firms, but much more importantly through direct cross-industry competition in products and services. This paper describes the more significant areas of cross-industry product and service competition, and argues that this competition will be the most likely driver of regulatory restructuring for the financial services industry—including insurers—in the future.

Introduction

Convergence in financial services refers to two quite different developments, each of which is likely to have a different but cumulative effect on regulatory structure. The most obvious form of convergence is conglomeration among banks, securities firms and insurance companies, largely the result of banking organizations—freed to do so by the Gramm-Leach-Bliley Act of 1999 (GLBA)—acquiring insurance and securities affiliates. To a much lesser extent, insurance companies have acquired securities firms, and in even fewer transactions securities firms and insurance companies have acquired banks. The second form of convergence is in products and services, where each of the industry members—banks, securities firms and insurance companies¹—have developed products that directly compete with the products and services of the others. Moreover, all three industries are currently engaged in one or another part of a rapidly developing derivatives business which is both increasing competition among them and driving them to behave in similar ways.

¹ The financial services industry is often described as consisting of four separate services—banking, securities, insurance and futures. The futures industry, although growing, is still substantially smaller than the other three, and is not covered in this paper.

As noted in this paper, “convergence” in the financial services industry is frequently reported in academic and government studies, but is seldom separated into its component parts or described in detail. Yet cross-industry competition—the most significant element of the convergence phenomenon—is extensive across a range of products, and has a profound influence on the competitive behavior of financial services companies. Understanding the scope and scale of this competition is necessary for a full assessment of the likelihood that the regulation of insurance will change significantly in the future, and the direction any change will take. Accordingly, this paper attempts to describe some of the most significant areas of cross-industry competition, and then to assess how this competition will drive regulatory restructuring in the future.

Although the implications of convergence have already resulted in major changes in regulatory structures in many developed and developing countries,² this is not true in the United States. Under the U.S. regulatory structure, banks, securities firms and insurance companies are separately regulated. Banks and other depository institutions are chartered at both the state and federal levels, and regulated at the federal level by four different agencies. Securities firms are ordinary business corporations, chartered under state law but largely regulated at the federal level by the Securities and Exchange Commission.

² According to the Institute of International Bankers Global Survey for 2001, by that year the following countries had established consolidated regulatory authorities for financial services: Australia, Canada, Columbia, Denmark, Ireland, Japan, Korea, Norway, Peru, Sweden, and the United Kingdom. According to the GAO, Germany should be added to this list. See United States Government Accountability Office, Financial Regulation, Industry Changes Prompt Need to Reconsider U.S. Regulatory Structure, GAO,-05-61, October 2004, p. 62

Insurance companies are solely state chartered and regulated.³ Combined, more than 100 state and federal regulators have jurisdiction over one or more members of all three industries. Recently, the US Treasury Department—citing industry convergence, among other things—recommended what it called an “optimal regulatory structure” for the future. The Treasury noted:

The growing institutionalization of the capital markets has provided markets with liquidity, pricing efficiency, and risk dispersion and encouraged product innovation and complexity. At the same time, these institutions can employ significant degrees of leverage and more correlated trading strategies with the potential for broad market disruptions. Finally, the convergence of financial services providers and financial products has increased over the past decade. Financial intermediaries and trading platforms are converging. Financial products may have insurance, banking, securities, and futures components.

These developments are pressuring the U.S. regulatory structure, exposing regulatory gaps as well as redundancies, and compelling market participants to do business in other jurisdictions with more efficient regulation. The U.S. regulatory structure reflects a system, much of it created over seventy years ago, grappling to keep pace with market evolutions and, facing increasing difficulties, at times, in preventing and anticipating financial crises.⁴

The Treasury’s new structure (apart from an ill-defined role for the Federal Reserve as “market stability regulator”) would consist of two agencies, one to perform the functions of a prudential or safety and soundness regulator and the other to act as a consumer protection or business conduct regulator for all three industries. This is a radical new idea for the United States, where the notion of “functional regulation” has always

³ A more complete summary of the current regulatory structure for financial services in the United States appears in Elizabeth Brown, “E Pluribus Unum—Out of Many, One: Why the United States Needs a Single Financial Services Agency,” *University of Miami Business Law Review*, Vol. XIV, No. 1, Fall-Winter 2005, pp. 10-19.

⁴ The Department of the Treasury, *Blueprint For a Modernized Financial Regulatory Structure*, March 2008, p.4

meant regulating separate industries separately—the functional regulation recognized by the GLBA—and advocates of consolidating the financial regulatory agencies often went only as far as to suggest that a single agency might regulate banks as well as securities firms.

The Treasury’s proposal, however, is even broader; the Treasury’s “optimal regulatory structure” would regulate banks, securities firms and insurance companies as though they are simply different ways of delivering essentially the same product—financial services. The Treasury calls this an “objectives-based regulatory structure,” meaning that the regulatory purpose would be the same for each of the industries and thus should emanate from a single agency. “The goal of establishing a [single agency for prudential regulation],” according to the Treasury, “is to create a level playing field among all types of depository institutions where competition can take place on an economic basis rather than on the basis of regulatory differences.”⁵

Although some will argue that this is a bridge too far, and unnecessary to bring about an orderly system of financial regulation in the United States, it is quite similar to the approach that has been adopted in the United Kingdom, where the Financial Services Authority (FSA) regulates banks, securities firms and insurance companies as though they were one industry with three different branches. Thus, the FSA has three directorates that cover, for all three industries, Regulatory Processes and Risk; Consumer, Investment and

⁵ Id., at p. 18

Insurance; and Deposit Takers and Markets.⁶ This more flexible definition of functional regulation seems more consistent with the regulation of an industry in which each of the major components is in fact competing with each of the others. To be sure, the U.K.'s move to an FSA—a single consolidated financial services regulator—was apparently stimulated by conglomerate mergers among financial services firms rather than competition among the principal constituents of the financial services industry,⁷ but as noted below existing laws in the United States make the development of competitive financial conglomerates unlikely.

As expected, the Treasury's recommendations were greeted with reactions ranging from yawns to howls of opposition, but provoked very little serious discussion. Although convergence along several lines is obviously occurring in the financial services industry, there is still very little apparent interest in changing the overall U.S. regulatory structure. If any significant change occurs in the near future, it will be the authorization of an optional federal charter for insurance companies, but that will simply add another agency—for chartering and regulating insurance companies—to the federal government's already rich palette. To be sure, such a development will have profound effects on the insurance industry, but the question I will address in this paper is whether the convergence that is now occurring in the financial services industry will, over the longer term, result in a substantial change in the *way* insurance is regulated, not simply in *where* it is regulated.

⁶ Howell E. Jackson, "An American Perspective on the U.K. Financial Services Authority: Politics, Goals & Regulatory Intensity," Discussion Paper no. 522, *The Harvard John M. Olin Discussion Paper Series*, http://www.law.harvard.edu/programs/olin_center/, August 2005, pp. 25-30

⁷ See, e.g., Clive Briault, "The Rationale for a Single National Financial Services Regulator, Financial Services Authority," Occasional Paper Series 2, May 1999.

As the Treasury's report suggests, convergence in the financial services industry is putting pressure on U.S. regulatory structures. These pressures will only increase in the future as changes in technology, government policies to encourage saving, financial innovations and economic conditions encourage even more cross-industry competition. In this paper, then, I will argue that convergence along the lines outlined below will eventually force a change in the US financial services regulatory structure, and in that case insurance regulation, of necessity, will be significantly affected.

In the following discussion, I will first review the different forms of convergence that are occurring in the financial services industry, and then how and why these forms—over the longer term—will exert pressure on policymakers to change the regulatory structure. Because of the phenomenon of cross-industry competition, the eventual change in the U.S. regulatory structure is more likely to be something similar to the Treasury's "regulation by objective" than the more conventional approach adopted in the GLBA, in which the three principal industries that make up the financial services industry are regulated separately under a more powerful consolidated federal regulator.

Conglomeration

Since the adoption of the GLBA, over 700 banking organizations have become financial holding companies (FHCs) by acquiring insurance companies or securities firms, or both. Because the participants in this expansion are for the most part the largest banking organizations in the United States, these 700-plus companies hold by far the major portion

of all the assets in the banking industry.⁸ The development of these conglomerate organizations has of course led to calls for a consolidated regulator with the authority to oversee the activities of consolidated financial services firms. To be sure, under the GLBA the Federal Reserve Board (Fed) has some limited authority to function as an “umbrella regulator” over all the subsidiaries of an FHC, but as a practical matter its scope of action is limited by the fact that the GLBA continued to recognize the states as the primary regulators of insurance companies and Securities and Exchange Commission (SEC) as the primary regulator of securities firms. For the Fed to break into this circle would entail a nasty turf fight.

The effect of conglomeration on regulatory structure is further limited by the fact that combinations among securities firms, insurance companies and banks may be only a temporary phenomenon. It is noteworthy that within four years after it received approval to engage in both banking and insurance activities—the transaction that stimulated the enactment of the GLBA—Citigroup sold off its Travelers Insurance affiliate, and has since also done the same with its mutual fund business. Periods of conglomeration, followed by periods of divestment, are common in the US business community, and it remains to be seen whether combinations of banks, insurance companies and securities firms really lend their parent companies any significant competitive advantages. Since the recent turmoil in

⁸ Citing an International Monetary Fund study, the GAO reports: “[B]ased on a worldwide sample of top 500 financial services firms in assets, the percentage of firms in the U.S. that are conglomerates—firms having substantial operations in more than one of the sectors (banking, securities and insurance)—increased from 42 percent of U.S. firms in the sample in 1995 to 61.5 percent in 2000; however, for the sample of U.S. firms, the percentage of assets controlled by conglomerates declined from 78.6 percent in 1995 to 73 percent on 2000.” United States Government Accountability Office, *Financial Regulation: Industry Changes Prompt Need to reconsider U.S. Regulatory Structure*, GAO-05-61, October 2004, p.50

the financial markets, there has been increasing discussion in the banking industry about divesting a lot of extraneous financial activities and refocusing on banks' core business.

In addition, without a change in current law, it is unlikely that conglomeration will extend much beyond its current level. This is because an insurance company or securities firm that acquires a bank will immediately become subject to regulation by the Fed as an FHC. In this event, in addition to becoming subject to the Fed's stringent and complex capital requirements for FHCs and bank holding companies, FHCs are not permitted under the GLBA to acquire companies or to engage in activities that are not "financial in nature." This term is not well defined in the GLBA, and its application can create severe restrictions on expansion into new businesses. For example, it is now nine years since the banking industry asked the Fed to declare that real estate brokerage is a financial activity. The Fed has not acted on the request, largely because of opposition in Congress stimulated by the Realtors, who fear bank competition. Under these circumstances, few companies that are not already subject to regulation by the Fed are likely to acquire banks and become FHCs.

A change in current law is not out of the question, but must be considered highly unlikely. In its recent report, Treasury recommended the elimination of holding company regulation by the Federal Reserve. The ostensible purpose of holding company regulation is to protect the bank subsidiary from overreaching or manipulation by its parents and affiliates. The Treasury correctly noted that this can be accomplished equally effectively by the regulator of the bank itself. A reform of this kind would permit the elimination of restrictions on ownership of banks by commercial companies, and more importantly from the perspective of this paper would permit securities firms and insurance companies to

acquire banks and form conglomerate enterprises that combine all three major elements of the financial services industry. However, because holding company regulation—and the concomitant restrictions on the activities of holding companies—protects the banking industry against new entry and new competition, and is also vitally important to the Fed as a source of its continuing control over the banking industry, it is unlikely to be changed in the near or even medium term.

Accordingly, although it is the most frequently cited reason for seeking regulatory consolidation, conglomeration among securities firms, insurance companies and banks is not a likely source of pressure for fundamental changes in the structure of financial services regulation.

Product Convergence

In a 2004 report, the Government Accountability Office noted that convergence did not solely involve conglomerate mergers among financial services firms:

While convergence has taken place among firms using similar products and derivatives to manage assets and risks, it has also taken place in product offerings by firms in different segments of the financial services industry. These firms are competing against each other to provide households, businesses, and governments with the same basic services....Similarly, firms in different sectors compete by offering products that have similar ability to meet some business needs. Issuance of commercial paper can provide financing similar to commercial loans, and catastrophe bonds and reinsurance provide similar protections, as do surety bonds and standby letters of credit.⁹

⁹ GAO, op.cit. note 8, pp54-55.

The trend highlighted by the GAO has developed over the last quarter century. Unlike conglomeration, this development is driven by continuing advances in information technology, tax changes that encourage savings, and increasing amounts of disposable savings in the hands of consumers. As Elizabeth Brown writes in recommending a consolidated regulator for financial services:

In the latter half of the twentieth century, market forces increasingly pushed banks to offer more securities and insurance products and pushed securities and insurance firms to devise new products that were in direct competition with banking products. The distinction between the banking, securities and insurance sectors began to blur because these new financial products were fungible. A consumer could choose to open a deposit account with a bank or a money market account with a securities firm. An investor could buy securities through a brokerage firm or a bank. As a result, pressure was brought to bear on Congress to move away from a system based predominantly on entity regulation to a system that employed a more functional regulation approach in order to create a level playing field. Functional regulation focuses on regulating based on the type of product being provided, instead of on the type of institution providing the product. Under a pure functional regulation scheme, the securities regulators would regulate securities regardless of whether they were sold by banks or securities firms.¹⁰

Because it is driven by government policies and long-term trends that are likely to continue, cross-industry competition in consumer and business products and services is likely to become even more intense in the future. The relative size of the largest and most competitive products offered by the members of the financial services industry is shown in the following list:

¹⁰ Elizabeth Brown, *op.cit.* Note 2, pp. 11-12 (footnotes omitted)

Financial Asset	2003		2004		2005		2006		2007	
	\$ Billion	%	\$ Billion	%	\$ Billion	%	\$ Billion	%	\$ Billion	%
Deposits	5,327.7	15.6	5,706.3	15.4	6,087.9	15.4	6,732.7	15.6	7,388.5	16.3
Life insurance	1,013.2	3.0	1,060.4	2.9	1,082.6	2.7	1,163.7	2.7	1,204.8	2.7
Pension fund reserves	9,744.4	28.6	10,654.6	28.7	11,391.0	28.8	12,323.6	28.5	12,779.5	28.2
Corporate equities	5,767.5	16.9	5,938.1	16.0	5,874.9	14.9	6,178.3	14.3	5,446.6	12.0
Non-corporate equity	5,396.8	15.9	5,986.4	16.1	6,651.4	16.8	7,329.8	17.0	7,891.9	17.4
Mutual fund shares	2,904.3	8.5	3,417.4	9.2	3,839.7	9.7	4,536.0	10.5	5,081.9	11.2
Debt securities	2,929.7	8.6	3,213.0	8.7	3,449.8	8.7	3,666.9	8.5	3,977.0	8.8
Other	964.5	2.8	1,119.8	3.0	1,166.4	2.9	1,286.9	3.0	1,562.8	3.4
Total	34,048.1	100	37,096.0	100	39,543.7	100	43,217.9	100	45,333.0	100.0

Source: Flow of Funds Accounts of the United States, "L.100 Households and Nonprofit Organizations (1)," March 6, 2008, pg 62
Available at <http://www.federalreserve.gov/releases/z1/Current/z1.pdf>

Cross-Industry Competition

The following section will outline the major areas where cross-industry competition is occurring. This is an illustrative rather than exhaustive list; there are other less important areas of cross-industry competition that are not discussed.

Banks vs Securities Firms

Banks originally developed as intermediaries between the suppliers and users of capital. Banks and securities firms are natural competitors because both perform the same general function of channeling capital from disparate and anonymous suppliers to specific users. The value of banks in this role rested on their superior information about borrowers, which could not be efficiently obtained by bank depositors acting on their own. However, with the development of standardized accounting and faster, cheaper and more decentralized communications, financial and other information could be made available to investors. More borrowers were thus able to access a wider pool of capital through the less expensive securities market, where the intermediaries—securities firms—were usually acting as agents rather than buying and reselling as principals. Securities firms have been

able to outcompete banks in this space because they could perform their intermediary function less expensively acting as agents than banks acting as principals. This competition has forced banks to change their business model. As recounted by the GAO:

Generally, financial services firms, especially banks, have had to adapt to the ease with which corporations can now directly access capital markets for financing, rather than depending on loans. For example, with the emergence of the commercial paper market, many large firms with strong credit ratings that had been dependent on bank loans were able to access capital markets more directly. As a result, those large banks that had been major lenders to these firms have had to find new sources of revenue. Banks are now relying more on fee-based income that is generated by structuring and arranging borrowing facilities, providing risk management tools and products, and servicing the loans they have sold off to other institutions as well as from fees on deposit and credit card activity, including account holder fees, late fees, and transactions fees. Many large banking institutions have moved into investment banking activities, including arranging OTC derivative transactions for their corporate customers.¹¹

Technology has also provided advantages to securities firms. Fast data processing permitted the growth of mutual funds, and CMA accounts made possible by fast data processing allowed consumers to write checks on their mutual fund savings, thus competing directly with bank transaction deposits.

Bank deposits are so close to securities products that litigation has been necessary to tease them apart. Without an express exemption from the securities laws, bank deposits would be regarded as securities, and in numerous cases certificates of deposit have been found to be securities when they were issued by uninsured banks¹² or when a securities

¹¹ GAO, op.cit note 8, p. 51.

¹² SEC v First American Bank & Trust, 481 F. 2d 673 (8th Cir. 1973)

firm made a market in them.¹³ The Office of the Comptroller of the Currency, the regulator of national banks, has ruled that banks can offer insured but unsecured notes with floating rates of interest.¹⁴ These would compete directly with mutual fund shares or floating rate corporate securities.

The competition, then, between banks and securities firms took the form of investment and savings products as well as payment vehicles and consumer lending. Interest-paying bank deposits and bank sweep accounts competed with money market mutual funds; bank certificates of deposit competed with mutual funds and the short term notes sold by securities firms. Banks acquired stables of mutual funds that enabled them to offer their customers equity as well as fixed income investments. Banks and securities firms both offer credit cards, and both create mortgage-backed and other asset-backed securities that facilitate consumer lending and compete for the funds of institutional investors.

Banks have also established private banking sections and collective investment funds which compete directly with the traditional investment advisory and asset management functions of securities firms.

On the commercial side, commercial paper and longer term debt securities sold by securities firms compete with short and long term bank loans. The larger securities firms, which do not have the capacity to take deposits, gained access to the capital markets by

¹³ Gary Plastics Packaging Corp v. Merrill Lynch 756 F.2d 230 (2nd Cir. 1985)

¹⁴ OCC Interpretive Letter No. 922 (Dec. 13, 2001)

using their securities portfolios as collateral, and now offer short-term bridge loans to corporate clients that are making acquisitions for cash, thus competing directly with banks that had traditionally been the source of this form of financing. Commercial banks—principally after the GLBA eliminated restrictions on affiliations between banks and securities firms—acquired or established securities affiliates that could and did underwrite securities in direct competition with investment banks. In addition, banks offer participations in loans that they maintain on their books and also syndicate loans to other banks. Securities firms privately place notes and bonds for corporate clients that in substantial respects mimic banks loan participations and syndications.

The table below shows that one investment bank product—medium term notes—has grown faster in recent years than the commercial and industrial loans traditionally offered by commercial banks:

Year	Medium Term Loans			Commerical & Industrial Loans	
	Total All Issuers	Financial Issuers	Non-Financial Issuers	Commerical Banks	Savings Institutions
1993	210.9	125.4	85.5	538.6	9.8
1994	235.5	145.9	89.6	589.1	9.9
1995	267.5	171.1	96.4	661.4	12.2
1996	287.3	194.5	92.8	709.6	14.9
1997	302.1	221.2	80.9	795.0	16.2
1998	388.7	290.4	98.3	898.6	21.1
1999	420.6	320.2	100.4	969.3	27.1
2000	446.4	349.3	97.1	1052.0	34.0
2001	479.2	384.9	94.3	981.1	38.8
2002	515.9	422.9	93.2	910.8	41.7
2003	556.1	470.6	85.4	869.5	51.6
2004	639.4	560.3	79.1	907.7	59.8
2005	712.9	641.3	71.6	1019.6	66.0
2006	869.7	796.3	73.3	1139.6	75.2

All numbers are in billions of dollars

Source for MTNs: Federal Reserve Statistical Release, "Corporate Medium-Term Notes: 2006 Report,"

Available at <http://www.federalreserve.gov/releases/medterm/medterm.pdf>

Source for C&I Loans: Federal Deposit Insurance Corporation, "Statistics on Depository Institutions"

Available at <http://www4.fdic.gov/SDI/SOB/>

Finally, both securities firms and banks are active competitors in the derivatives market. Derivatives of various kinds are synthetic instruments that can be designed to accomplish a number of risk-management purposes. Interest rate swaps, for example, in which two companies exchange fixed and floating payments on a notional principal amount, have been a prominent feature of the capital markets for at least 25 years, and both banks and securities firms serve as both principal and agency intermediaries for interest rate swap transactions. Credit default swaps are another and even more interesting development, in which banks and securities firms both compete on a principal or agency basis. In a credit default swap (CDS), any company can take on or divest risk by buying or selling protection against a third party's default on an obligation. The implications of this transaction for the future of convergence have not been fully assessed, but in principle it allows securities firms, insurance companies or banks to trade exposures to different kinds of risks—including risks that they might not be permitted to acquire by the regulatory regime under which they function. For example, a securities firm can take on the risk of a long term commercial loan by selling protection through a CDS to a bank that wants to continue to hold the loan its portfolio but would like to divest all or a portion of the credit risk. In effect, the bank has off-loaded the credit risk on the loan to the securities firm while retaining the cash flow the loan provides. This can be a profitable transaction for the bank if the cash flows on the loan exceed the payment it is making to the securities firm. But it is noteworthy that in this transaction the securities firm has moved one step closer to being a commercial bank by assuming the credit risk on a traditional bank product. The fast-growing CDS market consists of about \$62 trillion in notional amount of swaps today,

and is likely to grow considerably larger in the future. The more mature interest rate swap market has a notional amount of \$382.3 trillion outstanding.

Banks vs Insurers.

The effect of derivatives such as CDS is particularly strong in the convergence of banking and insurance. As one study notes: “Convergence [between banking and insurance] refers to the fact that

- “Insurers have developed tools and products which are increasingly substitutes for capital market instruments
- “Banks and the capital markets have developed tools and instruments which are substitutes for traditional insurance products
- “Customer companies increasingly go to both the capital market and banks and to insurers to buy risk management products...”¹⁵

There are two distinct types of insurance companies—life insurers and property and casualty (P&C) insurers. It is life companies, which offer investment-based insurance policies to consumers, that have generally been in competition with banks. But recently innovations in the capital markets have also caused some of the products of P&C companies to converge with the products and services of banks.

Bank competition with life companies occurs on both the liability and the asset side. Both entities are seeking investments and funding from the same sources. In this

¹⁵ Ernst Baltensperger, Peter Buomberger, Alessandro A. Iuppa, Arno Wicki, and Benno Keller, “Regulation and Intervention in the Insurance Industry—Fundamental Issues,” Zurich Reinsurance Co, September 2007.

connection, life insurers offer guaranteed investment contracts (GICs) and banks offer Bank Investment Contracts (BICs) and certificates of deposit. BICs and GICs are similar in that both offer investors—often pension funds and other institutional investors—the opportunity to add to or withdraw funds from the account without penalty while still receiving a rate of interest that is better than the ordinary certificate of deposit. GICs can also be short-term and thus competitive with certificates of deposits and interest bearing bank accounts.

On the asset side, some of the competition between life insurers and banks has revolved around the effort of banks to revise their deposit structures so that they can function as fixed annuities. A long term bank deposit like a CD already has some of the characteristics of an annuity. When it matures, it can be drawn upon in retirement. What is lacking is the tax-free internal build-up of value and an indefinite life. In an annuity, traditionally an insurance product, a consumer agrees to make one or a series of payments to an insurer in exchange for the insurer's agreement to make a series of payments to the consumer for life or for a specified period of years. In the 1980s, banks began to offer annuity deposits, in which the consumer would make a fixed deposit and receive a series of payments for life, and the Federal Deposit Insurance Corporation (FDIC) determined that a similar instrument, the Retirement CD, which combined a bank deposit with an agreement by the bank to pay out the proceeds after maturity for the life of the holder, was insurable. Under pressure from the insurance industry, Congress removed the tax advantages of this instrument in 1996, but the ordinary time and savings deposit is a significant competitor with insurance company fixed annuities, since it offers FDIC insurance.

The following table shows the ebb and flow of funds into fixed annuities offered by insurance companies and the time and saving deposits offered by banks as they have competed for savings over the last 10 years:

Year	Time and Savings Deposits		Annuities	
	Flows	Total Assets	Fixed Deposited Funds	Total Reserves
1997	219.6	3187.5	131.9	1455.0
1998	244.5	3432.0	166.5	1608.5
1999	175.3	3607.3	78.6	1780.7
2000	309.1	3916.4	288.9	1819.7
2001	335.8	4248.8	193.7	1585.0
2002	321.5	4570.2	324.1	1619.1
2003	291.4	4861.1	296.5	1900.0
2004	470.4	5381.6	439.1	2105.9
2005	586.0	6375.4	470.1	2258.2
2006	608.2	6997.0	507.4	2415.2

All numbers are in billions of dollars

Source (annuities): American Council of Life Insurers, "ACLI Product Line Report: Annuities"

Member-only information obtained from ACLI on June 2, 2008

Source (deposits): Flow of Funds Accounts of the United States

Flow of Funds Matrices, available at <http://www.federalreserve.gov/releases/z1/>

P&C companies compete with banks principally on the product side. Among the products of P&C companies is the surety bond, which provides an insurance company's backing for a financial risk. This product is matched by a bank's standby letter of credit, which performs the same function. Here is an area where CDS are driving a convergence between banks and insurance companies. Both are able to buy and sell protection, and both are active in acquiring risks by swapping protection for cash flows. Insurance companies, in particular, are able to take on risks in the form of ordinary commercial loans that they would not ordinarily be able to acquire. With GICs as a funding source and a portfolio of commercial loan risks taken on through the CDS market, an insurance company can look a

lot like a traditional commercial bank. At the same time, banks offering protection through CDS are competing with the bond insurance offered by insurance companies.

Securities firms vs Insurance companies

Securities firms compete with life insurance companies on the investment or asset side. Mutual funds, for example, although not exclusively a product of securities firms, are competitive with universal life policies and with variable annuities. Variable annuities provide variable returns during the annuity period based on the performance of separate accounts within the annuity. Sometimes they are accompanied by a guaranteed level of return offered by the insurer with an additional amount paid if investments exceed a threshold level. In the sense that they pay off based on investment performance, variable annuities are very similar to mutual funds, but there are differences. Variable annuities are not liquid before maturity, while the investment in a mutual fund may be withdrawn at any time in whole or in part, generally without penalty. On the other hand, variable annuities have tax advantages in that the buildup in value in the annuity over time is tax free; taxes apply when the annuity payments begin. The relative growth of mutual funds and variable annuities is shown in the following table.

Year	Equity & Hybrid Mutual Funds		Annuities	
	Net New Cash Flow	Total Net Assets	Variable Deposited Funds	Total Reserves
1997	243.6	2685.1	119.5	1455.0
1998	167.2	3342.9	126.0	1608.5
1999	173.9	4420.7	140.7	1780.7
2000	278.6	4308.2	165.9	1819.7
2001	41.5	3764.5	160.3	1585.0
2002	-20.0	2988.0	142.1	1619.1
2003	184.2	4114.6	163.1	1900.0
2004	220.6	4903.3	190.9	2105.9
2005	160.8	5507.1	197.5	2258.2
2006	166.5	6563.7	208.6	2415.2

All numbers are in billions of dollars

Source (mutual funds): *Investment Company Institute*, "2008 Investment Company Factbook"

Table 3: U.S. Mutual Fund Industry Total Net Assets, http://www.icifactbook.org/pdf/08_fb_table03.pdf

Table 16: Net New Cash Flow of Long-Term Mutual Funds, http://www.icifactbook.org/pdf/08_fb_table16.pdf

Source (annuities): American Council of Life Insurers, "ACLI Product Line Report: Annuities"

Member-only information; obtained from ACLI on June 2, 2008

Life insurance companies have also established investment advisory units—like banks' wealth management groups—that seek to manage clients' funds in a comprehensive way, in competition with the traditional role of securities firms.

It is on the P&C side that some of the more interesting developments are occurring. There, the development of catastrophe bonds directly challenges the role of reinsurance. In a catastrophe bond transaction an insurer typically contracts with a special purpose entity (SPE) for which agrees to pay all or a portion of the insurer's loss if a specified catastrophe—like a hurricane or a tornado—occurs. The SPE sells bonds which are entitled to receive the proceeds of the premium paid by the insurer to the SPE if the catastrophe does not occur during the time specified in the contract. If it occurs, the debt to the bondholders is canceled and they lose their investment; if it does not occur, the bondholders receive the premiums plus whatever has been earned on the funds through investment of the principal by the SPE. In this case, then, securities firms have developed a

product that competes directly with reinsurance, although not with primary insurance. Nevertheless, for very large and specific risks, it is possible that catastrophe bonds could be a substitute for primary insurance.

As in the case of banking, securities firms are also able to challenge insurance companies for financial guarantees such as surety bonds or bond insurance. This is done through CDS which are bought and sold by securities firms as principal or agent. At the time of its collapse in March, Bear Stearns had approximately \$40 billion in notional amount of CDS on its books. Although there is little data on this, and no court decisions of which I'm aware, it also appears that CDS might enable securities firms and banks to cover losses in a way that is similar to the indemnities offered by insurance companies for the destruction of property. In that case, the products of securities firms and banks could be highly competitive with the traditional products of insurance companies.

The implications of Convergence for Regulatory Structure

Just as the touchstone of convergence is product competition among the banks, securities firms and insurance companies that are the principal members of the financial services industry, so it is competition among these players that is likely to force serious consideration by Congress of changes in the current regulatory structure. As this competition comes to dominate the financial services industry, sound government policy should appropriately focus on ways to keep the playing field level. It is difficult to see how this could be done in a regulatory regime in which each of the competing industries is regulated in a different way. This thought was well-expressed in a recent report of the Government Accountability Office (GAO) to the Senate Banking Committee:

The [financial services] industry’s trends, coupled with legislative changes, challenge regulatory agencies to provide adequate regulatory oversight while ensuring that regulation does not place any segment of the industry at a disadvantage relative to the others. The current structure—with its multiple regulators and charters—is further challenged by the need to recognize sector differences and simultaneously provide similar regulatory treatment for similar products. Regulatory agencies do collaborate to ensure consistent treatment of similar activities across institutional charters and legal entities, as well as in consolidated supervision of large complex organizations. However, our prior work...found instances where regulatory differences could lead to unequal treatment of firms.¹⁶

The GAO enlarged upon this idea later in the report:

The federal financial regulatory agencies face challenges posed by the dynamic financial environment: the industry’s trends of consolidation, conglomeration, convergence, and globalization have created an environment that differs substantially from the prevailing environment when agencies were formed and their goals set by legislation. In particular, the fact that different agencies have jurisdiction over large, complex firms that offer similar services to their customers creates the potential for inconsistent and inequitable treatment. Differences, even subtle ones, among the agencies’ goals exacerbate the potential for inconsistency.¹⁷

The GAO’s views actually describe only a portion of the problem of inconsistent regulation. In reality, regulatory agencies—like other government agencies—actively resist collaboration that might reduce their own control. This “turf protection” is rampant in government and is a constant source of friction among agencies with overlapping jurisdictions. The jurisdictional brawl between the SEC and the Commodity Futures Trading Commission over which agency has regulatory jurisdiction over securities derivatives is a classic case that is still not fully resolved, and the current dispute between

¹⁶ United States Government Accountability Office, *Financial Regulation: Industry Trends Continue to Challenge Federal Regulatory Structure*, October 2007, GAO-08-32, pp 25-26.

¹⁷ *Id.*, at p. 36

the Office of Thrift Supervision and the SEC over which agency has jurisdiction over the holding companies of both securities firms and thrift institutions is another salient example. Jurisdictional disputes between agencies with similar jurisdictions must be accepted as a fact of life in government, and pretending that they can be avoided is naïve.

The problem here is not simply that regulation will be inconsistent, as the GAO seems to assume, but rather that agencies will actively seek to advantage their regulated clients in their competition with other participants in the financial services industry. This is not a case of regulatory competition or the classic “race to the bottom.” Instead, it reflects a tendency on the part of the regulatory agency to see the world from the perspective of the industry it regulates. This phenomenon is frequently described as “regulatory capture,” in which a regulatory agency protects the interests of the regulated industry.¹⁸

As former Treasury Undersecretary Peter Fisher noted:

I take it as given that too much of our financial regulatory process is aimed at limiting rather than expanding effective competition. We have too much, rather than too little, regulatory arbitrage. Rules that expand competition are in the public interest. Rules that limit competition—either directly by bestowing unique privileges on a narrow set of firms—are not in the public interest because they limit the forces that help us efficiently convert savings into investment.

In financial services this is not principally a function of “agency capture.” Individual firms do have incentives to limit competition and there may be some degree of agency capture. But in financial services a problem arises because the chartering regulatory authority has an incentive to promote the “soundness” of its particular form of intermediation by limiting competition. Each chartering regulatory authority has just a single corner or piece of the total capital structure of

¹⁸ Brown, *op. cit.*, note 4, p. 50-51.

financial intermediation and, thus, has an incentive to “protect” the revenue sources of its franchisees in order to assure their “soundness.”¹⁹

Regulatory arbitrage is a particular problem associated with diversified financial services firms. Because many banking products and services can be duplicated as securities or insurance products or services, and vice versa, it is possible for a single conglomerate organization to shift its product offerings from a place where they are heavily regulated to a regulatory regime where they are not. This has good and bad points—less regulation may spur innovation and competition—but it may also confer a competitive advantage on a conglomerate firm that is competing with a firm that does not have this regulatory option.

Finally, the implications of derivatives have not been fully explored by anyone who studies regulatory structure. The credit default swap (CDS), in particular, can easily elide the regulatory distinctions among securities firms, insurers and banks by transferring the risks traditionally taken by each of these constituents of the financial services industry. Thus, in a typical CDS transaction, an insurer can receive a stream of payments from a bank by promising to protect the bank against a default by one of its corporate borrowers. Although this looks like a simple indemnification arrangement, in reality the insurer is taking on the risk associated with a corporate loan—in a sense it is becoming a bank by taking on a typical bank risk. Similarly, a bank can sell “protection” to an insurer against a liability on a surety bond; in doing so, the bank has in effect taken on an insurance risk. The reason that these risk transfers do not provoke regulatory objections is in part that each

¹⁹ Peter R. Fisher, “The Need to Reduce regulatory Arbitrage,” Remarks at the Brooklyn Law School Center for the Study of International Business Law, September 20, 2002, p.3, available at <http://www.ustreas.gov/press/releases/po3444.htm>.

transfer—by diversifying risk—adds to the safety and soundness of the participants. In effect, it is a hedging transaction.

There is no indication that credit default swaps will be suppressed or restricted in the future. The notional amount of these facilities—i.e., the face amount of the obligations they are backing—is now \$62 trillion. Most of the proposals for controlling CDS are directed at making them more transparent or the trading in them more efficient. Meanwhile, their potential for turning insurers into banks and banks into securities firms will continue to confound efforts to maintain separate regulatory regimes for each of these industries.

To be sure, at this point the United States is not close to considering any significant change in the regulatory structure for financial services. Before that can even be considered by Congress, it will be necessary for one of the major components of the financial services industry—life and P&C insurers—to be chartered and regulated at the federal level. Legislation to create an optional federal charter (OFC) has been introduced in the Senate and the House of Representatives, but is not under serious consideration at this time. Nevertheless, with the support of the largest insurance companies and their business associations, it is likely that an OFC will be authorized within a few years. At that point, it will be possible to contemplate some form of consolidation of the federal financial services regulatory structure. Indeed, one of the driving forces for life insurers to support the OFC is the fact that they are placed at a disadvantage in competing with banks and securities firms because of the time required to gain the necessary approvals for new products from more than 50 state regulators at the state level.

It is a cliché that Congress never acts on anything unless there is a crisis at hand, and this is largely true. Even though many financial services firms are in difficulty today because of turmoil in the financial markets, this turmoil is not seen as the result of a dysfunctional financial services regulatory structure. Nevertheless, the strong trends toward cross-industry competition, driven by changes in technology, tax laws, economic growth and leveling developments such as CDS, are very likely to continue and expand in the future. Eventually, then, unless Congress rationalizes the regulatory structure it will be faced with unceasing requests to adjudicate jurisdictional disputes among agencies and between industries. Where industries are regulated separately but are competing directly with one another—as they are today and will be increasingly in the future—there will be more and more frequent instances in which one agency has authorized a product or service that another agency and its regulated industry believe is not authorized by law. The resulting disputes will force Congress to adopt clarifying legislation. Any such reform will not be complete until the insurance industry is included.

In this case, the objective of Congress should be to create the most level playing field possible, so that distinctions between the charters and traditional functions of the component industries do not provide advantages to any one of them. With this standard in view, a reasonable way to accomplish this objective is to treat banks, securities firms and insurance companies as a single industry, and regulate them as Treasury has proposed, according to the objectives of regulation rather than the particular way that their products and services were structured or delivered in the past.