

RESEARCH BUZZ



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New Actions on the Housing and Financial Crises—Do No Harm?

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On July 27, 2008, the U.S. Senate passed and sent on to the president the “Housing and Economic Recovery Act of 2008,” reportedly the most important housing bill since the Great Depression. The bill was originally aimed at addressing the foreclosure crisis which began in late 2006 and became especially apparent in the financial crisis that emerged in August 2007. Its passage was accelerated by the near or real failures of Fannie Mae and Freddie Mac, the nation’s two largest government sponsored enterprises (GSEs), who play a central role in the functioning of the nation’s housing, mortgage and financial markets. It is unlikely that the new steps will have much effect on the foreclosure crisis or short-term economic performance, but they create serious uncertainty over the future of the GSEs, federal finance and the status and role of the U.S. financial markets. It is likely, however, that the new arrangements for Fannie Mae and Freddie Mac will not remain static for more than a few months and that newly authorized

steps for the new regulator of the GSEs are likely to ramp up the discussion and need for regulation soon.

The New Housing Bill

The new bill was originally aimed at providing relief to the mortgage foreclosure crisis. At the end of the first quarter of 2008, 2.5 percent of all mortgages were in the foreclosure process, up from about 1 percent in mid 2006. This was largely due to the growing foreclosures among subprime loans, which climbed to a 10.7 percent rate from about a 3.5 percent rate in 2005. Owners of about 1.5 million homes entered foreclosure over the past year and this is expected to climb to about 2.5 million over the next year (see Tatom 2008 for a fuller description of the foreclosure problem and its effects).

The new bill expands upon efforts to use Federal Housing Administration lending to refinance problem loans about to enter foreclosure. In the new bill, mortgage holders spending more than 31 percent of their income on housing (principal, interest, property taxes and insurance) can refinance with FHA. They must first obtain their lender’s willingness to take a 10 percent “haircut” on the remaining balance of the loan. Mortgage holders must also be capable of paying the new loan and they must agree to pay the federal government half of any capital gain they might receive on a sale of the home within the first five years that it is outstanding. Congress appropriated \$300 billion for these new loans, expecting to help up to 400,000 people, but this total could rise to up to 2 million mortgages holders if more are qualified than expected. This provision ends September 30, 2011.

Ironically, the program does not begin until October 2008, and, based on recent trends, as many as 400,000 mortgages are likely to enter foreclosure by then. This reflects the most obvious shortcoming of the bill: it is too late and too little to make a serious dent in the foreclosure problem.

Perhaps 40 percent of the homeowners faced with the foreclosure problem will have already lost their homes before the program begins, and fewer than 20 percent of the remainder will be able to obtain some relief from this program. Moreover, even for the few borrowers who are assisted, the foreclosure rate on the group obtaining FHA loans will remain relatively high, despite the positive factor that the FHA loans are fixed rate mortgages and will largely replace higher default, variable rate mortgages. For example, in the first quarter of 2008, the FHA loan foreclosure rate was 2.4 percent, about the same as the national average, but double the foreclosure rate on prime mortgages.

There are many other aspects of the housing bill aimed at subsidizing housing activity besides the foreclosure refinancing scheme. The bill provides about \$4 billion for local government programs to redevelop abandoned and foreclosed homes, one of the most controversial components of spending in the bill. Other stimulus to the housing market includes a first-time buyer tax credit of up to \$7500, funds for housing counseling of about \$180 million, improved benefits for veterans, including a moratorium on foreclosures of military mortgages of servicemen returning from foreign conflicts, a one-year property tax deductibility for non-itemizing taxpayers on the first \$1000 for taxes, and many others.

Reforming and Reviving the GSEs

The most sweeping and costly actions in the housing bill are aimed at regulatory reform and saving the insolvent housing-related GSEs, Fannie Mae and Freddie Mac. According to Poole (2008), Fannie and Freddie (hereafter Fan and Fred) are already insolvent. These institutions were created by Congress and granted federal charters as privately held corporations, originally to provide liquidity to the nation's housing markets and to provide affordable housing programs desired by the government. Under the bill, Congress granted temporary authority for the Secretary of Treasury to purchase debt or stock in unlimited amounts from Fan and Fred or the Federal Home Loan Banks. This made official the unlimited line of credit backed by the full faith and credit of the United States, which had long been assumed by financial markets.

The bill also provides for a single regulator, the

Federal Housing Finance Authority (FHFA), for these organizations, replacing the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board, which had supervised the 12 Federal Home Loan Banks, the orphans of the Federal Home Loan Bank Board which was abolished as part of the Savings and Loan reforms of the early 1990s. The first head of FHFA will be Dennis B. Lockhart III, the current head of OFHEO, until he is replaced by the next president. The expectation is that the new regulator will toughen capital requirements and provide closer scrutiny over the GSEs, especially now that Congress has clarified the legal standing of the GSEs as essentially public enterprises.

Interestingly, the new bill also requires that Fred and Fan pay a tax of 4.2 basis points on each dollar of unpaid balance of each enterprise's total new mortgage purchases. Presumably, this is to remove some of the advantage of their government related low cost of funds, and to offset some of the new higher costs of FHA lending. It is not sufficient to fully offset the lower cost of capital of the GSEs and will continue the disadvantages that private mortgage holders face in competing with them.

One of the greatest problems presented by the new bill's treatment of Fred and Fan is their recapitalization. The GSEs were long believed to be substantially undercapitalized, and plans in Congress as recently as last spring looked for the capital requirements to be substantially raised with the addition of private sector financing. A March 2008 estimate of their capital, at about \$80 billion, was far less than banks of equal size would be required to hold. But raising new capital will be difficult so long as the possibility of being taken over by the receiver is possible.

Another major problem is the size of the potential budgetary cost. The Congressional Budget Office (2008) estimates the cost of the GSE exposure to be \$25 billion. However, the potential cost is much greater than this. Suppose that the number of foreclosures rises to about 4 percent from the first quarter 2008 level of 2.4 percent, and further suppose that the GSEs are equally exposed, which may be an overstatement of their exposure. Further suppose that, in a typical foreclosure, 50 percent of value is recoverable, a fairly standard assumption. In this event, the GSEs would lose about \$30 bil-

lion on their books and another \$70 billion on outstanding guarantees, a total of \$100 billion. The GSEs had capital of about \$80 billion in March 2008 and had already taken losses of \$11 billion. Thus the expected cost to the Treasury would be about \$9 billion under this scenario, ignoring the undercapitalization of the GSEs that would then exist. The latter cost is likely to be over \$86 billion for the mortgages on the books of the GSEs; a further 4 percent is necessary to cover the cost of guarantees under the assumed default experience. Thus the total cost to the Treasury could be as much as \$230 billion, or more depending on the extent of losses over the next year at the GSEs. The CBO assumes that there is only a five percent chance of a loss greater than \$100 billion and a 50 percent chance of no direct cost to the Treasury, but this ignores a reasonable estimate of the expected losses and costs to bring these firms up to private sector standards for capital.

The Future of Fred and Fan

The failure of Fred and Fan prompted many of their critics to rejoice, declaring “I told you so,” and in some cases projecting the end of their lives as government sponsored entities or as independent agencies of government. Many financial market leaders, on the other hand, celebrated the recognition that the government stands behind Fan and Fred and expected the enterprises to be refinanced at public and private expense, in the latter case with clear recognition by the government that Fan and Fred would ultimately be going concerns as GSEs with explicit backing of the government. Neither side is likely to be satisfied; indeed, all sides face as much uncertainty about the future of Fred and Fan as they did before the new law was passed. Poole (2008) has called for the eventual privatization of Fred and Fan in five to ten years. If the firms can survive that long, it is most unlikely that they will be as weak as today and that they can be fully privatized. Former Secretary of Treasury Lawrence Summers (2008b) has pointed out the impossibility of sustainable GSEs under the previous arrangements and he has (2008a) called for them to be put in receivership and, in “several years,” privatized. “Several years” is likely to be sooner than five or ten years, with the length of time conditioned upon the end of the financial crisis, which is not imminent.

The recent actions and prospects are largely affected by perceptions of the effects of the imposing size of Fred and Fan. They hold about 15 percent of all mortgages and they guarantee another 35 percent or so of the remainder of mortgages. Their exit from the market would be a catastrophic event for the U.S. and global financial markets, in the minds of many observers. Certainly in the current financial environment, any such large change could have serious ramifications. As recently as 2007, Fred and Fan restricted their purchases of mortgages to about 15 percent of the market, as noted by Poole (2008), with no obvious effect on housing, mortgage or financial markets. A further cut to zero would have had little more effect, except perhaps for a temporary one based on expectations or announcement. The threat to ending guarantees is more serious according to many analysts. The most credible estimates suggest that Fred and Fan have lowered conforming mortgage interest rates by less than 10 basis points and may have had no significant effects on primary or secondary market spreads; the latter result is independent of whether the firms have added to their own “owned” portfolio or securitized loans with a guarantee (see Passmore, Sherlund and Burgess 2005 and Lehnert, Passmore and Sherlund 2006).

The exposure of the government to the insolvency of Fred and Fan creates an unsustainable situation. The firms are still private, in the sense that they have listed stock, stockholders and pay dividends. As Poole has noted, they have very large lobbying and political contribution budgets and they also pay very large salaries that are competitive with private financial institutions. The new bill gives the FHFA power to influence salaries and other operating expenditures. The biggest problem going forward is that there is a strong case to privatize the activities of Fred and Fan, though the recent insolvency complicates this effort. Presumably the new regulator could declare the firms to be insolvent and take control as the receiver under newly defined receivership powers. Problematic budgets could be eliminated immediately, and the claims of common and preferred stockholders and subordinated debt holders could be wiped out. Restrictions on new business and an orderly process reducing the exposure could begin immediately, as well as efforts to privatize components of the firms with sufficient capital to be attractive to

private sector bidders. Eventually the receiver would have to sell off the less desirable remaining assets and assume the remaining liabilities of the firms.

One putative problem, taking the debt of Fred and Fan on the federal budget, is an issue in the minds of some analysts, but taking them on budget would simply be a clear recognition of what was already known with a high degree of certainty. Moreover, those debts come with assets that are nearly as large, so that the creditworthiness of the U.S. government would not likely be impaired. For those fooled by accounting constructs, the initial structure (but not the extended life) of the Resolution Trust Company could be emulated, under the FHFA to keep the gross debt of Fred and Fan off the books.

Working against such an effort is the fact that Fan and Fred have long standing and strong political support in Congress because of their bureaucratic and political largess, as well as their support for political agendas. Numerous efforts over the past two decades, at least, have failed to reign in or to privatize their activities. The current weakness of Fan and Fred could eventually be overcome under government control and pressures would be exceedingly strong to remove some of the federal oversight from these firms, especially if the existing board and ownership structure remain in place. It is far too premature to believe that the problems of Fan and Fred for financial markets, housing markets and politicians are about to end. Indeed, without immediate attention to ending the federal charter and link to the nation's Treasury, Fan and Fred are likely to rise again.

The new housing bill has been debated for almost a year, but it has become a symbol of a much larger effort to enhance government regulation and its role in the economy, especially since July 13, 2008 when the Secretary Paulson announced the importance of making official the government backing of GSE debt (2008a). This appeared to be a major departure from the U.S. Treasury's (2008b and c) call for regulatory modernization and improvement of private sector competitiveness in the blueprint announced less than four months earlier, at least in the sense that the plan called for streamlining and simplifying regulation and role of the government in order to lessen its burden and improve the competitiveness of the nation's financial

industry. It may be premature to suggest that regulatory reform to lighten the burden of regulation is no longer on Treasury's agenda (see Davis et al 2008), but the tone and content of recent discussions call for an enhanced role of the Federal Reserve (Fed) and the Securities and Exchange Commission in regulating products and market activities in ways not seen before in the United States. For example, the Treasury and the Fed endorsed Fed lending to Fred and Fan, though the Fed was quick to indicate that this is not likely because it is incompatible with their "lender-of-last-resort" policy and is not likely to be necessary. The latter policy has been changed dramatically in the past year, however (see Tatom 2008). The Treasury Secretary insists that a new consultative role for the Fed in setting capital requirements and prudential standards that require new congressional authority in the housing bill is consistent with the "*de facto* market stability regulator" role envisioned in the Blueprint. Perhaps the new role of financial market stability czar is the exception to the government restraint otherwise envisioned in the Treasury's blueprint. In any event, recent emergency steps may simply disguise the new course of the nation's financial leadership.

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A Race to the Top?

U.S. Financial Regulatory Reform, as Envisioned by the Treasury Department

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In the January 2008 edition of *Research Buzz*, Networks Financial Institute (NFI) provided a description of the process for the U.S. Treasury Department's review of the structure of financial institutions regulation. Steps toward a capital markets competitiveness action plan started in March 2007 with the Treasury's convening of a blue ribbon panel on U.S. capital markets competitiveness. The first stage of the review was Treasury's announcement in May 2007 of a "set of capital markets initiatives . . . to strengthen financial reporting and seek a more sustainable and transparent auditing profession." In June 2007, Treasury followed with an announcement that stage two would include a formal regulatory review process to yield "a rationalized regulatory structure with improved oversight, increased efficiency, reduced overlap and the ability to adapt to market participants' constantly-changing strategies and tools."¹ By October 2007, Treasury issued a call for public comments, to which NFI Executive Director Liz Coit replied, and on March 31, 2008, Treasury announced its release of a *Blueprint for a Modernized Financial Regulatory Structure*.

In all public comments about the *Blueprint*, Treasury officials have not been inclined to place a timeframe on the implementation of recommendations. Indeed, many will likely never be implemented; unsurprisingly, several of the concepts that Treasury outlines have met already with stiff resistance from industry players and lobbyists, and legislators as well. Even given the fact that many of the recommendations will not come to fruition, Treasury has only said that they envision a timeframe of many years, citing as precedent the 1991 Bush administration "Green Book" review, which did not result in a financial regulatory overhaul until the 1999 passage of the Gramm-Leach-Bliley

(GLB) Act.² GLB took the step of allowing “broader affiliation of financial service firms through a Financial Holding Company Structure,” and the new recommendations go further by confronting and bridging the siloed, functional regulatory agency structure “across the traditional securities, futures, insurance and banking industry segments”³ in order to mitigate regulatory jurisdictional disputes and arbitrage and the migration of financial services and products to more hospitable foreign markets. However, by July 10, 2008, Treasury Secretary Henry Paulson’s comments to the House Committee on Financial Services indicate that in the space of just over three months, Paulson’s vague timeline has already been foreshortened. Speaking about both the *Blueprint* and the potential government provision of an increased line of credit as a liquidity backstop to Fannie Mae and Freddie Mac, in consequence of investor wariness over the mortgage backers’ capital reserves, Paulson commented:

When we released the Blueprint, I said that we were laying out a long-term vision that would not be implemented soon. Since then, the Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our financial regulatory system, and has convinced me that we must move much more quickly to update our regulatory structure and improve both market oversight and market discipline.⁴

Paulson, as well as Assistant Secretary for Financial Institutions David Nason, both have commented that the unfortunate and dramatic upswing in financial market instability since August of 2007 has increased considerably the public and financial sector professional interest in the review of regulatory reforms. Paulson commented that, when the *Blueprint* process was announced last year, “other than some enthusiastic academics, few noticed.”⁵ One notable group with prior expressed public interest in capital markets regulation is the [Committee on Capital Markets Regulation](#), an independent, nonpartisan research group dedicated to improving the regulation of U.S. capital markets and comprised of 27 leaders from the investor community, business, finance, law, accounting and academia. Originally formed in September 2006, the group’s initial focus was on the competitiveness of U.S.

public equity markets. Their current research, due for publication before a new presidential administration takes office, is a response to crisis in the securitized debt market and focuses on five topics: transparency, consumer protection and borrower relief, capital requirements, regulatory reorganization and monetary policy.⁶ The recent marketplace changes, including recession fears, increases in fuel prices, the credit crunch and the subprime lending crisis, have focused the attention of ever greater numbers of industry players on the Treasury review and influenced its content. For example, in response to the foreclosure crisis, Treasury includes a short-term recommendation for the creation of a federal Mortgage Origination Commission (MOC) to “evaluate, rate, and report on the adequacy of each state’s system for licensing and regulation of participants in the mortgage origination process.”⁷ Though not part of the *Blueprint*, Treasury is additionally “urging Congress to finish legislation creating a world-class [government-sponsored enterprise (GSE)] regulator, including a consultative role for the Federal Reserve in the new GSE regulator’s process for setting capital requirements and other prudential standards.”⁸ But more generally, recent blows to U.S. economic indicators and attitudes have informed the tenor of Treasury’s document and its presentation to the public. It shaped the decision to chart a third course, toward what Treasury calls objectives-based structure for financial services regulation, as opposed to the U.S. approach to date, characterized as rules-based, or the approach to financial institutions oversight in countries like the U.K., characterized as principles-based. Additionally, Paulson and Nason stress that the document is not intended to, and indeed could not, “eliminate all bouts of financial instability.” Nason, in addressing the New Financial Frontiers conference in April 2008, remarked,

In a dynamic market economy, it is impossible to eliminate instability through regulation. At a fundamental level, the root causes of market instability are difficult to predict, and past history may be a poor predictor of future episodes of instability. Nonetheless, we should not stop trying to understand better and mitigate instability.⁹

So, what does Treasury mean by “objectives-based” regulation? Treasury argues that objectives-based regulation “more closely link[s] the

regulatory structure to the reasons why we regulate.”¹⁰ Treasury’s proposals link each of three regulatory objectives to one responsible agency: a market stability regulator across the entire financial sector, an institutional safety and soundness regulator for those institutions supported by a federal guarantee, and, lastly, a consumer and investor protection regulator.

Focus on market stability has been sharpest, since Treasury released the *Blueprint*, due to the combination of safety and soundness issues (especially in light of the IndyMac Bank failure on July 11, 2008), risks related to non-bank financial institutions (such as larger hedge funds) and their regulation, and GSE housing market issues with the near failure of Fannie Mae and Freddie Mac. Treasury holds up the Federal Reserve as what it calls a natural choice for market stability regulator. The Fed already plays that role as it relates to monetary policy implementation and financial system liquidity, but Treasury’s recommendations would elevate the Fed’s role beyond bank holding company supervision to include evaluation of capital, liquidity and margin practices across the entire financial system. This necessitates an extension of the Fed’s current ability to collect information to include commercial and investment banks, insurance companies, hedge funds, commodity pool operators. Simultaneously, it requires a shift away from the Fed’s focus on the financial health of individual and particular organizations, a function that would transfer to the proposed prudential regulator.¹¹ Assistant Secretary Nason added some detail to Paulson’s description of this new vision for the Fed’s role:

At the outset, a goal of this regulator is to attempt to harness market forces. The market stability regulator must have access to detailed information from all types of financial institutions, including data submissions and the ability to join in or initiate examinations. Second, the market stability regulator should have the authority to require additional disclosure by financial institutions so that market participants can better evaluate their risk profiles. Third, the market stability regulator should also be involved in financial institution regulatory requirements to include a focus on broader market stability perspectives. Finally, the market stability regulator should

have the ability to require financial firms to undertake corrective actions to address financial stability problems.¹²

The safety and soundness, or prudential, regulator proposal combines all federal bank charters into one charter and all federal bank regulators into a single regulator and serves a role similar to the current Office of the Comptroller of the Currency (OCC). It includes the recommendation of a federal insurance charter, known as the Optional Federal Charter (OFC).¹³

The third objective regulator for consumer and investor protection is also known as a conduct of business regulator. If enacted, it will strive for more consistency across product lines and will be responsible for ensuring adequate disclosures to consumers and investors, regulating business practices, the chartering and licensing of certain categories of institutions, and enforcement programs.¹⁴

The *Blueprint* also contains several additional near- and intermediate-term recommendations, which can be explored more fully in the [Blueprint Fact Sheet](#) or most fully in the *Blueprint* itself. Short-term recommendations not yet discussed include, first, a clarification of liquidity provisioning by the Fed as regards lending to non-depository institutions. Second, Treasury suggests an enhancement of the Executive Order creating the President’s Working Group on Financial Markets (PWG) to 1) emphasize coordination and communication, 2) increase its membership, and 3) clarify its mission of mitigating systemic financial risk, enhancing financial market integrity, promoting consumer and investor protection, and supporting capital markets efficiency and competitiveness. Nason’s April 2008 speech further addresses the question of the Fed’s temporary extension of liquidity facilities to financial institutions such as investment banks and its implications for expanding bank-like regulation to this wider range on non-bank firms; his concerns were echoed in Paulson’s July 2008 comments to the House Committee on Financial Services. Nason identifies two potential outcomes, both of which he characterizes as “unattractive,” but less so than the status quo:

One outcome could be that innovation and risk-taking decline to levels below what the market would normally allow. This could inhibit overall economic growth and could push market-permitted risk-taking to those

firms not swept into broader regulatory reach. Another outcome would be to provide a false sense of security to market participants, potentially leading to less market discipline and even greater complexity and opacity in the future that could lead to even greater financial instability. . . . For this reason, the Blueprint advocated for a separation of responsibilities between a regulator looking at the system as a whole and another regulator focused on the health of individual institutions. A bifurcation of regulatory responsibility properly aligns regulatory incentives.¹⁵

Intermediate-term recommendations address payment and settlement systems by calling for a federal charter for them and their regulation by the Fed. Additionally the middle-term recommendations include merging the Securities and Exchange Commission (SEC) and the Commodities Future Trading Commission (CFTC), who are already operating under a mutual cooperation agreement; state-chartered bank oversight and supervision by either the Fed or the Federal Deposit Insurance Corporation (FDIC); the revocation of the Federal Thrift Charter and the discontinuation of the Office of Thrift Supervision (OTS); and the aforementioned OFC and the related establishment of a federal insurance regulator to be housed within Treasury.¹⁶

In summation, Treasury has presented in its *Blueprint* a revised vision for financial sector regulation that it hopes is designed for the contemporary financial landscape and times, yet flexible, adaptable, efficient and effective. Treasury's goal is to enhance U.S. financial innovation and protect American primacy and competitiveness in a global financial marketplace. While not insulating the market from inevitable disruptions, Treasury hopes the eventual enactment of its *Blueprint* recommendations serves to attract global capital, manage system-wide risk, promote consumer and investor confidence and insure the U.S. a winning place in a "race-to-the-top"¹⁷ of the global financial services industry.

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Article Summary:

Insurance Regulation—The Need for Policy Reform

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The American Enterprise Institute for Public Policy Research (AEI) on July 9, 2008 held a conference, cosponsored by the Brookings Institute and Georgia State University, on the “Future of Insurance Reform.” This article summarizes “Insurance Regulation: The Need for Policy Reform,” a paper by Martin F. Grace and Robert W. Klein, both of the Center for Risk Management and Insurance Research at Georgia State University. This paper presented at the July AEI conference, discusses some policy reforms in the critical areas of financial oversight, market regulation and anti-trust. Over time the market place has changed, so that insurance companies are now competing in a number of areas with banks, security firms and with foreign firms, but with the same regulatory

structure that has existed for several decades. Lately the drumbeat is up for an optional federal charter that allows for dual regulation, allowing a company to opt for federal or state regulation. Currently, insurance regulation is provided by individual states.

The Rationale for Insurance Regulation

The economic foundation for regulation is based on the possibility of market failures, which are judged against the social welfare maximizing conditions for perfect competition. The rationale for government intervention when market failures occur is that regulators can remedy the failure and restore economic efficiency. Perfect competition criteria include many buyers and sellers in a market, free entry and exit, perfect information, and a homogenous product. However, it is not a perfect world and potential market failures in insurance could arise from severe asymmetric information problems and principal-agent conflicts, which could lead some insurance companies to incur excessive financial risk and/or engage in abusive market practices that harm consumers. Consumers could find it difficult to compel insurers to fulfill their obligations under their contracts. Further, there is the possibility that insurers could acquire sufficient market power to restrict competition, resulting in barriers to entry, higher prices and excessive economic profits.

There are also a set of circumstances that are not considered as failures in the economic sense, but constitute “undesirable” market outcomes, e.g., high prices, the unavailability of insurance coverage, etc., that result from conditions affecting the cost of risk, rather than violations of the conditions for perfect or workable competition. If it is more efficient for government to monitor and undertake other compliance/enforcement measures, then regulatory intervention could be welfare-enhancing.

Grace and Klein cite several types of regulation, which may be grouped in different categories. *Solvency regulation* attempts to minimize or limit the social cost of insurer insolvency within acceptable parameters by requiring insurers to meet a set of financial standards and taking appropriate actions if an insurer assumes excessive default risk or experiences financial distress. The objective of *price regulation* is to enforce a ceiling that will

prevent prices from rising above a competitive level. Another reason for price regulation is to minimize the temptation on insurers to incur excessive financial risk while charging inadequate prices. *Market conduct regulation* is necessitated by information problems, constraints on consumer choice and unequal bargaining power between insurers and consumers amongst other things, which can make some consumers vulnerable to abusive marketing and claims practices of insurers and their agents. Also, negative *externalities* could create an undersupply of insurance where risks are uninsurable by private insurers without government assistance, hence an additional need for regulation. The following discussion looks at solvency regulation issues, market regulation and insurance and anti-trust issues.

Solvency Regulation

The authors note that, unlike the United States, an increasing number of countries (e.g., the United Kingdom and other European countries) have employed, or are moving towards a “prudential” or principles-based approach to insurance regulation, where emphasis is placed on insurers’ maintaining an adequate “solvency margin” and the competence and judgment of an insurer’s management with regards to its financial risk being the ultimate point of focus for supervisors. Many European Union countries have also embraced a financial/economic approach to insurer regulation more quickly than their U.S. counterparts, whose standards are stated in terms of accounting values. Insurers’ compliance with these standards is assessed by examining their financial statements and other financial reports that they are required to submit. Clearly, the filing of financial statements according to a set of accounting principles is an essential part of any financial regulatory system. However, the concern is that regulators place too much emphasis on these financial statements and the accounting values reported and on compliance with a detailed set of rules. Accounting values may not provide a true picture of an insurer’s financial condition and are inadequate for assessing an insurer’s financial risk. Further, an insurer can comply (or at least appear to comply) with all of the regulatory rules, yet still assume an excessive level of financial risk. Below are some considerations for solvency regulation.

1. Capital Standards

The U.S. financial regulatory system uses risk-based capital (RBC) requirements which rely on, but are not confined to, accounting values. RBC requirements are based on a standard formula developed by the National Association of Insurance Commissioners (NAIC) that is both complex and flawed. All of the “charges” used to calculate an insurer’s RBC requirement involve the application of selected factors to various accounting values. All but a few companies greatly exceed their RBC requirements which are considerably less stringent than the capital standards set by rating agencies (Klein and Wang, 2007). The imperfections in the U.S. approach have likely compelled regulators to set the bar fairly low to avoid being forced to take actions against insurers that are actually financially sound.

2. Financial Monitoring

The U.S. financial monitoring framework is motivated by static, “ratio-based” low capital requirements and does not involve dynamic testing or modeling. A more comprehensive and “hands-on” approach to financial monitoring would naturally be melded with a shift towards the use of dynamic financial analysis to determine the adequacy of an insurer’s risk management and capital.

3. Reinsurance

Another problem lies with the U.S. approach towards foreign reinsurers. In order for a U.S. insurer to claim “accounting credit” for reinsurance recoverables from foreign insurers, their reinsurers must be licensed in the U.S. or post collateral equal to their obligations to U.S. insurers. This increases the cost of reinsurance for U.S. insurers and creates a disincentive to purchase more adequate amounts of reinsurance, especially from foreign firms. It also places U.S. insurers at a competitive disadvantage relative to non-U.S. insurers. In contrast, the E.U.’s Solvency II initiative would eliminate collateral requirements for foreign reinsurers.

4. Intervention and Managing Insolvencies

The paper cites Grace, Klein and Phillips (2002), which identifies several problems within the U.S. receivership system and finds evidence of regulators exercising excessive forbearance in deal-

ing with troubled insurers, noting the NAIC’s tortuous but futile efforts to reform aspects of the system.

5. Moving Towards a Better System

Grace and Klein discuss upgrading U.S. solvency regulation to “best practices,” with the E.U.’s Solvency II as a template but tweaked to U.S. needs, such as employing some form of dynamic modeling. The use of a principles-based system to solvency oversight has fallen short and would be difficult to implement, mostly due to voluminous rules currently in place that would be difficult to discard.

Market Regulation

Grace and Klein add that problems in pricing regulation arise when strong cost pressures compel insurers to raise their prices and regulators resist market forces in an ill-fated attempt to ease the impact on consumers. The case for rate deregulation is that prices in competitive insurance markets would be “actuarially-fair” and not excessive and that competition would drive insurers to be efficient, with prices gravitating to the lowest possible level. If insurers will charge competitive prices in the absence of government intervention, then there is no need for rate regulation, that is, if insurance markets are competitive. Many states conflate efforts to promote competitive prices with efforts to aid low income buyers who might remain uninsured in the face of competitive prices. They use residual market mechanisms (RMMs) to provide a source of insurance coverage for buyers who cannot obtain coverage from an insurer in what is called the “voluntary” market. When the voluntary market is subject to severe regulatory constraints and residual market mechanisms are mismanaged, RMMs can grow rapidly and incur substantial deficits that are assessed back to voluntary market insurers. Good rate regulatory policies – preferably price deregulation – can be accompanied by the proper design and administration of residual market mechanisms by letting RMMs charge risk-based rates, enforce strict eligibility requirements, and avoid funding shortfalls.

Two aspects of product regulation require the most attention: one, mandated coverage or prohibitions on the exclusions that may be offered in a policy; and, two, the arduous review process insur-

ers undergo to get a product approved and introduced to the market. The authors suggest rationalized and standardized regulatory oversight for personal insurance products as well as minimal mandated coverage and benefits.

Regulatory rules and interference with underwriting activities and other market practices varies by state and product line. For the most part, regulators tend to give insurers fairly wide discretion in underwriting risks but there are some notable exceptions that this paper notes, including: 1) mandatory offer requirements; 2) restrictions on the use of certain factors in underwriting and pricing; and 3) interference with an insurer's efforts to restructure its portfolio of exposures.

Insurance and Antitrust Policy

The McCarran-Ferguson Act of 1945 (MFA) provided a Commerce Clause exemption to the insurance industry, allowing it to operate under the regulatory authority of the states and not federal antitrust laws. The principal objective of the exemption is to allow insurers to use uniform price structures developed by industry rating organizations and approved by state regulators.

One of the main arguments in favor of the MFA is to allow smaller companies to share data because they would not have the actuarial staff or sufficient numbers of customers to set accurate prices using internal data. In most proposals involving repeal of the MFA, this is the exemption that still remains.

Arguments for the repeal of MFA

Arguing against MFA is the concept that competition allegedly causes price decreases and insurers would therefore have an incentive to lower prices so much that their solvency would be endangered. This argument is now widely dismissed because the understanding of competition and insurance pricing is more accurate now than it was in the beginning of the twentieth century. While it is true, according to Grace and Klein, that one of the major reasons insurers fail has to do with improper pricing and inadequate reserves, there is not an apparent link between the competitive market environment and failure.

One of the arguments for its repeal is that all the industry's collusive behavior will vanish. However, since concentration measures and entry barriers

in most markets are relatively low, it is difficult to see how the industry will be affected by repealing a rule which prevents collusion when the structure of insurance markets precludes collusion.

Arguments for the Status Quo

One of the arguments for the status quo is the ability of companies to share data. The concern is that eliminating the pooling and analysis of loss data would undermine accurate pricing by insurers, particularly smaller companies that are more reliant on industry data. Also, the MFA gives each state the right to choose the style of regulation consistent with the preferences of its voters. Some states might permit more joint behavior than others.

Conclusion

Grace and Klein foresee continued difficulties in the implementation of insurance regulatory reform and view as unlikely a major revamping of the current system. Due to both practical considerations and formidable political opposition, they see "smaller" incremental changes at both state and federal level. However they emphasize that of the policies that most impair consumer wellbeing, promoting market efficiency should be a key goal.

Reference

Grace, Martin F., Robert W. Klein and Richard D. Phillips, "Managing the Cost of Property-Casualty Insurer Insolvencies in the U.S.," Center for Risk Management and Insurance Research at Georgia State University, December 2002.
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