January 2009

Analysis

Financial Oversight Failure Highlights Effectiveness of Insurance Regulation

NAMIC®
National Association of Mutual Insurance Companies

EFFECTIVE ADVOCACY
STRATEGIC PUBLIC POLICY
VALUABLE MEMBER SERVICES

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NAMIC®
NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

National Association of Mutual Insurance Companies
Founded in 1895, the National Association of Mutual Insurance Companies (NAMIC) is a full-service national trade association serving the property/casualty insurance industry with more than 1,400 member companies that underwrite more than 40 percent of the property/casualty insurance premium in the United States. NAMIC members are small farm mutual companies, state and regional insurance companies, risk retention groups, national writers, reinsurance companies, and international insurance giants. Together, we are NAMIC.

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Executive Summary

Policymakers should aggressively remedy demonstrated failures and gaps in the financial regulatory system exposed during the current financial crisis. Prudence, however, demands careful review and analysis to ensure that reform initiatives are tailored to real and demonstrated problems.

With respect to insurance regulatory issues, two prevalent but highly misleading labels threaten to distort public debate:

- American International Group (AIG) is commonly called an "insurance company" – but the rescued entity is a diverse financial services holding company. AIG's non-insurance operations grievously harmed its balance sheet; its insurance company holdings are sound and well capitalized.

- Credit default swaps (CDS) are commonly called "insurance" – but they, like many other financial products that hedge risk, are not insurance products under established law and are neither managed nor regulated as insurance. Derivatives and CDS failures are thus not caused by or related to insurance regulation.

The inaccurate premises identified above lead some observers to the misplaced conclusion that insurance regulation suffered massive failure. The members of the National Association of Mutual Insurance Companies (NAMIC) – with their established record of conservative management and rational decision making – submit that the state-based system of insurance company solvency regulation has proven stable and reliable such that insurance companies are today able to provide their individual and commercial insureds with needed protection even in a time of terrible strain. This paper discusses what insurance is and what insurers do while distinguishing insurance from derivatives; argues that the States have effectively regulated insurer solvency; describes how the states regulate this important national market; and offers policy suggestions for framing federal review of the insurance regulatory system.

NAMIC believes that:

- State regulation of insurance neither caused nor contributed to the current financial crisis.

- Suggestions that the current crisis provides justification for the creation of a new federal regulator of insurance are mistaken.

- State insurance solvency regulation steadily improved during precisely the years when expanded use of unregulated derivatives and the growing threat of CDS went unaddressed.

- Congress' longstanding policy choice in the McCarran-Ferguson and Gramm-Leach-Bliley Acts to delegate insurance solvency regulation policymaking and implementation to the states has produced effective results and remains well founded.

Insurance is the pooling of risk by individual people and businesses who band together with other similarly situated people to protect themselves from the uncertainty of potentially overwhelming financial losses by paying fixed and affordable amounts into a common indemnification fund.

- Accurate, fairly presented information from a well conceived federal Office of Insurance Information would enhance Congress' monitoring of state insurance regulation and the efficiency of the financial services regulatory system, including oversight of systemic risk.

Necessary Starting Point: What is Insurance?

Insurance is the pooling of risk by individual people and businesses who band together with other similarly situated people to protect themselves from the uncertainty of potentially overwhelming financial losses by paying fixed and affordable amounts into a common indemnification fund. The common fund covers the anticipated aggregate losses of all of its participants by charging each insured a premium reflecting that person or entity's risk.

Insurance empowers individuals and businesses to take the risks created by the cornerstone activities of modern society. A middle-class family seeking to buy a house with a $250,000 mortgage could not consider such a purchase due to the risk of fire – absent homeowners, insurance sold by NAMIC members and their competitors. To earn a living, most citizens get to their jobs by climbing into two-ton structures of steel and glass on wheels, which they drive at high speeds alongside and at intersecting paths with other such vehicles, creating extraordinary potential financial risks far greater than their net worth – an irrational activity without automobile insurance.

> We buy insurance because we cannot afford to take the risk of losing our home to fire. ... That is, we prefer a gamble that has 100 percent odds on a small loss (the premium we must pay) but a small chance of a large gain (if catastrophe strikes) to a gamble with a certain small gain (saving the cost of the insurance premium) but with uncertain but potentially ruinous consequences for us or our family. ... [I]n the absence of insurance, just about any outcome seems to be a matter of luck.[1]

Similarly situated individuals and businesses thus protect themselves by taking out insurance policies that provide them access to a common fund upon an insured event. The Supreme Court and Congress have thus recognized that the essence of insurance is risk pooling:

> The primary elements of an insurance contract are the spreading and underwriting of a policyholder's risk. "It is characteristic of insurance that a number of risks are accepted, some of which involve losses, and that such losses are spread over all the risks so as to enable the insurer to accept each risk at a slight fraction of the possible liability upon it." [Citation omitted.] "Insurance is an arrangement for transferring and distributing risk." [Citation omitted.] ... .
>
> References to the meaning of the "business of insurance" in the legislative history of the McCarran-Ferguson Act strongly suggest that Congress understood the business of insurance to be the underwriting and spreading of

> risk. Thus, one of the early House reports stated: "The theory of insurance is the distribution of risk according to hazard, experience, and the laws of averages. These factors are not within the control of insuring companies in the sense that the producer or manufacturer may control cost factors."[2]

The policies sold by NAMIC members to automobile, home, and business owners are contracts of indemnity that constitute the most basic of "arrangement[s] for transferring and distributing risk."[3] As discussed below, CDS do not pool risk in this way so as to "'substitut[e] ... certain for uncertain loss,' or the diffusion of positive loss over a large group of persons"[4] who have chosen to seek common indemnification in this way.

Insurance Requires Insurable Interest –

> The insurable interest requirement is fundamental to insurance. An insured may collect on a policy of property insurance only by showing both an insurable interest and a loss by reason of the damage to or destruction of the property. The rule is stated ... as follows: "A contract of fire insurance is a personal contract for indemnity for the insurable interest possessed by the insured at the time of the issuance of the policy, and also at the time of loss. ... All such contracts of property insurance, whether of fire, marine, or other types are considered contracts of indemnity, intended solely to indemnify the insured for his actual monetary loss by the occurrence of the disaster."[5]

Insurable interest constitutes a necessary counterbalance to the danger of "moral hazard" that otherwise is attendant to the financial incentives created by an insured event. As discussed below, CDS are risk hedging devices that do not require and usually do not contain the insurable interest protection that is an essential characteristic of insurance agreements.

Credit Default Swaps are Not Insurance – Most experts agree that the current financial crisis is the result of a housing market "bubble," the effects of which were exacerbated by a proliferation of largely unregulated hedging mechanisms, especially derivatives such as credit default swaps (CDS). CDS have often been described as insurance. "The buyer of the credit default insurance pays premiums over a period of time in return for peace of mind, knowing that the losses will be covered if a default happens. It's supposed to work similarly to someone taking out home insurance to protect against losses from fire and theft."[6]

But, although CDS are risk management products, they lack the core legal elements and business characteristics that are a prerequisite to homeowners and other property/casualty insurance products.[7] The vast majority of CDS clearly lack insurable interest and are initiated by speculators who have no exposure to the underlying debt instrument whose credit default risk the CDS could be used to hedge. Unlike in insurance, there is no necessary relationship between the amount of CDS "protection" sold and the size of the issued debt potentially being protected. This not only conflicts with the

Derivatives and CDS are certainly a prominent form of *risk management*. But these products are not *insurance* – which is itself another, but not the only, method of managing risk.

basic rules, but also the core function of insurance: CDS's can be a source of additional risk whereas insurance can only serve to reduce risk. "Call it insurance if you like, but it's not the insurance most people know. It's more like buying fire insurance on your neighbor's house, possibly for many times the value of that house – from a company that probably doesn't have any real ability to pay you if someone sets fire to the whole neighborhood."[8]

> In addition to the lack of insurable interest present in the vast majority of CDS, the basic relationship between insurers and insureds compared to that between seller and buyer in any CDS transaction is fundamentally and qualitatively different.
>
> In constructing risk classes, the insurer's goal is to determine the expected loss of each insured and to place insureds with expected similar losses into the same class, so that each may be charged the same rate. By creating classes of insureds that correspond to individual risk profiles, the insurance market is able to efficiently spread catastrophic risk across the full spectrum of policyholders. In contrast, derivatives "reduce risk through trading – matching counterparties with complementary and offsetting risk profiles."[9]

Derivatives are thus more akin to securities markets (counterparties hedging risk through trades with each other)[10] than to insurance risk pools (insurers underwriting and classifying their consumers by risk for placement in a common fund). CDS purchasers are sophisticated commercial parties who shift risk with other sophisticated commercial parties in distinct, individualized "swaps," whereas consumers buy insurance for the specific purpose of gaining protection from a common fund. "Insurance, by combining the risks of many people, enables each individual to enjoy the advantages provided by the Law of Large Numbers. Insurance is available only when the Law of Large Numbers is observed."[11] No such requirement[12] attaches to derivative instruments like CDS – and nor do or should the insurance unfair discrimination laws (which impose a regulatory obligation on insurers to apportion risk in a patterned way based on actuarial principles) apply to CDS.

Derivatives and CDS are certainly a prominent form of *risk management*. But these products are not *insurance* – which is itself another, but not the only, method of managing risk.[13]

The Diverging Regulatory Systems for Derivatives and Insurance

The Longstanding but Overlooked Need to Regulate Derivatives – The danger that derivatives can actually increase rather than mitigate risk was described many years ago in Peter Bernstein's 1996 book about risk management, "Against the Gods: The Incredible Story of Risk":

> In 1994, a few of these apparently sound, sane, rational, and efficient risk-management arrangements suddenly blew up, causing enormous losses among the customers that the risk-management dealers were supposedly sheltering from disaster.

Spurred by concerns regarding risk assessment and national coordination of insolvencies in the late 1980s and early 1990s, and prodded by threat of congressional oversight, insurance regulators developed and implemented a comprehensive system of financial oversight that includes capital and surplus requirements, risk-based capital standards, sophisticated review of reserves, and a national accreditation system that provides incentives for each state to thoroughly and rigorously supervise their domestic companies.

> These disasters in derivative deals among big-name companies occurred for the simple reason that corporate executives ended up adding to their exposure to volatility rather than limiting it. … They treated low-probability events as being impossible. When given a choice between a certain loss and a gamble, they chose the gamble. They ignored the most fundamental principle of investment theory: *you cannot expect to make large profits without taking the risk of large losses.*[14]

More than a decade ago, Bernstein then explained the danger that these transactions posed to the economy at large.

> The financial solvency of these institutions supports the financial solvency of the world economic system itself. Every single day, they are involved in millions of transactions involving trillions of dollars in a complex set of arrangements whose smooth functioning is essential. The margin for error is miniscule. Poor controls over the size and diversification of exposures are intolerable when the underlying volatility of the derivatives is so high and when so much is at stake beyond the fortunes of any single institution.[15]

These dangers – that derivatives ignore the very essence of insurance (which assumes and prepares for the likelihood of losses), and that the financial system was imperiled by the interlocking and overlapping of these instruments – were readily apparent years ago: "[E]veryone is aware of the dangers inherent in this situation, from the management of each institution on up to the government regulatory agencies that supervise the system."[16] But such well-documented warnings were ignored; instead, these products, including CDS, facilitated the abusing of leverage rather than tempering volatility, infecting the global financial system with unmanageable systemic risk.[17]

Insurance Solvency Regulation has Matured and Excelled – During precisely the same time period that the derivatives crisis grew unabated, the insurance solvency regulatory system matured into a model of financial oversight. Spurred by concerns regarding risk assessment and national coordination of insolvencies in the late 1980s and early 1990s, and prodded by threat of congressional oversight, insurance regulators developed and implemented a comprehensive system of financial oversight that includes capital and surplus requirements, risk-based capital standards, sophisticated review of reserves, and a national accreditation system that provides incentives for each state to thoroughly and rigorously supervise their domestic companies. The industry supervised by this system is well capitalized, stable, and reliable.

The National Association of Insurance Commissioners (NAIC) Solvency Agenda adopted in 1989 and updated in 1991 renewed the states' commitment and significantly restructured insurance solvency regulation. Accountants, actuaries, and other professionals provided their expertise in a process that stressed long-term results, per the following initiatives:

Simply put, despite common perceptions, the troubled company American International Group is not an insurer, and its insurance subsidiaries and insurance products did not cause this holding company's problems.

- **Standardizing insurance regulatory accounting.** The NAIC adopted its "accounting codification" project to develop uniform regulatory accounting standards. The new NAIC Accounting Practices and Procedures Manual containing completely revised Statements of Statutory Accounting Principles was adopted effective for reporting periods starting January 1, 2001.

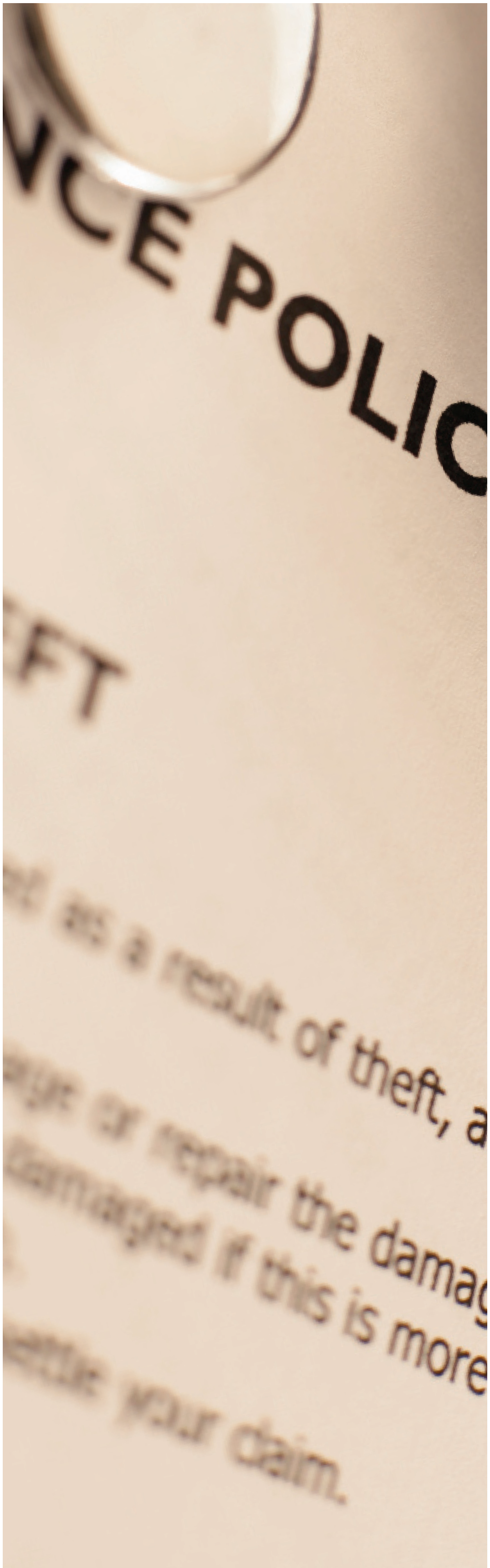
- **Establishing risk-based capital standards.** Statutorily required minimum capital requirements for starting new insurance companies were supplemented by minimum capital standards and formulas pegged to the risks taken on by insurers reported in the required insurer statutory financial statement. "Risk-based capital" requirements are compared with adjusted actual capital figures measured by the insurer's audited financial statement. Implementing legislation authorizes or requires insurance regulators to take action when a company's capital compares unfavorably to risk-based capital calculations, lessening the incidence of insolvency, and increasing the resources available to settle the claims of troubled insurers.

- **Other Requirements.** A non-exhaustive list of other elements of the NAIC Solvency Agenda includes the following requirements: Model investment laws specify the types of permitted investments, expectations regarding how insurer portfolios are selected, and limitations on what assets receive regulatory credit. The states uniformly impose requirements for professional actuarial review of reserve liabilities, require reporting of audited financial statements, and establish guidelines for selection of auditors. Finally, an accreditation standard was adopted that encouraged each state to adopt the NAIC-developed standards: Companies domiciled in states not adopting the NAIC standards may face additional regulatory scrutiny from other states in which they do business, creating a powerful incentive for each state to adopt the NAIC standards.

The insurance regulatory system's method of discharging insolvencies further contributes to vigilant solvency regulation. Because insurers, not the taxpayers, pay assessments for insolvencies through the guaranty fund system, insurers have every incentive to work with regulators to strengthen and fully fund insurance department financial regulatory staffing and resources. This is a highly unusual but beneficial dynamic: It is quite rare for regulated entities to have every incentive to push for more, rather than less, regulation.[18]

While no system is perfect, the state insurance financial regulatory system has been effective and has provided a source of comparative stability during the recent financial crisis. For instance, NAMIC members and property casualty insurers in general have repeatedly stated that they have no need for, or interest in, accessing the Troubled Assets Relief Program or any similar special government capital assistance program.

AIG's Troubles Do Not Stem From Its Insurer Holdings or State Regulation – While press accounts of American International Group's receipt of massive capital assistance from the United States typically refer to it as an insurer, the company receiving this federal support is actually a diversified holding company that owns hundreds of companies. Some are



insurers, but these companies did not cause AIG's financial problems.[19] AIG also owned or owns a slew of non-insurance subsidiaries, including but not limited to an airport, an aircraft leasing business, a lender, an asset manager – and most significantly AIG Financial Products, a relatively autonomous unit based in London with far less than 1 percent of AIG's employees. AIG Financial Products is the central cause of American International Group's financial freefall.[20]

AIG Financial Products sold CDS instruments, which are non-insurance financial products. Just as with the derivatives described by Mr. Bernstein a decade before, this company apparently "treated low-probability events" – such as declines in home prices and foreclosures that ruined mortgage-backed securities products – "as being impossible."[21] This was not insurance, and no company that entered into a CDS with AIG Financial Products could reasonably have believed that it was buying an insurance product from a U.S. state-regulated insurance company.

Simply put, despite common perceptions, the troubled company AIG is not an insurer, and its insurance subsidiaries and insurance products did not cause this holding company's problems.[22] State insurance regulators were not responsible for holding company or systemic oversight of AIG, which was subject to holding company supervision and assessment by the Office of Thrift Supervision.[23] (In addition, as a publicly traded stock company, AIG was subject to the supervision of the Securities and Exchange Commission.[24])

NAMIC defers to others regarding whether AIG's meltdown is attributable to gaps in or performance problems in the non-insurance sectors of the financial regulatory system, but this association emphatically asserts that state insurance regulation has played no material role in causing the current financial crisis.

Responsive Policymaking and Effective Insurance Regulation

The Mutual Insurance Enterprise in the American Economy – Mutual property/casualty insurance companies today are a critical part of the American economy. NAMIC members on the whole are very well capitalized and in no danger of insolvency. Their conservative management and prudent approach to long-term stability are particularly well suited to protecting insurance consumers. NAMIC's surveys of its members (in which they rejected any interest in government loans or other support) and numerous analyses of the industry bear out the stable financial performance of the industry during the current financial crisis.

Mutual companies, which are owned by their policyholders rather than stockholders whose interests are distinct from those of insureds, embody the very notion of the common fund at the heart of the insurance enterprise and its importance to the public.[25] NAMIC offers its public policy recommendations in that spirit.

Placing Insurance Products and Regulation in Their Proper Perspective – NAMIC members urge policymakers to focus their responses to the financial crisis by identifying and remedying documented problems – but not fundamentally disturbing markets and regulatory systems that have served consumers well.

Congress's policy choice to delegate basic insurance regulatory authority to the states has successfully passed a significant test during the current financial services regulatory crisis.

The auto, home, and business coverages provided by NAMIC members are well-regulated insurance products, as opposed to the largely unregulated instruments such as CDS that have caused the current crisis. The legislative and regulatory solution to the derivatives crisis should address any products and lack of oversight that Congress determines to have caused the problem – but should not trigger unjustified changes in a system whose regulation and products are, in fact, well structured and stable.

Appropriate Public Policy Responses and Effective Insurance Regulation – Congress – in exercising its oversight of interstate insurance commerce under Article I, Section 8 of the United States Constitution – has repeatedly chosen to delegate the on-the-ground regulation of insurance to the states. The McCarran-Ferguson and Gramm-Leach-Bliley Acts embody that clear and considered policy choice, which NAMIC believes is supported and has been well served by the recent performance of state insurance solvency regulation.[26]

Effective and practical policy responses to the current financial crisis should not displace the current division of labor in federal law. Under functional regulation, the regulator is determined by the type of product rather than the label commonly given to the company that sells it. More clarity in the Federal Code may be necessary regarding holding company regulation to avert future crises, but preemption of the basic state authority over insurance solvency regulation need not and should not be part of any program of systemic regulatory reform.

NAMIC thus urges Congress not to create an Office of Insurance Regulation in the federal government in response to the current financial regulatory crisis. But legislation creating an Office of Insurance Information (OII) – designed to bolster the federal government's institutional knowledge of insurance markets – would be appropriate. This paper's assertion, that basic and fundamental misconceptions about insurance in the current financial crisis may be distorting public debate, itself provides a rationale for an OII.

A well-conceived OII would address federal information gaps about insurance regulation and assist Congress in overseeing the functional regulation of financial services. For instance, an OII could help federal policymakers monitor systemic risk[27] throughout the financial services industry by providing a central repository to gather and analyze information already collected by state insurance regulators, such as insurer investment activity, capital adequacy, and loss exposure.

Conclusion

The Congress's policy choice to delegate basic insurance solvency regulatory authority to the states has successfully passed a significant test during the current financial services regulatory crisis. Congressional concern over systemic risk, however, would properly translate into the creation of an institutional informational office in the executive branch to acquire, analyze, and disseminate information about insurance markets and regulation. Given Congress's oversight responsibilities over interstate commerce and the importance of insurance to the United States economy, a limited but effective OII would be a proper and reasonable means of ensuring that Congress will have access to the expertise and information it needs to make informed policy choices regarding financial services regulation.

Endnotes

1 Peter Bernstein, *Against the Gods/The Incredible Story of Risk*, John Wiley & Sons (1996) at 203-204.

2 *Group Life and Health v. Royal Drug*, 440 U.S. 205 (1979).

3 *Id.*

4 *German Alliance v. Lewis*, 233 U.S. 389 (1914).

5 *Transportation Equipment Rentals, Inc. v. Oregon Auto. Ins. Co.*, 257 Or. 288 (1970). An insurance contract of indemnity like property insurance, which is what credit default swaps would be if they were insurance, is different from life insurance, which can be viewed as an investment. *See, e.g., Dalby v. The India and London Life Assurance Co*, 28 Eng. Law & Eq. 312 ("Life-policies bear no analogy whatever to fire or sea-policies. A life-policy increases in value as time progresses: not so a fire or a marine policy. The latter are strictly contracts of indemnity."); *Olmsted v. Keyes* 85 N.Y. 593 (1881) ("A life insurance is not like fire insurance, a contract of indemnity.").

6 Janet Morrissey, "Credit Default Swaps: The Next Crisis?", *Time* Magazine, March 17, 2008. *See also* Andrew Ross Sorkin (ed.), "S.E.C. Chair: Regulate Credit-Default Swaps Now," *New York Times* "Dealbook", Sept. 23, 2008 ("Credit-default swaps function like a kind of insurance, allowing the holder of a piece of debt to collect the debt's face value if the issuer defaults.").

7 *See, e.g.,* Agasha Mugasha, "The Secondary Market for Syndicated Loans: Loan Trading, Credit Derivatives, and Collateralized Debt Obligations," *Banking & Finance Law Review*, February, 2004 ("[W] hile both derivatives and insurance contracts hedge against risk, there are noteworthy commercial and legal differences between the two. The following have been noted: (i) The insured is required to have an economic exposure to the event ('insurable interest') in order for the transaction to be a valid contract of insurance under English law. This is not necessarily the case for derivative transactions, where the party buying the protection is not required to hedge its own position, or do so by holding the underlying reference obligation. (ii) Derivatives specify payments that are either fixed or linked to independent prices or indices. By contrast, insurance policies indemnify the insured against its particular losses following an insurance event .... (iii) Insurance policies are designed to protect the insurer against the possibility that the insured will have access to better information about the risk, so the insured will have a duty to disclose all relevant information to the insurer.... The protection buyer has no similar duties under a derivatives contract."); David S. Miller, "Distinguishing Risk: The Disparate Tax Treatment of Insurance and Financial Contracts in a Converging Marketplace, *Tax Lawyer*, Winter, 2002 ("Because the transactions are not documented as insurance, do not reference any specific security, do not require the trust's counterparty to have an insurable interest, reference an index and not a specific security, do not necessarily offset the counterparty's loss, and may not provide for subrogation rights, the credit derivatives in each of these transactions are not generally

treated as insurance under local law. Accordingly, the credit derivatives purchased or entered into by the trusts in these transactions may not qualify as '"insurance" in its commonly accepted sense.'").

8 Michael Lewis and David Einhorn, "The End of the Financial World As We Know It," *New York Times*, Jan. 4, 2009.

9 Robert F. Schwartz, "Risk Distribution in the Capital Markets: Credit Default Swaps, Insurance and a Theory of Demarcation," *Fordham Journal of Corporate and Financial Law*, 2007.

10 Consider the Dec. 5, 2008, testimony of International Swaps and Derivatives Association CEO Robert Pickel to the New York Assembly Insurance Committee. He describes "the efforts of the industry to clean up outstanding trades through a process known as 'tear-ups,' whereby trades between counterparties which are still on the books but effectively cancel one another out are removed, or 'torn up.'" He explains that "the notional amount of a derivative contract refers to an underlying quantity upon which payment obligations are obligated. ... [T]he exposure under a CDS contract is in fact a fraction of the notional." He describes the basic purpose of CDS: "Credit default swaps benefit the broader economy by facilitating lending and corporate finance activity .... They perform a valuable signaling function and allow investors to express a view on the market." None of these concepts— "trades between counterparties"; "notional amounts"; "performing a valuable signaling function"; and "expressing a view on the market" – are consistent with insurance products.

11 Bernstein, *supra* note 1 at 203.

12 *See, e.g., State Farm Mut. Auto. Ins. Co. v. Fisher*, 735 N.E.2d 747 (Ill.App. 1 Dist. 2000) ("Insurance is based upon the theory of spreading risk among many policy holders."); *Griffin Systems, Inc. v. Washburn*, 505 N.E.2d 1121 (Ill.App. 1 Dist.,1987) ("Insurance policies ... are generally issued by third parties and are based on a theory of distributing a particular risk among many customers.").

13 The recent efforts of the New York Superintendent of Insurance appear to have helped politically prod the likelihood of needed federal regulation of CDS, but we consider further efforts by insurance departments to regulate CDS, while well-intentioned and honorable, to be unfounded under the law. The point of this paper is that insurance regulators regulate a particular kind of product and have done so relatively quite well. Insurance regulators' attempts to extend jurisdiction beyond well established boundaries – at a time of financial crisis when their core job has never been more important – are thus misdirected and not in their best interest or that of the policyholders whom they protect.

14 Bernstein, *supra* note 1, at 323.

15 *Id.* at 327.

16 *Id.*

17 A *New York Times* article reported in detail how this unraveled in 2008. Using language strikingly echoing Bernstein's prescient description – a dozen years before – of the dangers of the system, and of the importance of rigorous supervision. "Theoretically intended to limit risk and ward off financial problems, the contracts instead have stoked uncertainty and actually spread risk amid doubts about how companies value them. ... Throughout the 1990s, some argued that derivatives had become so vast, intertwined and inscrutable that they required federal oversight to protect the financial system. ... In the fall of 1998, the hedge fund Long Term Capital Management nearly collapsed, dragged down by disastrous bets on, among other things, derivatives.... Despite that event, Congress froze the Commodity Futures Trading Commission's regulatory authority for six months.... In November 1999, senior regulators .... recommended that Congress permanently strip the C.F.T.C. of regulatory authority over derivatives." Peter S. Goodman, "Taking Hard New Look at Greenspan Legacy," *New York Times*, Oct. 8, 2008.

18 By contrast, the optional federal chartering for banking creates opposite incentives: Insolvencies are funded by the taxpayers, not other banks; and, banks can choose their regulator and thus who receives their fees, creating incentives for the regulated entity which run the opposite direction as insurers'.

19 "It's important for everyone, and especially policyholders in AIG insurance companies, to understand that the insurance companies, which are regulated by New York and other states, are solvent and have the funds to pay any policyholder claims. AIG's problems came from its parent company and from its non-insurance operations, which are not regulated by New York or any other state." Testimony of New York Supt. of Insurance Eric Dinallo, House Committee on Oversight and Government Reform, Oct. 7, 2008.

20 "AIG's Financial Products unit, a non-insurance company, sold hundreds of billions of dollars of credit default swaps and other financial products. .... By marking its securities to market, AIG was forced to announce losses, which kept growing. As a result, investors became concerned about just how serious the company's problems would end up being and whether the company had a full grasp of and was taking necessary steps to deal with its problems. AIG's stock price fell sharply." *Id.*

21 *See supra* note 14 and accompanying text. This was apparently a significant and widespread error common to many companies' rapid decline during the current crisis. *See, e.g.,* Joe Nocera, "Risk Mismanagement/Were the Measures Used to Evaluate Wall Street Frauds Flawed?", *New York Times Magazine*, Jan. 4, 2009 ("[T]he risks that VaR [Value at Risk] measured did not include the biggest risk of all: the possibility of a financial meltdown.").

22 This is not the first instance where a significant financial impairment in a huge holding company with a name brand associated with insurance was caused by problems with non-insurance subsidiaries while the state-regulated insurance companies remained stable and solvent. Like AIG, Conseco's problems that triggered its 2002 bankruptcy filing resulted from a non-insurance company subsidiary, Green Tree Financial Corp.,

a mobile home lender. *See Indianapolis Star*, "Rebuilding Conseco," Aug. 13, 2004. Conseco's problems at the holding company were not related to, nor threatened, its regulated insurance companies; like the New York Department of Insurance with AIG, the Texas Department of Insurance coordinated a thorough response that ensured that accurate information was disseminated and policyholders were protected.

23 *See, e.g.,* Jeff Gerth, "Was AIG Watchdog Not Up to the Job," *Pro Publica*, Nov. 10, 2008 ("Simply put, the job of the OTS was to make sure AIG did not take on too much risk and to assess the overall risk environment of the company and other global financial companies it oversaw.").

24 NAMIC agrees with SEC Chairman Cox's testimony before the House Committee on Oversight and Government Reform on Oct. 23, 2008 regarding "The Role of Federal Regulators: Lessons from the Credit Crisis for the Future of Regulation" that the current crisis should not be the impetus for public policy solutions that are not responsive to proven problems. "Some have tried to use the current credit crisis as an argument for replacing the SEC in a new system. ... But what happened in the mortgage meltdown and the ensuing credit crisis demonstrates that where SEC regulation is strong and backed by statute, it is effective." Chairman Cox's testimony identifies several causes of the current financial crisis and suggests several regulatory remedies, none of which question the core competence and effectiveness of state insurance regulation.

25 *See German Alliance v. Lewis*, 233 U.S. 389 (1914) ("[T]he companies have been said to be the mere machinery by which the inevitable losses by fire are distributed so as to fall as lightly as possible on the public at large. ... Their efficiency, therefore, and solvency, are of great concern. ... Indeed, it may be enough to say, without stating other effects of insurance, that a large part of the country's wealth, subject to uncertainty of loss through fire, is protected by insurance. ... We can see, therefore, how it has come to be considered a matter of public concern to regulate it.").

26 NAMIC believes that any systemic problems in state insurance regulation relate not to financial oversight but to anti-competitive market regulatory practices in areas such as price and risk classification controls that interfere with fair and well-established business practices designed to result in policyholders paying into the common fund in relation to their expected risk.

27 Usages of the term "systemic risk" have varied in recent debate. NAMIC recommends the Commodity Futures Trading Commission's definition: "The risk that a default by one market participant will have repercussions on other market participants due to the interlocking nature of financial markets. For example, Customer A's default in X market may affect Intermediary B's ability to fulfill its obligations in Markets X, Y and Z." Available at www.cftc.gov/educationcenter/glossary/glossary_s.html.

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