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The Fate of the State Guaranty Funds after the Advent of Federal Insurance Chartering

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There is a growing likelihood that Congress will authorize the federal chartering of insurance companies as an alternative to state insurance chartering. This chapter addresses the issue of protecting the insureds of federally chartered insurance companies and third-party claimants of those companies under liability policies against any loss of their insurance coverage, should a federally chartered insurance company become insolvent. The second section of this chapter will frame that issue, and the third will describe the state guaranty funds that have provided insolvency protection for state-chartered insurance companies, up to specified dollar limits.

The fourth section of the chapter will discuss similarities and, more important, differences between the state guaranty funds and federal deposit insurance. That comparison is important because federal deposit insurance will provide Congress with an important point of reference in designing a system for protecting the insureds and third-party claimants of federally chartered insurance companies. The fifth section will discuss eight important policy questions Congress must address in designing a protection mechanism for federally chartered insurers. A second point of reference for that design will be legislation that Representative John Dingell (D-Michigan) introduced in 1992 and 1993 that would have created a Federal Insurance Solvency Commission. The final section of the chapter will describe the

cross-guarantee concept for privatizing banking regulation and its attendant financial risks, and how that concept can be extended to provide protection for insureds and third-party claimants of federally chartered insurers.

Framing the Issue

If Congress decides to authorize the federal chartering of insurance companies, it will be faced with a fundamental question—what obligation will the federal government have toward the insureds, third-party claimants, and other creditors of federally chartered insurance companies? That is the same question that state legislatures have faced for decades in chartering and regulating state-chartered insurance companies.

In addressing that question, Congress almost certainly will slide down the same slippery slope as did the states in establishing the state guaranty funds, based on the following logic. Insurance is the kind of business, like banking, in which there is a strong public policy interest in preventing the insolvency of insurance companies in order to protect the insureds and third-party claimants of those companies. That is, government wants insurance companies to be highly reliable sources of insurance protection, particularly for individuals and small businesses. As one commentator has observed:

Because banks, insurance companies, and related financial intermediaries play an important role in the financial security of the citizenry, the government has a strong interest in assuring their soundness and in preventing the kinds of systemic failures that led to financial devastation in the [Great] Depression.¹

Therefore, to ensure the solvency of federally chartered insurance companies, Congress almost certainly will enact, as a key component of federal insurance chartering legislation, a set of rules designed to minimize the occurrence of insolvency among federally chartered insurers and to quickly put out of business those insurers chartered under federal law that are sliding toward insolvency.

Those rules will be enforced by a government agency, most likely the issuer of insurance charters. That agency will issue

insurance solvency regulations, periodically examine the federally chartered insurers, supervise them, and, under procedures akin to the prompt corrective action (PCA) rules enacted by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), will close and liquidate or sell failing insurance companies. Anyone familiar with federal banking law and regulation will quickly recognize the many parallels that will exist with federal insurance regulation. Complaints about federal insurance regulation will sound remarkably similar to complaints about federal banking regulation.

If insurance regulation, like banking regulation, worked perfectly, then failing insurance companies would be resolved before they became insolvent. In that circumstance, there would be no need for insurance guarantee protections, just as there would be no need for deposit insurance. Insureds and claimants, like bank depositors, would never suffer a loss or delay in receiving payment. But, alas, insurance regulators, like bank regulators, are far from perfect—hundreds of insurance companies have failed in recent decades, with substantial insolvency losses that would have been borne by insureds and claimants had it not been for the state guaranty funds. For example, the net loss (payouts and administrative expenses minus recoveries) of the state property-and-casualty (P&C) guaranty funds for the 1969–1997 period was \$6.5 billion.² The net loss for the state life and health (L&H) guaranty funds, in multistate insolvencies only, for the 1990–1998 period was \$4.45 billion.³ While not insignificant, those are modest amounts compared with the \$160 billion cost of the S&L crisis.

Although not widely recognized as such, the state guaranty funds, like federal deposit insurance (FDI), represent a product warranty. Specifically, the states have created a mechanism (the state guaranty funds) that protects innocent third parties (insureds and third-party insurance claimants) against regulatory negligence and failure on the part of state-employed insurance regulators. In effect, the state guaranty funds, like FDI, reflect this political reality: if government wants to be in the business, for whatever reason, of regulating financial institutions, then it has no choice but to provide a warranty for the service that business supposedly provides to the general public.⁴ That proposition can be viewed from another perspective—if government is not

liable for its regulatory negligence, then what is the point of having government regulation in the first place?

Just as the states provide a product warranty for their insurance regulation, in the form of the state guaranty funds, and just as the federal government provides a product warranty for its banking regulation, through FDI, so too will Congress feel compelled to provide a product warranty for its regulation of federally chartered insurance companies. Major questions will arise, though, as to how the product warranty will be specified, how warranty losses will be minimized, and who will pay for those losses. Initially, the state guaranty funds will coexist with a federal insurance product warranty; that is, a federal insurance guarantee, or FIG. However, just as nonfederal deposit insurance, with two exceptions,⁵ could not compete successfully against FDI, one must wonder how long the state guaranty funds will be able to compete against a FIG. Victor Palmieri, chairman and CEO of the Palmieri Company and the receiver in several major insurance insolvency cases, observed after envisioning a federal insurance charter that:

This would leave smaller, less capitalized insurers under state regulation. This dual system will likely result in new strains for the guaranty association system because of the reduced assessment capacity of state guaranty associations as the largest companies opt for federal regulation.⁶

The Background of the State Guaranty Funds

As with deposit insurance, the state guaranty funds sprang from adversity, in particular from the failure of more than one hundred "high-risk" auto insurers in the 1960–1969 period. As a result of those failures, several bills were introduced in the Senate in the 1960s to establish a federal insurance or guaranty mechanism to protect the insureds and third-party claimants of failed insurance companies. In May 1969, Senator Warren Magnuson (D-Washington) introduced a bill (S. 2236) to create a Federal Insurance Guaranty Corporation (FIGC) that would have provided insolvency protection for virtually all lines of P&C insurance. Within a month, the National Association of Insurance Commissioners (NAIC) began work on a model State Post-Insol-

veny Assessment Insurance Guaranty Association Act for P&C insurers.

By the end of 1971, most states had enacted some version of that model, thereby creating the state guaranty funds. Today, all states have guaranty funds for their P&C insurers. All of them, with one exception, operate on a post-assessment basis; that is, they assess surviving insurers for losses in failed insurance companies as those losses are paid. New York is the sole exception—it operates a pre-assessment system, with the insurance companies assessed only when there is a need to replenish the state fund.

A similar state guaranty fund system to protect the insureds of insolvent L&H insurance companies emerged more slowly, largely because of opposition from the life insurance industry. Consequently, it took until 1983 for thirty-four states to enact guaranty association laws for their L&H insurers.⁷ Not until 1992 had all states enacted guaranty association legislation for their L&H insurers.⁸

Because many insurance companies, including all the larger ones, have long operated on a multistate, if not national, basis, the guaranty funds, working through the NAIC and the two national associations of guaranty funds, have developed procedures for managing the loss payouts of failed multistate insurers. Those associations are the National Conference of Insurance Guaranty Funds for P&C insurers and the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA).

The creation of the state guaranty funds enabled the insurance industry and the NAIC to fend off federal intervention in an important aspect of the insurance industry: the protection of insureds and third-party claimants. However, the spate of insurance company failures in the 1980s and early 1990s prompted Representative John Dingell, then chairman and now ranking Democrat on the powerful House Commerce Committee, to introduce in 1992 and again in 1993 a bill entitled the Federal Insurance Solvency Act (H.R. 1290 in 1993). That bill would have created a Federal Insurance Solvency Commission that would establish and enforce uniform national standards for all insurers operating in interstate commerce. As a practical matter, the bill would have established federal regulation for all multistate insurers. The Dingell bill also would have federalized the regula-

tion of the reinsurance industry. Finally, the bill would have established the National Insurance Protection Corporation (NIPC) to protect the insureds of any insolvent insurer regulated by the federal government. The operation of the NIPC would have been modeled on the structure, procedures, and requirements of the Securities Investor Protection Corporation.⁹

Similarities and Differences between the State Guaranty Funds and Federal Deposit Insurance

There are important similarities and differences between the state guaranty funds and FDI that will have a strong bearing on the construction of a FIG for federally chartered insurers.

Limits on the scope of protection are perhaps the greatest similarity between the guaranty funds and FDI. However, while FDI has a fairly simple and widely advertised limit—\$100,000 per depositor, per bank¹⁰—the guaranty fund limits are more complex and they vary from state to state. For example, there might be one limit on the refund of unearned premiums, a separate limit on loss claims, and other limitations and exclusions, such as excluding coverage on punitive damage claims, or for insureds with a net worth exceeding a stated amount. The other key similarity is that survivors in the industry, presumably the better capitalized and managed firms, are taxed to pay for regulatory failure, specifically the failure of regulators to promptly close those firms that the regulators have not prevented from becoming insolvent.

The differences between the state guaranty funds and FDI, however, are significant in two respects that will have an important bearing on how Congress resolves the issue of protecting the insureds and third-party claimants of federally chartered insurers. First, Congress may find certain aspects of the state funds unacceptable for ensuring the protection of the insureds and third-party claimants of federally chartered insurance companies. Second, Congress may reject various aspects of state guaranty fund operation in constructing a FIG and its administrative apparatus. The following are the key differences.

Fund Administration. The state guaranty funds are nonprofit associations of all companies licensed to write insurance within

a state in the lines of insurance covered by the guaranty fund. Insurance companies therefore are required to belong to a state's guaranty fund in order to obtain a license to sell insurance in that state. The board of directors of each guaranty fund is composed of representatives from member companies and from the state insurance commissioner's office.¹¹ Sometimes there is a public member or two on those boards. Overall, though, there is a close working relationship between the insurance industry and its regulators. That is quite different from FDI, which is run as an integral component of federal banking regulation, or from the operation of the Federal Insurance Solvency Commission that would have been created under the Dingell legislation.

Fund Balance, or Lack Thereof. With the exception of New York's pre-assessment system, the state guaranty funds are not funds in the sense that they have fund balances from which losses are paid. Instead, loss payments are assessed on surviving insurers as those losses are paid. Under FDI, however, there is no direct linkage between the occurrence of losses (when the existence of a loss is first recognized by the regulators) and the payment of a loss. The Dingell bill envisioned the creation of a fund balance in the NIPC comparable to the fund balances that exist in the FDIC's two insurance funds, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF). However, as a practical matter, the two fund balances are fictions, since they are treated as part of the consolidated federal budget. Further, any decline in either fund below a 1.25 percent reserve ratio (the fund's balance as a percentage of insured deposits) must quickly be offset with higher deposit insurance premiums. That requirement effectively means that the bottom portion of a fund balance, up to 1.25 percent of insured deposits, is *not* available to absorb bank or thrift insolvency losses, except over the short term.

Product Line Differentiations. Unlike deposit insurance, which does not differentiate between types of deposits (checking versus savings) or types of domestic depositors (individual versus large corporation),¹² the state guaranty funds have various product divisions. The guaranty funds divide into two broad categories—P&C and L&H. Within those two categories are subdivi-

sions such as workers' compensation, automobile, and all other P&C lines, or life, health, and annuities; those subdivisions vary from state to state. Also, certain forms of insurance, such as title insurance, are often excluded from guaranty fund protection. The Dingell bill would have had six subdivisions within the NIPC, and yet it also listed thirteen exclusions from any NIPC protection at all.

Coverage Limits. As noted above, coverage limits vary from state to state, up to \$500,000, by type of insurance product, and by type of liability (prepaid premiums versus actual loss, cash values versus life insurance death benefits, and so forth). For FDI, there is one nationwide insurance limit—\$100,000 per depositor, per bank.

Who Ultimately Pays for Insolvency Losses. One of the major differences between FDI and the state guaranty funds is the extent to which losses are contained within the affected industry. With the significant exception of the taxpayer bailout of the Federal Savings and Loan Insurance Corporation, depository institutions have paid for FDI losses through deposit insurance premiums. Further, numerous reforms that Congress has enacted since 1989 have effectively eliminated the taxpayer risk previously posed by FDI.¹³ Treatment of guaranty fund assessments, however, varies significantly among the states, with many states permitting insurers to reduce the premium taxes they pay by the amount of the guaranty fund assessments they pay.¹⁴

Premium tax offsets permit surviving insurance companies to pass the cost of insurance company failures through to general taxpayers. More states permit L&H insurers to offset fund assessments against premium taxes than is the case with assessments against P&C insurers because L&H insurers cannot pass their assessments through to owners of existing long-term life insurance contracts. The Dingell bill did not provide any such offset, possibly because insurance companies do not pay premium taxes to the federal government.

Risk Sensitivity of Premiums. One of the surprising shortcomings of the state guaranty funds, given that insurance com-

panies are supposed to factor risk into the premiums they charge, is the complete lack of risk sensitivity in state guaranty fund assessments. That lack at least partially reflects their ex post, or after-the-fact, nature. Although Congress, through FDICIA, tried to push the FDIC toward levying risk-sensitive premiums, the FDIC has not been very successful in developing genuinely risk-sensitive premiums: that is, premiums that are based on leading measures of banking risk and are intended to deter banks from unwise risk-taking. Interestingly, when the FDIC in early 1999 attempted to introduce more risk into its premiums, it quickly had to back down because of political opposition.¹⁵

Public Policy Questions Congress Must Address

Operating on the fairly safe assumption that Congress will insist on protecting insureds and third-party claimants from the insolvency of federally chartered insurance companies, Congress will have to address a number of questions regarding the nature and provision of that coverage. Although many of those issues were addressed in the 1993 Dingell bill, it is useful to review them, particularly in light of the financial services modernization legislation Congress enacted in 1999 (S. 900). Those issues include:

Whether or not to provide federal insolvency protection for the insureds of federally chartered insurers. The threshold question that Congress must address in creating a federal insurance charter is how to provide for the insolvency protection of the insureds and third-party claimants of federally chartered insurers. One option would be to rely on the existing system of state guaranty funds to provide that protection, including the existing mechanism for dealing with the insolvency of multistate insurers. However, Congress might be troubled by the lack of uniformity of guaranty fund protections across the states. If Congress were so troubled, it might then insist on a uniform standard of protection, which would put many of the guaranty funds in the position of operating with different levels of protection for state and federally chartered insurers, or having to adopt the federal standard for its state-chartered members.

Congress also would be concerned with the assessment ca-

capacity of the state guaranty funds, since there would be, in light of Congress's bailout of the FSLIC, a fairly explicit federal guarantee of the insolvency protection provided for the insureds and third-party claimants of federally chartered insurers. Given those complexities and the precedent set by the two Dingell bills, Congress probably would opt to create a FIG for federally chartered insurance companies.

Admission of state-chartered insurance companies into the FIG program. If Congress does create a FIG and a federal agency to administer that guarantee, then Congress will have to immediately address the question of whether or not to admit state-chartered insurers into the program in the same manner that the FDIC has always been open to state-chartered banks. However, just as Congress broadly extended federal safety-and-soundness regulation to state-chartered, federally insured banks and thrifts in the aftermath of the S&L crisis, so too would it reasonably take the same approach toward state-chartered but federally guaranteed insurers. That approach reflects the fact that he who insures must, of necessity, also regulate in order to minimize losses. The failure in 1999 of seven insurance companies controlled by Martin Frankel raised anew long-standing concerns about the quality of state insurance regulation; losses in the Frankel fiasco may exceed \$200 million.¹⁶ What is especially troubling is that Tennessee insurance examiners had been suspicious about the activities of one of the Frankel-controlled insurance companies since 1993.¹⁷

Admission of state-chartered insurers into a FIG program would then create not only dual chartering for insurers, but also a dual guaranty mechanism that did not exist in the banking industry when the FDIC was created (all state deposit insurers had failed by 1933). Further, very limited nonfederal deposit insurance for S&Ls and credit unions emerged after World War II, so there never has been significant competition between state-chartered insurers and the federal government in the deposit insurance arena. Given that nonfederal deposit insurance has almost entirely disappeared, it is reasonable to speculate that the state guaranty funds would soon start to wither if state-chartered insurers could become federally guaranteed, as the Dingell bill envisioned.

Relationship of the FIG program to the FDIC. Although the Dingell bill envisioned an NIPC that would be independent of the FDIC, that independence must be questioned in light of the convergence of banking and insurance, as reflected in the financial services modernization legislation Congress enacted in 1999. Further, given the many similarities between the FDIC's mission as a deposit insurer (as differentiated from its mission as a banking regulator) and the mission of the federal agency administering the FIG Fund, a strong argument can be made that all forms of federal financial insolvency protection (including credit union share insurance), as well as the resolution of failed financial institutions, should be administered by one federal agency. The federal resolution of insolvent, federally guaranteed insurers would represent a significant change from the existing, expensive state system for resolving insolvent insurers. According to one estimate, for every one dollar of assets in insolvent P&C companies, liquidators turn over an average of only 33 cents to the guaranty funds.¹⁸ Asset recovery rates generally are much higher in failed institutions insured by the FDIC.

The argument for having just one federal insolvency insurer/resolution agency was strengthened by the 1999 financial services modernization legislation, which permits banks and insurers to affiliate within a holding company structure. Although that legislation strengthened the obsolete notion of functional regulation, Congress may be reluctant to extend the functional regulation concept to creditor protection if it creates a FIG program.

Fund balance in a FIG Fund. Although there is no logical relationship between a deposit insurance fund balance and the insolvency risks which that fund faces, the concept of a deposit insurance fund balance has become well embedded at the federal level, partly because it is fairly easy to compute a desired fund balance—simply multiply some measure of bank deposits (usually an estimate of insured deposits) by an arbitrary percentage. Life is not so easy in the insurance arena, though, because liabilities to insureds and third-party claimants are not easily measured, particularly for P&C companies and especially for their long-tail liabilities. Natural disasters, which strike suddenly and, often, fatally for small P&C insurers, create another major

uncertainty in determining an appropriate fund balance. Therefore, assuming that Congress will want the FIG Fund to have some sort of advanced funding, it will have to determine how that fund balance will be calculated. The Dingell bill left that determination to the directors of the NIPC.

Emergency access to the Fed discount window. Theoretically, insurance companies, like securities firms, can borrow from the Federal Reserve's discount window in "unusual and exigent circumstances"; that is, if they are experiencing severe liquidity problems. However, unlike banks, which can borrow at the discount window of a Federal Reserve Bank without prior approval of the Board of Governors of the Federal Reserve System, loans to nonbank firms, such as insurance companies, require an affirmative vote of five members of the Board of Governors.¹⁹ Unpublished reports suggest that there have been times, specifically in the mid-1970s and the late 1980s, when insurance companies suffering liquidity problems approached the Fed about borrowing at the discount window, but were rebuffed by the Fed. According to NOLHGA, the July 1991 failure of the Mutual Benefit Life Insurance Company, a \$13 billion insurer, created a classic "run-on-the-bank" scenario, in part "because Mutual Benefit's pension plan-held contracts did not have very restrictive withdrawal provisions."²⁰

Although not widely seen as a problem, a run on a life insurer in particular can create a much longer term liquidity problem for that company than troubled banks usually experience, since people return to banks more quickly, in order to manage their liquidity, than they will return to a life insurer. P&C insurers facing substantial claims after a major natural catastrophe also can face liquidity problems. If Congress creates a FIG program, it almost certainly will want to liberalize the access that federally guaranteed insurers have to the Fed's discount window. That would give the FIG program a significant competitive advantage over the state guaranty funds.

Product line coverages and exclusions/coverage limits. One of the most important determinations Congress will have to make in creating a FIG program will be determining who will be protected by the FIG, what types of insurance coverages and insureds will *not* be protected, and the amount of coverage. That

problem will be made more complex by the substantial exposure that many P&C companies have to natural disasters such as hurricanes, floods, and earthquakes. Although the states have regulated many of the insurances that have not been subject to state guaranty fund protection, it is an open question as to whether or not Congress will be comfortable with such exclusions for federally chartered insurers, and specifically with the range of exclusions specified in the Dingell bill. If there is any aspect of the federal chartering of insurance companies where the devil is in the details, it certainly will lie in defining the coverages, coverage amounts, and exclusions under a FIG program and in dealing with catastrophic risk exposures.

FIG premiums. Given its extensive experience with FDI, it is unlikely that Congress, in creating a FIG program, will adopt the relatively simplistic post-insolvency loss assessment procedures of the state guaranty funds. First, it probably will insist on some degree of prefunding for a FIG Fund, as did the Dingell bill. Second, it probably will want an attempt made to incorporate risk-sensitivity into FIG Fund premiums. Third, it will expect the FIG Fund to be entirely self-sufficient, even during times of great economic distress, as it now expects for FDI. That requirement will be especially tough on life insurers because they would not be able to pass premium increases through on existing policies that account for most of their insurance liabilities. A taxpayer bailout of the FIG Fund will be highly unacceptable to Congress, as will any delay in FIG payments attributable to an annual assessment cap common to the state guaranty funds. Fourth, it will have to categorize the broad range of insurance products for the purpose of determining separate assessment rates for each category.

The federal chartering/guarantee challenge. The federal chartering of insurance companies is becoming increasingly likely because of the growing inefficiencies associated with the highly balkanized state regulation of insurance. However, determining the means for protecting insureds and third-party claimants against insurance company insolvencies may present the toughest set of issues Congress will have to address when authorizing a federal insurance charter. In part because of its experience with FDI, Congress most likely will *not* emulate the

structure and operation of the state guaranty funds when creating a mechanism for protecting the insureds and third-party claimants of federally chartered insurance companies.

While the 1993 Dingell bill provides one road map for providing that protection, that bill did not provide for federal chartering of insurance companies, although it did envision establishing a strong federal influence over the regulation of state-chartered, multistate insurers. The issue of protecting the insureds and third-party claimants of federally chartered insurers may therefore become both the Achilles' heel and the briar patch of federal insurance chartering. That possibility suggests that fresh, radical thinking should be applied to the federal chartering/guarantee issue.

The Cross-Guarantee Alternative for a Federal Insurance Guarantee

One approach to a federal-level guarantee fund would be the 100 percent cross-guarantee concept, which has been proposed for privatizing banking regulation and its attendant deposit insurance, too-big-to-fail, and systemic risks.²¹ Representative Tom Petri (R-Wisconsin) has introduced legislation on several occasions, most recently in 1996 as H.R. 4318, which would implement the cross-guarantee concept.

Despite contrary impressions, the cross-guarantee concept represents a modest departure from the present system of FDI and government banking regulation as well as the state guaranty funds and state insurance regulation. Essentially, all the cross-guarantee concept does is (1) delegate the safety-and-soundness regulation of individual banks and insurance companies to the *direct*, private-sector guarantors of each guaranteed institution's guaranteed liabilities; (2) explicitly extend the too-big-to-fail (TBTF) concept to all banks and insurers; (3) further strengthen the already substantial taxpayer protections of FDI. Central to the cross-guarantee concept is the notion that the protection of depositors and insureds should *not* be viewed as social insurance funded by general tax revenues. Instead, that protective activity should be viewed as a business, just as P&C and L&H insurance have long been viewed.

The first step in implementing a cross-guarantee system is

to introduce marketplace democracy by giving individual banks and insurers the freedom to decide which institutions they will help to guarantee and which ones they will not guarantee. In return for providing that guarantee, those guarantors will charge a contractually specified, risk-sensitive premium (discussed below) as well as appoint a private-sector firm, called a "syndicate agent," to ensure that the guaranteed institution (bank, thrift institution, or insurance company) complies with the negotiated safety-and-soundness provisions of the cross-guarantee contract (also discussed below). Once a contract takes effect, the guaranteed institution will be exempt from *all* government safety-and-soundness regulation. Therefore, it will be exempt from all government safety-and-soundness oversight; that will become the sole responsibility of the institution's guarantors and their syndicate agent. As a result of that voluntary contracting process, those guarantors directly at risk in bank or insurance company failures will be able to optimize that risk, through negotiated premium rates and contractual restrictions, thereby eliminating one of the great shortcomings of FDI and the state guaranty funds—their systemwide mutualization of losses.

One of the great virtues of privatizing banking and insurance regulation, or more specifically, delegating it to guarantors and their syndicate agents, is that it will permit banks and insurers to escape one-size-must-fit-all regulation, an inherent characteristic of government regulation, state or federal. Instead, each guaranteed bank or insurance company, working with a syndicate agent, will negotiate with its syndicate of direct guarantors only those safety-and-soundness requirements that are logical for that bank's or insurer's business strategy. In effect, a bank or insurance company would negotiate contractual terms, including premium rates, that fit its business strategy. More diversified strategies will result, leading to a sounder financial services industry.

Perhaps the most important element in a cross-guarantee contract would be the formula for periodically computing its risk-sensitive cross-guarantee premium; under the formula, the premium rate might be adjusted as often as monthly or even weekly. As with other provisions in a cross-guarantee contract, the factors in the formula would be negotiated by the guaranteed bank or insurance company with its direct guarantors. The periodic

adjustment of premium rates under those formulas would discourage sudden increases in a bank or insurance company's risk appetite. In effect, the keen risk sensitivity of cross-guarantee premium formulas will become a powerful deterrent to risky banking and insurance practices, a deterrent now absent in FDI premiums or state guaranty fund assessments. The marketplace tailoring of premium formulas to individual business strategies will have an important side benefit—the cross-subsidies that now plague FDI and the state guaranty funds will be minimized.

Thus, the cross-guarantee concept, although developed initially for use in the banking industry, can easily be extended to protect the insureds of federally chartered insurance companies.

Conclusion

The time is fast approaching when Congress will authorize the federal chartering of insurance companies, as the present balkanization of state insurance regulation increasingly hobbles that industry. Politically, increasing segments of the insurance industry favor a federal chartering option so that the insurance industry will have a dual chartering option that has long been available to banking. However, the protection of the insureds and third-party claimants of federally chartered insurance companies remains a seldom discussed aspect of federal insurance chartering. Yet this aspect of federal insurance chartering may be one of the most difficult to accomplish, largely because of the manner in which the state guaranty funds have evolved over the past three decades.

Separately, Congress is struggling with other issues: deposit insurance reform; the growing obsolescence of functional regulation, attributable to the melding of all types of financial services products and firms; and the emergence of threats to the federal financial safety net *outside* of the banking industry, as the Long Term Capital Management caper demonstrated in 1998. That melding process will accelerate the growth of large, globally active financial conglomerates offering a broad range of banking, insurance, and securities products. The challenge that policy-makers face was acknowledged by one NOLHGA official when he wrote:

It is increasingly apparent that convergence in the financial services industry is a fact of life. What is not quite so apparent is the regulatory framework in which these industry giants will work.²²

The cross-guarantee concept for privatizing banking and insurance regulation and its attendant financial risks would facilitate financial services modernization by eliminating the need for regulatorily differentiating financial products and firms. More specifically, it would facilitate federal insurance chartering by resolving, in a highly satisfactory manner, the surprisingly thorny problem of providing for the protection of insureds and third-party claimants of federally chartered insurers. In fact, pulling banks and insurance companies into the same cross-guarantee system would go a long way toward eliminating the increasingly unnecessary need to regulatorily differentiate banks from insurance companies.

Notes

1. David A. Skeel, Jr., "The Law and Finance of Bank and Insurance Insolvency Regulation," *Texas Law Review* 76 (4) (March 1998): 723-80.

2. "Financial Information, 01/01/69 to 12/31/97" (table), National Conference of Insurance Guarantee Funds, Indianapolis, Indiana, September 1998.

3. Figure obtained from the National Organization of Life and Health Insurance Guaranty Associations.

4. The author discusses the notion of deposit insurance as a product warranty more fully in "Regulatory Moral Hazard: The Real Moral Hazard in Federal Deposit Insurance," *The Independent Review: A Journal of Political Economy* (Fall 1999).

5. The first of the two exceptions comprises the American Share Insurance Company of Dublin, Ohio, and its wholly owned subsidiary, the Excess Share Insurance Corporation. The first company provides deposit insurance for several hundred state-chartered credit unions not insured by the federal government's National Credit Union Share Insurance Fund. The second company provides excess deposit insurance coverage, up to \$250,000, for federally insured credit unions. The second exception is the Kansas Bankers Surety Company of Topeka, Kansas, which offers excess deposit insurance to small banks.

6. Victor Palmieri, as quoted in Peter Marigliano, "Convergence of Banks, Insurers May Cause Headaches for Guaranty Associations,"

NOLHGA Journal [National Organization of Life and Health Guaranty Associations] 5 (1) (Winter 1998): 4.

7. "NOLHGA and the Evolution of the State Guaranty Association System," *NOLHGA Journal* (May 1997): 17.

8. *Ibid.*, 5.

9. Representative John Dingell, "Congressional Record—Extension of Remarks," March 10, 1993: E557–59.

10. Two or more depositors can, however, obtain multiples of the \$100,000 insurance limit in a bank by varying how they legally title their accounts in that bank.

11. James G. Bohn and Brian J. Hall, "The Moral Hazard of Insuring the Insurers," National Bureau of Economics Research, Inc., Cambridge, Mass., Working Paper 5911 (January 1997): 4.

12. Depositors in foreign branches of U.S. banks are not protected against loss unless their bank is declared to be too-big-to-fail under FDICIA's systemic risk exception (12 U.S.C. Sec. 1823(c)(4)(G)).

13. Those reforms are discussed in a paper by the author, "Banks Do Not Receive a Federal Safety Net Subsidy," Financial Services Roundtable, Washington, D.C., May 1999: 6–8.

14. According to various sources, P&C insurers can offset guaranty fund assessments to some extent in at least seventeen states; for L&H insurers, premium tax offsets are permitted in at least thirty-seven states.

15. Scott Barancik, "FDIC Is Developing a System to Make Some Well-Capitalized Banks Pay More," *American Banker* (January 4, 1999): 2; Scott Barancik, "FDIC Puts Off Charging Banks More," *American Banker* (February 16, 1999): 4.

16. Deborah Lohse and Leslie Scism, "Scandal's Toll May Be Sliced to \$215 Million," *Wall Street Journal* (June 30, 1999).

17. Scot J. Paltrow, "Tennessee Insurance Official Quits amid Frankel-Related Inquiry," *Wall Street Journal* (August 9, 1999).

18. Brian J. Hall, "Regulatory Free Cash Flow and the High Cost of Insurance Company Failures," Harvard University Graduate School of Business, Boston, Mass., unpublished paper, August 1998: 2–3.

19. 12 U.S.C. Sec. 343, second paragraph.

20. "NOLHGA and the Evolution of the State Guaranty Association System," National Organization of Life and Health Insurance Guaranty Associations (May 1997): 37–38.

21. The cross-guarantee concept is discussed at greater length in Tom Petri and Bert Ely, "Better Banking for America: The 100 Percent Cross-Guarantee Solution," *Common Sense* (Fall 1995): 96–112. Other articles and papers on the cross-guarantee concept are posted on the Ely & Company website at <http://www.ely-co.com>.

22. Marigliano, "Headaches for Guaranty Associations": 5.

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