FINANCIAL SERVICES & E-COMMERCE

IS FEDERALISM CONSISTENT WITH NATIONWIDE MARKETS AND GLOBALIZATION? THE CASE OF THE INSURANCE INDUSTRY

Mr. Bert Ely, *Ely & Company*
Mr. Noel Francisco, *Assistant Counsel to the President, The White House*
Mr. Robert Gordon, *Senior Insurance Counsel, House Financial Services Committee*
Dr. Michael Greve, *Director, American Enterprise Institute's Federalism Project; Author, Real Federalism*
Mr. Gary Hughes, *Senior Vice President and Chief Counsel, American Council of Life Insurers*
Hon. Peter Wallison, *American Enterprise Institute; former White House Counsel/Treasury Department General Counsel (moderator)*

MR. WALLISON: I'd like to welcome everybody to our program on "Is Federalism Consistent with Nationwide Markets and Globalization? The Case of the Insurance Industry".

I'm Peter Wallison. I'm the moderator of this panel, which will set before you today the very interesting federalism issues associated with regulating insurance, an industry that is engaged in competition with banks and securities firms. As you will see, our current state-based system of regulating insurance creates difficulties for the insurance industry.

As many of you probably know, insurance is regulated currently only at the state level. This has been the case since insurance companies were founded close to the time of the founding of our country itself. The federal government has largely stayed out of the regulation of insurance. Recently, representatives of the insurance industry — the associations here in Washington and others — have begun thinking seriously about whether it would be appropriate and sensible to have a federal chartering and regulation system for insurance. That may seem counter-intuitive to many, but people in the insurance industry have reasons for this.

We will first hear what the insurance industry's reasons are, and why it poses the question of which is more sensible — a national system that would permit competition among industries, or continuing the state system that we're using today. We thought that, inasmuch as the Federalist Society is interested in promoting federalism, this is an interesting question for all of you to contemplate.

We'll start today with Gary Hughes, who is the senior vice president and general counsel of the American Council of Life Insurers, one of the associations here that is most interested in considering optional federal chartering. Recently — in fact, this past weekend — the board of the ACLI endorsed a system of optional federal chartering. They're working on legislation for this purpose, and we'll hear the reasons for this.

After Gary talks, we will hear from Michael Greve. He's a resident Fellow at the American Enterprise Institute, and his specialty is federalism — what Michael calls competitive federalism. He'll suggest another way that federalism can be made consistent with a nationalized competitive system.

Then we'll go to Bert Ely, who talks about some very interesting questions that arise under the federal system of regulation.

Finally, we will go to Noel Francisco.

I will introduce Michael, Bert, and Noel just before their turns to speak.

First, we'll turn it over to Gary, who has been deeply involved in federal and financial services issues in Washington since 1977. He now is one of those who is spearheading the ACLI's consideration of optional federal chartering and drafting the legislation, I presume. Gary is a lawyer.

Thanks, very much.

MR. HUGHES: As Peter said, I represent an industry that, since time immemorial, has resolutely supported state regulation and opposed all efforts to broaden any federal role with respect to our business. That in and of itself should give you a sense of the gravity with which we've treated this whole issue, and the thought that's gone into this and ultimately prompted our board of directors to do the less-than-obvious for us and support the notion of an optional federal charter.

One footnote here that probably is worth mentioning. If there are those of you who are regulatory purists in the audience and think this is really a debate about pure state regulation versus something else, you're about 25 years late to the table.

Life insurance companies, and particularly those that are involved in growth areas — variable annuities, variable life, the pension area — have had a significant aspect of federal regulation for about 25 years.

Our variable products are regulated comprehensively by the SEC. In fact, I would say the SEC regulates those products more heavily than do the states, and certainly our pension activities are regulated by the Department of Labor. So, we stand as a business today that has some aspect of dual regulation. Again, I don't think about purity of regulation.

We took stock of this whole thing several years ago, and we found ourselves as the only significant segment of the financial services business that was predominantly regulated by the states. We're subject to a system of regulation that was devised when insurance, by definition, was not interstate commerce. Insurance companies did business almost exclusively within the borders of a single state. The vestiges of that intrastate nature of regulation unfortunately are still with us today. Yet, life insurers are global, if not certainly most of its national competitors, and it's been a very difficult situation.

We find that more and more of our important issues are being decided by Congress; certainly more now than even ten years ago. We've gone through Gramm-Leach-Bliley. We have tax legislation, whether it's part of the economic stimulus package or otherwise, which is always at the top of our agenda.

Certainly, September 11 and its aftermath have been an issue that is now being debated by the Congress. I think there's been frustration not only on our part but on the part of lawmakers that there isn't a federal regulatory presence in Washington that understands this, that's available, that can help them parse this out.

The most important thing is that the competitive paradigm for us has changed. Historically, life insurance companies competed against other life insurance companies. We knew the system of state regulation had a lot of baggage with it, but it was something that everyone was subject to uniformly.

If you were my competitor and you had the inefficiencies and I had them, it didn't really translate to the bottom line. We might both be frustrated by it, but it wasn't that much of a competitive economic issue. We griped about a number of things and the never did anything about it.

It's almost as though we woke up one morning and realized that we were now positioning our companies as providers of diverse retirement service products. We were using insurance products in the same market that mutual funds were using, securities products, and all in the same market that commercial banks were using, deposit products.

But here's where the math breaks down for us. National banks within about a matter of weeks can be in the market nationally with an innovative product. If a mutual fund comes up with something fairly similar, it gets through the SEC in three to four months. If an insurance company comes up with an innovative product, even if it's relatively simple, 12 months, 18 months, sometimes up to 2 years pass before it gets in the market.

The life cycle for a lot of our products some years ago was in the neighborhood of eight to ten years. Today, it's about two years. If the life cycle of your product is two years and it takes you two years to get it approved on a national basis, you do the math and you think this is not very good. As a result of that, we're seeing more and more evidence of adverse capital allocation within a single corporate enterprise.

If you have mutual funds and insurance under the same roof, and the mutual fund folks and the insurance folks make a pitch to management — we need internal capital to roll our product out — and again, the mutual fund people are saying we can hit the market window the first quarter of the year and the insurance people are saying we think we can be in 12 states by the end of the year; we can be in 30 states by the middle of next year; and maybe, if everything goes right, in 2 years we'll be in all jurisdictions, the money goes to the mutual funds side of the house. Post Gramm-Leach-Bliley, as diversification of financial services continues, we see that adverse capital allocation issue becoming more serious.

Given this situation, our board of directors made what for them was a difficult and certainly a momentous decision to tackle this whole issue of regulatory efficiency as a top-tier issue and to do it on two bases. One — we're very serious about this and we're committing enormous amounts of resources to it — is to redouble our efforts to work with the states to make a state-based system of regulation operate much more efficiently, and to see whether we can edge into the 20th and, if we're lucky, the 21st Century in terms of our system of regulation.

We suspect that there are a substantial number of companies — perhaps even a substantial majority of our member companies — that would wish to remain state regulated, albeit on a more efficient basis.

If you're thinking it's probably going to be like banks, where big insurers want federal regulation, and small insurers want state regulation, we have not found that it works out that way. Think of it this way. A big insurance company has an innovative product, has funds and internal resources to throw at the product approval process, and anticipates a volume of sales that would recoup whatever capital they expend pretty quickly.

A small company has the same innovative product. It has to go through the same groups in all 51 jurisdictions, it doesn't have the internal resources; they don't have the volume of sales that would recoup that money. For that company, something like an optional federal charter, where you have a single place to go to get a product approved, is much more significant an improvement than it is for the larger companies.

We did a study, before we really got into options, of what's working and what isn't with life insurance regulation at the state level. The conclusion was interesting. It showed, by and large, the laws on the books weren't bad. They're just different. You have 51 different ways of doing the same thing. No state is necessarily doing it wrong. You're doing it differently, and we have to do it multiple times, whatever it is. This mainly is in the area of the ability to get our products to market quickly.

If you do have an innovative product, you have to get it approved state by state by state. Each state has different requirements, and the net result at the end of the day is that you have to seek the highest common denominator. You don't even worry about what liberal states will let you do because it's the states that want ten additional things that you have to comply with in order to have a product out on a national basis.

In any event, our board said that track one will be to work with the states. Track two will be to develop an optional federal charter. As Peter said, our board this weekend finally said go for it. Be mindful of the events of September 11 and Congress' agenda, but this is serious enough that we think we want you to move ahead on that second track.

Let me give a couple of notions of how we think this ought to be done, what would be optional. There are companies that wish to remain state-regulated. They ought to have that option. If a company, for whatever business reasons, thinks a federal charter makes sense, it should have that option.

Exclusivity — if you want to remain state-regulated, the new federal regulators shouldn't muck around in your business, and if you want a federal regulator, the states shouldn't have any role to play either.

A general notion of charter neutrality — and by that, we mean don't build so many advantages into the federal option that even those that want to remain state-regulated feel, for competitive reasons, they can't. For example, don't put federal tax benefits that attach only to the federal options because, if you do, it's not really regulatorily neutral.

DR. GREVE: Thank you, Peter. Since I do not actually know anything about financial markets and regulation, Peter and my distinguished fellow-panelists graciously acceded to my request for a conceptual assignment, rather than a policy-reform talk.

I will argue that there is no necessary conflict between federalism and efficient insurance regulation; it all depends on what kind of federalism. I will distinguish a bad, states' rights federalism, which does present such a conflict, from a good, competitive federalism, which does not. I have tried to develop that distinction and argument in other contexts. With my trusted federalism hammer in hand, the forebodingly complex and confusing subject-matter looks like just another nail. Having hit my nail one more time, I will make a concession to the topic at hand and argue that proposals for an optional federal insurance charter are in principle consistent with competitive federalism, though not a necessary part of it. Finally, I'll argue that Gramm-Leach-Bliley may represent a step towards, and an opening for, competitive federalism- or the opposite.

Federalism means that states will attempt to protect and favor their own citizens and companies vis-a-vis outsiders. Bad, states rights federalism lets them get away with it. First, bad federalism allows states enact statutes that discriminate against outsiders, openly or covertly. Second, bad federalism rests on a "destination" principle: in interstate transactions, it is the law of the customer's or buyer's state, not the law of the producer or seller, that governs the transaction. This means that companies - regardless of their domicile - must comply with the rules and regulations in each of the fifty states where they do business.

This, by large, is the "federalism" that we have in insurance, except that it's worse. Obviously, it is incompatible with a common market; in fact, it is a regulatory balkans. For the dangers and disadvantages of a regulatory balkans, see the actual Balkans.

States' rights federalism, however, is not the only possible federalism (and wholesale nationalization is not the only alternative to bad decentralized regulation). Also possible, and much closer to the Founders' vision, is a competitive federalism. Instead of facilitating parochial protectionism, competitive federalism integrates markets and compels states to compete for citizens' and companies' business.

Competitive federalism's structural principles must be supplied either by the federal Constitution or through federal law. Let me mention four principles and contrast them with current practice.

First, states must be barred from enacting laws that discriminate against outside parties. To the Founders' minds, this command constituted a principal protection against state protectionism and impositions on a common market. It is expressed in a half-dozen constitutional provisions, from the Privileges and Immunities Clause to the Export-Import Clause and the Full Faith and Credit Clause. The "dormant" Commerce Clause has also come to be understood as an injunction against (facially) discriminatory state statutes that are not specifically authorized by Congress.

The glitch with a constitutional anti-discrimination principle is that it captures only blatantly discriminatory state laws, not the states' countless "evasive maneuvers" (Madison) to disguise discrimination. That is why the Commerce Clause authorizes Congress to legislate against state discrimination and protectionism. In the insurance markets, however, Congress has failed to exercise this option and, in fact, done exactly the opposite: under the "reverse preemption" logic of the McCarran-Ferguson Act, blatantly discriminatory and protectionist state laws that would otherwise violate the dormant Commerce Clause are rendered lawful (subject only to very weak equal protection constraints).[1]

Second, competitive federalism requires free exit. Citizens and companies must be able to vote with their feet and their pocketbooks - companies, by choosing their domiciles and the places where they do business; citizens, by choosing products that, under competitive federalism, come along with the legal rules of the product's or service's origin state. The bedrock principle of American federalism is that citizens choose their state.

The bedrock principle of insurance regulation is the reverse: no exit. A California citizen is stuck with California's consumer protections, whether he wants them (on the books and in the product price) or not. Corporate changes of domicile are virtually unknown, both on account of regulatory obstacles and because threats of state retaliation appear to be widespread or at least widely feared by insurance companies that have contemplated redomestication. Several states even administer exit restrictions that preclude states from discontinuing product lines that have been rendered unprofitable by state regulation. We might as well legalize confiscation.

Third, competitive federalism requires reciprocity, meaning that each state will respect and enforce the legal rights (charters, licenses and so forth) obtained in another state. Under this "origin principle" (or "principle of mutual recognition," as it is called in the European Union), each company need comply with only one set of legal rules - those of its domicile state. Insurance regulation operates on the opposite principle: the customer's law governs. That is an annoyance in personal lines, where agents sell policies in one or two states; it is a much, much bigger deal in commercial lines, where the producers' compliance obligations in multiple jurisdictions drive expense ratios (of cost to premiums) through the roof.

Fourth, competitive federalism requires that citizens and companies must be able to rely on the application of the law of the state that they have chosen, either by domiciling in that state or by contractual choice-of-law and choice-of-forum clauses.

But bluntly, market participants-customers and sellers alike-need protection from state attorneys general and trial lawyers who will attempt to home cook out-of-state insurers in front of a home state jury and a state judge of their own choosing. Realistically, this requires a federal choice-of-law default rule designating the domicile state's law as governing multi-state transactions; uncompromising enforcement of contractual choice-of-law and forum clauses; and access to federal courts in cases of minimal diversity. None of these conditions, of course, exist in the insurance markets.

So, insurance isn't an example of competitive federalism. It is the exact opposite.

Do we have an example of competitive federalism? Why, yes. Corporate chartering works on that principle. Companies freely choose their state charters, which will then govern their legal relations with shareholders everywhere. In principle, this Delaware model (as it's sometimes called) can be applied to insurance regulation. The difficulty, I think, lies in specifying the appropriate range of application.

Solvency requirements for insurance companies or financial institutions would appear to be an obvious candidate for competitive state arrangements. Much as big, well-informed institutional shareholders induce corporations to obtain charters in states that will maximize shareholder value (as opposed to entrenching the management), so profit-maximizing financial institutions would presumably choose states with optimal, rather than excessively lenient, solvency requirements and arrangements.

Licensing and registration requirements are likewise plausible candidates for reciprocity. Full reciprocity in that area would eliminate the compelling complaints over the existing protectionism of the system and its inordinate compliance costs. Full reciprocity for new products would solve the speed-to-market issues that Gary mentioned and facilitate more efficient competition across industries.

In these areas, admittedly, the competitive mutual recognition principle threatens to undermine state consumer protection statutes and the rationales on which they are based, such as consumers' difficulties in understanding very complicated financial instruments. But concerns over adhesion, asymmetric information, and unequal bargaining power do not apply to commercial lines, where bargaining parity prevails and marginal purchasers can be presumed to be reasonably informed. Thus, the case for full reciprocity and state competition seems most plausible precisely in the area where those principles would do most good.

A hypothetical federal insurance reform that would mandate non-discrimination, free exit, full reciprocity, and access to an impartial forum in multi-state conflicts would be fully federalist. States, not the federal government, would continue to regulate insurers. Arguably, such a reform might be more efficient than a uniform substantive federal reform. We're very unlikely to find efficient regulation by drawing it on a piece of paper, and any mistake we make at a national level will, by definition, be a very big mistake.

The political viability of the competitive solution, of course, is much in doubt. That is because competitive federalism substitutes private arbitrage for political harmonization and thus wrings the rents out of the system, which means that nobody who has anything to say about the matter wants any part of it.

But in the insurance context, I think the much discussed option of an optional federal charter may provide an opening. That is because it follows the logic of competitive federalism. It offers producers and their consumers a choice between competing legal regimes, except that the choice takes place along a vertical dimension, not a horizontal dimension, and there are only 2 choices, rather than 50 or 51. Thus, no serious federalist should reject that proposal as unduly nationalist. It is not, at least not in principle.

I would caution that the devil lies in the details. It is hard to mimic the principles of horizontal competition among equals – non-discrimination, exclusivity, free exit both ways, full reciprocity, and a reliable and partial forum – in competition between two inherently unequal partners. That's the neutrality difficulty that Gary mentioned.

On the one hand, the federal charter must not be allowed to disintegrate into a kind of federal floor of minimum standards over and above which the states still regulate. In other words, unimpeded choice requires robust federal preemption. Such unequivocal preemptions are very, very rare in federal law and may be especially hard to come by in the insurance context. On the other hand, effective vertical competition requires some credible assurance that the senior federal partner will, over time, actually tolerate the competition that it has just established. These difficulties may prove considerable and even intractable, but they have nothing to do with federalism.

Since optional federal chartering follows federalism's competitive logic, it is fully consistent with that system. Under a fully competitive state regime, the additional option of a federal charter would simply turn the federal government into a 51st state. Obviously, that's not strictly necessary because state competition would do all the work that you want horizontal competition to do. There may be good reasons for providing a federal charter, even under a fully competitive state regime. There may be good arguments against it. But again, all these considerations have to do with policy and not with federalism.

Finally, a word about Gramm-Leach-Bliley. Title 3 of the Act prompts the states towards mutual recognition of insurance licenses. Should a sufficient number of states fail to achieve that objective by November 2002, Gramm-Leach-Bliley threatens the establishment of a suprastate agency under the supervision of the NAIC (and, failing that, directly under the federal government) to bring about the statutory objectives. That's a step towards a more competitive environment. But it's a small step, and unfortunately it's a step that may, in the end, make matters worse.

The problem isn't that the statute exempts the most odious protectionist restrictions, such as countersignatory requirements. The problem is that federal regulators and federal legislators, and certainly the NAIC itself, appear to view reciprocity as the first step toward harmonization. But I suggest that harmonization and reciprocity are mutually exclusive means of market integration. Reciprocity works through private arbitrage; harmonization, through political negotiation. Reciprocity means decentralization; harmonization means a single uniform regime. Reciprocity implies jurisdictional competition; harmonization, a policy cartel that suppresses that competition.

Gramm-Leach-Bliley entrusts the administration of its policy cartel to the NAIC, and perhaps a future NARAB, rather than an actual federal agency. But that concession to states' rights exacts a heavy price in terms of political accountability and transparency. In fact, Gramm-Leach-Bliley threatens to exemplify the depressing scenario that's being played out in a growing number of policy areas, from e-taxation to nuclear waste. Some states can move on their own towards reciprocity. But that doesn't help very much because California will insist on being California. In other words, the states cannot, on their own, overcome the free-rider and holdout problems, meaning that the balkanization persists. Congress recognizes that. But instead of trumping the states' rights regime with unequivocal federal rules, it pays ostensible deference to state autonomy and federalism. Then it nudges and bullies the states into "harmonizing" cartels under the authority of the suprastate authority that's off the constitutional charts, accountable to no one, and that no one outside the regulated industries has ever heard of.

The cleaner competitive solution would be to build on the reciprocity provisions of Gramm-Leach-Bliley, to make them mandatory rather than hortatory, to cover all states and all licensing requirements, to cover at least commercial product lines, to add federal prohibitions against discriminatory and no-exit provisions at the state level, to relieve the NAIC of its harmonizing obligations, and to put the envisioned NARAB out of its misery before a federal court strikes it down.

Against my better instincts and initial disclaimers, I seem to have actually ended up with an actual policy proposal. I'll do you the favor of not actually defending it. I'll instead end on a more modest and hopefully helpful note: There is a real competitive federalism that is fully consistent with the Founders' dual commitment to decentralization and to a common market. But the federalism we actually have in insurance isn't federalism; it is its parochial, evil states' rights' twin. There are lots of reasons to be cautious with federal interventions in financial markets. There are lots of ways to get confused about it. But the last thing that should deter or confuse reformers are false appeals to a false federalism.

MR. WALLISON: There's plenty to defend against, if you want to take it up.

Our next speaker is Bert Ely. He really needs no introduction to this audience. He is a very active member of the Federalist Society, as well as an active member of just about everything else that happens in Washington. It's hardly a conference at all if Bert is not there.

But I just want to say a few things about Bert. I've worked with Bert on a number of things. Together, we've prepared some papers and monographs, and he's an extraordinary colleague and enormously hard worker; very bright and innovative.

Bert was one of the first to predict the S&L crisis, and the fact that there was going to have to be a taxpayer bailout there.

He also doubted that there was going to be some sort of great commercial banking crisis. It's interesting to remember that this goes two ways. There are the pundits who predict crises and disasters that do happen, and those who predict that crises and disasters that won't happen. And it's important to have someone like Bert, who knows the difference. He said in 1991 that the commercial banking industry was healthy enough so that, no matter what people were saying about how it was going to collapse, it was not going to happen.

Finally, he predicted the eventual taxpayer bailout of the Japanese banking system well before most people here in the United States had focused on it.

Bert has developed a subspecialty. In addition to everything else he knows about in the financial area, he's developed a subspecialty in various market mechanisms for addressing what you might call inefficiencies or market failures in the financial services industry. And one of those is a private deposit insurance system that he's talked about for years and years — a very clever and interesting proposal.

The insurance industry has a kind of private deposit insurance system, which is what Bert is going to be talking about today. It relies on guarantee funds. They are run on a state-by-state basis for the companies that are active in the specific states, and cover those insurance companies that actually fail, for insolvency reasons, to meet their obligations. How you would combine a state-by-state guarantee system with a national or federalized system of optional federal chartering is a real puzzle. And if there's anyone who can figure it out, it's my man Bert.

MR. ELY: Peter, thank you for that excessively generous introduction.

I'm going to talk about the guarantee fund aspects of the federal insurance charter, which may sound kind of technical, but actually it's far from that because, for anybody who's been involved with banking regulation over the years, you know that much of what drives banking regulation is ultimately intended to prevent the failure of individual banks and perhaps more importantly to protect at least some class of depositors and other creditors in those failures. That's what the guarantee fund issue addresses with regard to the insurance industry.

I'm going to touch on four things. First of all, a little bit more about the state guarantee funds, beyond what Peter discussed; second, the guarantee fund concept as it relates to the federal insurance charter; third, the experience that Congress will bring to this issue — a sad experience, I might add; and then, a few predictions on how Congress will address the guarantee fund issue.

First of all, the guarantee funds are the insurance industry equivalent of federal deposit insurance for banks and thrifts. That is, they are designed to protect insureds — at least those insureds as defined by law — against any loss if an insurance company becomes insolvent. And insurance companies do fail on both sides of the house — the life and health side, as well as the property and casualty side.

We have had situations where there have been losses to insureds, which is what led to the development of the guarantee fund system over the last 30 years. It's fully in place now, for the insurance industry. But again, just like federal deposit insurance and state deposit insurance schemes before that, it stemmed from the failure of institutions and people being left with a loss. The government's got to do something and so, in the case of the insurance industry, we have the state guarantee funds.

I wrote a chapter for a book that Peter edited a couple of years ago from an AEI conference, talking in probably more detail than most of you would ever want to get into about state guarantee funds. But it's an interesting history, particularly in structure, particularly for those of you who are familiar with banking regulations and federal deposit insurance, both in the similarities and also the many differences.

Again, I'm going to try and hit on some of the differences between guarantee funds and deposit insurance. First of all, there are actually two sets of guarantee funds. There's one set of guarantee funds for the life and health insurance companies and another for the property and casualty insureds, and they're totally separate systems because there are significant differences between the two types of products.

What happens is, if you are licensed to do business in a particular state, then you have to join the guarantee fund association in that state. So if you're a multi-state insurer, you're in lots of different state guarantee funds. You're in as many as there are states in which you are licensed to do business.

Another significant difference between the state guarantee funds, on the one hand, and the FDIC, on the other, is that the FDIC is a large government bureaucracy run by a five-person board of directors, all of whom are full-time employees of the federal government. The state guarantee funds are much less bureaucratic in that regard. There's much more of an *ad hoc* nature to it, built much more around the receivership process. What's important is that the directors of the state guarantee fund associations include not only insurance regulators but also representatives of the insurance companies. So you have much more of an industry management role in the guarantee fund process than you do in federal deposit insurance. In fact, you don't have any in federal deposit insurance, as a practical matter.

Another thing that's interesting about it has to do with the guarantee fund limits. First of all, each state determines the scope of and the limits on its guarantee fund provisions. So it's a state-by-state process. The other thing is that the limits are really quite complicated. The limits vary from state to state. They go as high as $500,000, to the best of my knowledge; I'm not aware of any above that. They vary by type of insurance product and type of liability, and again, it's actually quite complex.

When you think about federal deposit insurance, it's very simple. $100,000 per depositor per bank. That's it. You can take an additive approach, and people can combine coverages through different ways in which they title accounts, but you have essentially a single limit. There is not at the state level, and my sense is that there couldn't even be at the federal level, one nice single number to which that people could point and say that's how much protection there is if an insurance company fails.

Another interesting distinctive characteristic of the guarantee funds, and again a differentiation from

FDIC, is that except for the State of New York, the guarantee funds are funded totally on an ex post basis. That is, they don't have a fund balance. Assessments are levied on insurance companies as needed to cover insolvency losses that would otherwise be incurred by the insureds that are protected under the law.

To the best of my knowledge, there's no such thing as too big to fail with regard to the protection of the insureds under the guarantee fund system the way we have, as a practical matter, with deposit insurance.

One of the things that I find most ironic about the guarantee fund assessments is that they're not risk-sensitive. They're levied on all the insureds, usually based on the amount of net premium income they've written in that state over some period of time. What's ironic about it is that the insurance business is the business of pricing risk. And yet, in its own self-insurance system, there's no pricing for risk. Maybe Gary will want to talk to that later.

Another thing that's interesting about it is that in many states — more so on the life side than the property and casualty side — guaranteed fund assessments can be offset against the premium taxes that the insurance companies pay to their states. In most cases, premium taxes are paid in lieu of corporate income tax.

What's the effect of that offset? It passes insolvency losses back to the general taxpayer, and that is very much in opposition to what has been the case in this country, certainly post-FDICIA, where Congress said after the S&L crisis, never again are we going to have the taxpayers on the hook. It will be an industry self-insurance mechanism.

And as Peter and I and some others argue, it's the banking industry that is on the hook going forward for all future deposit insurance losses, no matter how big they might get, including any monies that have to be spent to save a too-big-to-fail bank or to protect its creditors.

One last point on state guarantee funds. That is, there have been a few cases — *Mutual Benefit* about 10 or 12 years ago was a good example — where a life insurance company actually had a liquidity problem because people were cashing out their policies, or taking out policy loans.

Theoretically, the Fed can lend to insurance companies — not from the discount window but by a vote of the board of governors. They never have, but I think that one of the issues that comes up with regard to the guarantee funds, particularly for a large company, is the whole issue of having a discount window available for emergency liquidity borrowing.

Now, let me talk about the guarantee fund concept as it would relate to the federal insurance charter. First of all, it's highly unlikely that Congress will enact a federal insurance charter without insolvency protection for insureds, up to some set limit. What those limits might be, I wouldn't want to hazard a guess.

But I find it hard to believe that the United States Congress is going to allow federally chartered insurance companies to operate, and then if they fail, that's tough luck for the insureds. The United States Congress doesn't work that way, and I wouldn't expect them to.

So, I think in any federal insurance chartering legislation, there will be some kind of protective mechanism for insureds. Of course, as Michael said, the devil's in the details.

There are two bills out there, and soon we'll see the ACLI bill, that have approached the chartering issue. The American Bankers Association has put one out through its insurance subsidiary; the ABA has a great deal of interest in this issue.

In that bill, at least as it was circulated and discussed in an AEI forum last December, they took the approach of trying to set up a guarantee fund that was modeled after the FDIC. In fact, they followed the FDIC model slavishly. I was one of those on the panel who was very critical of that approach, and I've been told by one of the authors of the legislation that they're a little more open-minded about how to deal with this issue.

The ACLI and the American Insurance Association, which represents the large P&C companies, are proposing, in slightly different ways, that the federally chartered insurers participate in the state guarantee fund system; in other words, that the federal government not set up a guarantee mechanism, but that the federally insured companies piggyback off the state system.

This poses an interesting federalism question, which as a non-lawyer, I cannot answer. That is, can Congress mandate the participation of federally chartered insurers in a state-run guarantee fund system? Maybe we can answer that in Q&A time.

Let me just touch on some experiences that Congress brings to this issue. First, Congress has a long, unhappy experience with federal deposit insurance, including the $153 billion S&L bailout, which cost general taxpayers $124 billion. Anybody who has ever sat in on a deposit hearing in recent years in the United States Congress will constantly hear senior members of the Banking and Financial Services Committees harking back to that. That was a once in a lifetime experience that they never want to go through again.

What was important about that, particularly with the FDICIA legislation in 1991, is that Congress intends that deposit insurance going forward is to be industry-financed with absolutely no cost to taxpayers. Keep in mind that, under the state guarantee system, much of the cost of insolvencies and protecting insureds goes back to the general taxpayer.

Second of all, Congress is getting a crash course on insurance in considering the terrorist reinsurance legislation that's now on the table. My belief is that this legislation, however it turns out, will significantly influence the federal insurance chartering legislation. How specifically, I wouldn't want to speculate, but it's going to have an impact, because it's being handled by the two committees that are going to have a role in the federal chartering legislation.

Also, Congress has wrestled from time to time with insurance solvency issues, most recently in bills that Representative John Dingel introduced in 1992 and 1993. And as long as Mr. Dingel is around, even though the Commerce Committee on which he's the ranking Democrat no longer has jurisdiction over insurance, Mr. Dingel will undoubtedly have some influence on this issue.

Now, let me close by offering some predictions on how Congress will address the guarantee fund issue. First of all, Congress will reject complete reliance on the state guarantee fund system because if they authorize federal insurance charters, there's ultimately going to be some sense of federal political responsibility for the insureds of federally chartered companies.

I can see Congress going one of two ways. One is to create federal regulation of the state guaranty fund systems — something I think Michael alluded to — and the other is to create a federal guarantee system for federally chartered insurers. Both of these represent a harmonization that Michael referred to.

Second of all, Congress will be inclined or tilted toward a pre-funded system. That is, a fund balance is built up that presumably protects taxpayers. From it, you would pay losses. Anybody who's familiar with federal deposit insurance realizes that the insurance funds are no more real than the Social Security trust fund or Highway trust fund. But Congress buys into myths, and one is that there's this big fund out there that's going to protect the taxpayers. In fact, that is not the case.

But not only will they want a pre-funded system, they're going to want a system where all the cost of insolvencies is borne by the insurance industry, which again is another major departure from the present state system.

The other thing I think is that, even though you do have these two separate guarantee systems in the states for some very logical reasons, Congress may at least have a strong inclination towards having one guarantee fund system, in part because it will soon merge the separate bank and thrift insurance funds.

Finally, my last prediction is that Treasury will be the federal insurance regulator because it looks like Treasury is going to be the designated regulator under whatever federal terrorism reinsurance bill is enacted, possibly before the end of the year.

With that, I thank you, and I look forward to our discussion time.

MR. WALLISON: Our next speaker is Noel Francisco, who is in the Office of Counsel to the President. Noel prepared for this by serving as a law clerk for Justice Scalia, and prepared for that by serving as a law clerk to Michael Luttig.

He is also a graduate in economics from the University of Chicago and functioned as a financial analyst at Gleacher and Co. from 1992 to 1993. From 1991 to 1992, he was also a financial analyst in the Mergers and Acquisitions Transaction Development Group at Morgan Stanley.

So, Noel, we are delighted you are here. Actually, I should mention that there will be one person after Noel, and that is Bob Gordon. He's been working on some things on the Hill that are relevant to the discussion today. After Noel, we'll hear from Bob Gordon, and then we'll take questions.

MR. FRANCISCO: Good afternoon everybody. The question before the panel is, is federalism consistent with nationwide markets and globalization? The case of the insurance industry.

My remarks are going to focus on the first part of that question, which begin with the word "is" and end with the word "federalism". Notwithstanding my time in New York City working for an investment bank, I know virtually nothing about nationwide markets. I know very little about globalization. And aside from the car accident that my wife got into a couple of weeks ago, I don't know much about the insurance industry either.

But I do know a little bit about federalism. So, in my few minutes up here, I'd like to try to make the case for why federalism is, as a policy, as important today as it has ever been. I'll also briefly touch upon the overarching question before the panel, and that is whether federalism is consistent with the nationwide regulation of markets. In my view, it is.

Before I get into the substance, though, I just want to take a minute to explain what the Bush Administration is doing to promote federalism. In 1985, in a case called *Garcia v. San Antonio Metropolitan Transit Authority*, the Supreme Court suggested that the primary safeguard of federalism principles in our democracy isthe political process; that is, the process by which states petition the federal government to restrain itself from encroaching on traditional areas of state regulation.

This Administration takes the admonition of *Garcia* seriously. That's why on February 26, 2001, President Bush created what's called the Interagency Working Group on Federalism. This group consists of most of the executive branch agencies, as well as members of the White House staff. The President charged this group with consulting with a variety of state and local officials on issues pertaining to federalism. He also charged the group with drafting a new executive order on federalism.

These initiatives are designed to ensure that the voice of state and local governments are heard in the political process and, accordingly, that the political process safeguard relied upon by the Supreme Court in the *Garcia* case works as effectively as possible.

[1] See Prudential Insurance Co. v. Benjamin, 328 U.S. 408 (1946); Metropolitan Life Ins. Co. v. Ward, 470 U.S. 869 (1985)(equal protection constraint).