

An Evaluation of US Insurance Regulation in a Competitive World Insurance Market

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Presentation Outline

- Approach to Conducting the Evaluation
- What an Optional Federal Charter Might Provide
- Assessment of State Insurance Regulation
- Conclusions

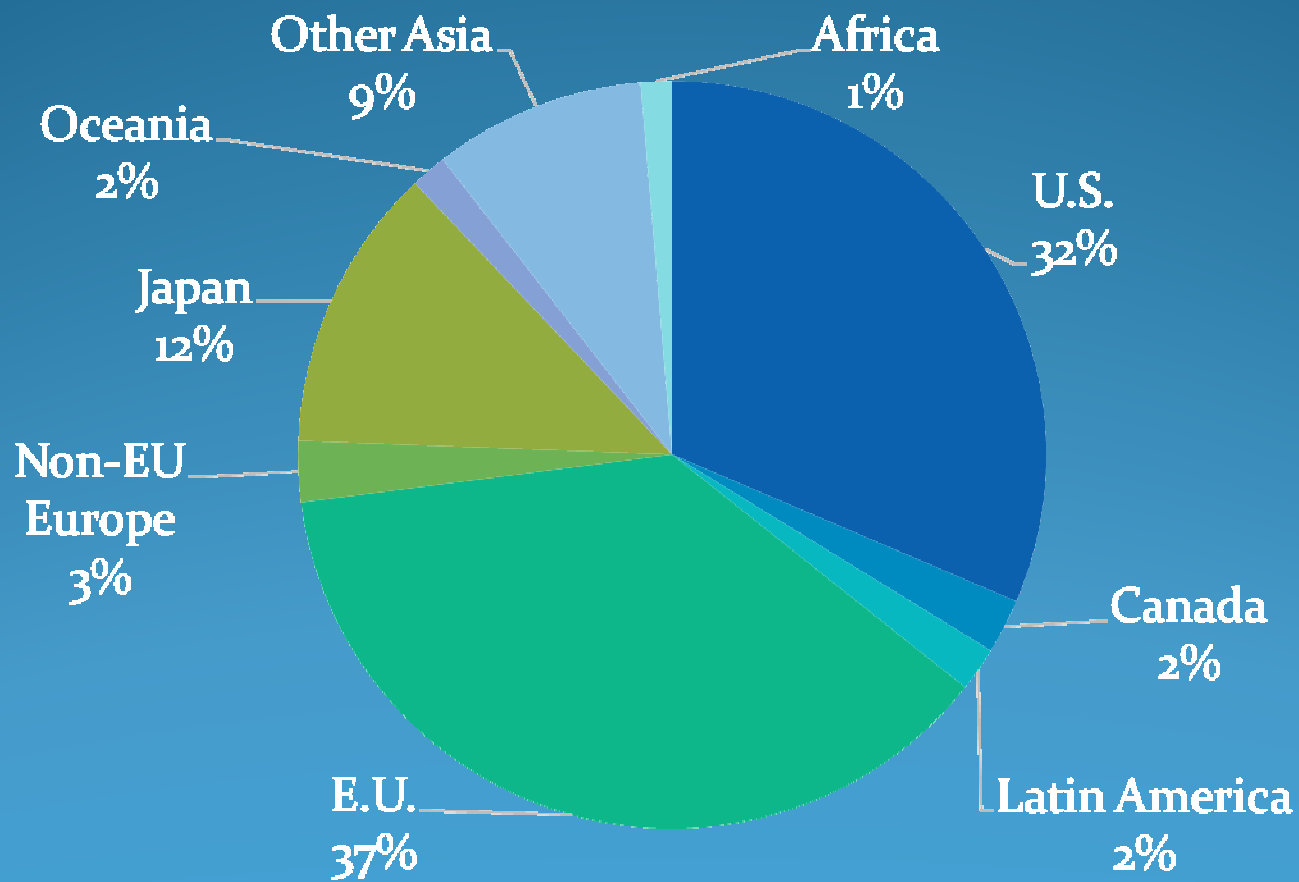
Approach: (1) Recognizing Trends

- **Complaints about US Insurance Regulation**
 - By Major US Insurers
 - By Elements of US Federal Government
 - By US Trading Partners
- **Internationalization of Financial Markets**
- **Convergence in Financial Services**
- **Why and How Financial Services Regulation is Evolving Internationally**
 - Is the US falling behind?

Approach: (2) Understanding Position of US Insurance Market

- Insurance growth opportunities have been greater outside the US than inside; e.g., premiums grew by 16 percent in emerging markets versus 2 percent real growth in US
- Consider the relative size of the US insurance market

Worldwide Distribution of Premiums (2007)



Approach: (2) Understanding Position of US Insurance Market

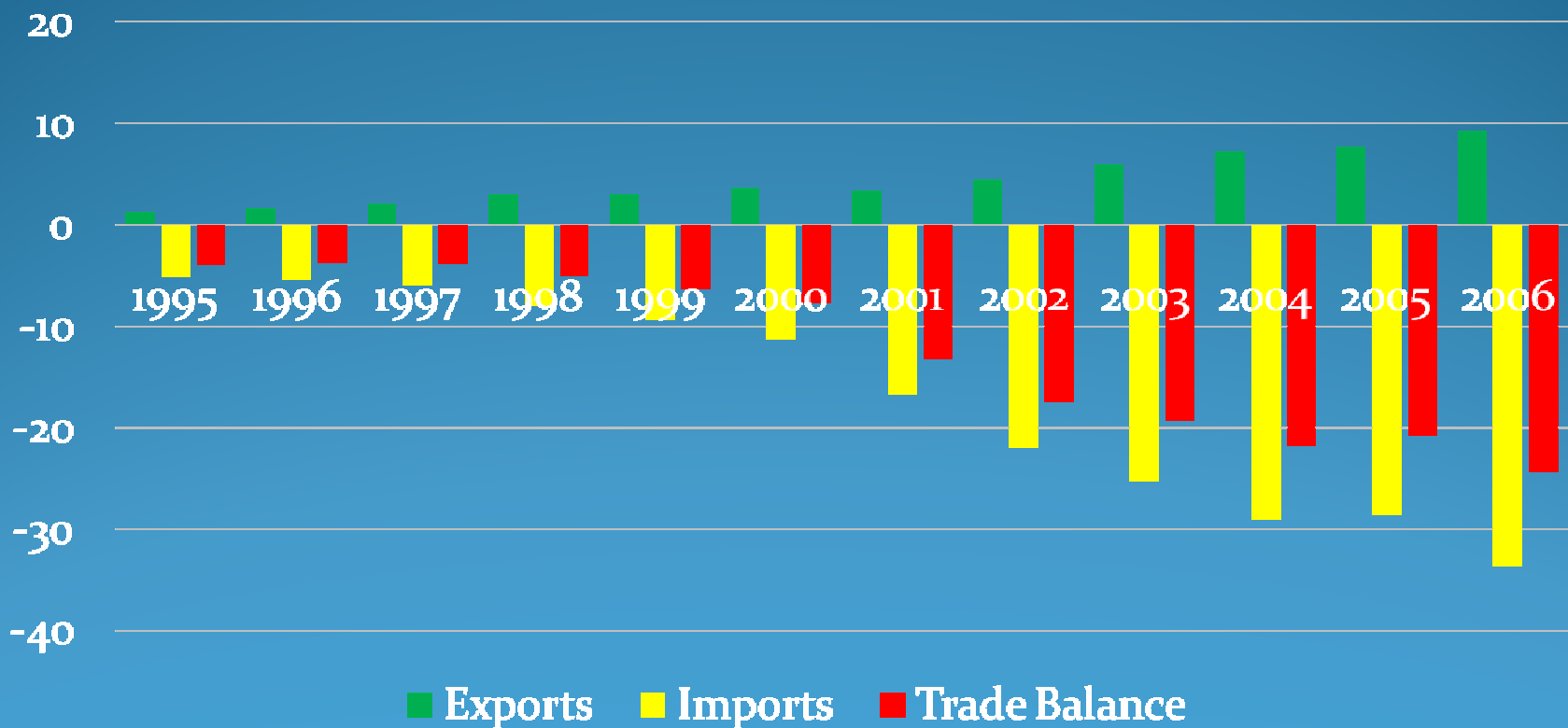
- **Relative Size of US Insurance Groups, Past and Present – Outreville Study (2008)**
 - In 1986, 8 of the world's 20 largest insurance groups were US, with 6 each from Europe and Japan
 - By 2003, 3 of the world's largest insurance groups were US, with 12 from Europe and 5 from Japan
- **Conclusion: Large US Groups seem not to have grown as rapidly as did European Groups**

Approach: (2) Understanding Position of US Insurance Market

- Relative Position of US Insurance Groups Internationally – Outreville Study (2008)
- The domiciles (2003) of the largest 45 groups and, of the 45, the 30 most international were:
 - Europe: 22 of 45 then 22 of 30 (occupying top 5)
 - US: 15 of 45 then 7 of 30
 - Japan: 7 of 45 then 1 of 30
- Conclusion: Large US Groups are falling behind European Groups in international expansion

Approach: (2) Understanding Position of US Insurance Market

US Insurance Exports and Imports (\$ Billion)



Approach: (2) Understanding Position of US Insurance Market

- US insurance market relies on foreign insurance groups for much capacity
 - Foreign-owned US domiciled nonlife insurers wrote about 14 percent of US direct nonlife market
 - Foreign-owned US domiciled life insurers wrote about 23 percent of US direct life market (including almost $\frac{1}{2}$ of all annuity considerations)
 - Foreign-owned nonlife reinsurers wrote about 85 percent of the US nonlife reinsurance market
 - Reinsurers cover about $\frac{1}{3}$ of US direct insurers' losses in natural disasters

Approach: (3) Testing US Insurance Regulation against Trade Concepts

- **Take as given:**
 - International competition in insurance is welfare enhancing and therefore is to be encouraged
 - Regulation exists to rectify market failures and not for redistributive reasons
 - Where regulation is essential, policymakers should select those approaches that minimize societal deadweight losses; i.e., are no more burdensome than necessary to accomplish their purposes

Approach: (3) Testing US Insurance Regulation against Trade Concepts

- **Four key concepts:**
 - **Market access** – right of a foreign supplier to enter a market (GATS Article XVI)
 - **Most-favored-nation (MFN) treatment** – no country's suppliers should be accorded treatment more favorable than any other country's suppliers (GATS Article II)
 - **National treatment** – domestic rules should ensure that foreign suppliers receive treatment no less favorable than domestic suppliers (GATS Article XVII)
 - **Transparency** – rules regarding market access and domestic operation should be clear, ascertainable, and openly administered (GATS Article III)

We return to these later

What an Optional Federal Charter in Insurance Might Provide

- We examine issue from two perspectives:
 1. Possible implications for US insurance groups seeking international expansion and
 2. Possible implications for foreign insurance groups seeking entry into the US market
- No meaningful support for maintenance of existing system precisely as it is
- We recognize that other regulatory reform proposals being considered could offer some of the same potential benefits as an OFC, but none of them offers all benefits of an OFC

Implications of an OFC for US Insurance Groups in International Expansion

- A greater US insurance presence internationally could benefit the US economy, assist US multinationals worldwide, and help other nations' businesses and citizens
- Specifically, an OFC could
 - provide US interests with stronger representation and advocacy,
 - enhance US insurer efficiency in international competition, and
 - minimize the possibility of retaliatory measures against US interests.

Implications of an OFC for US Insurance Groups in International Expansion

- *Concerning stronger representation and advocacy internationally*, an OFC could provide the US government with a more informed and stronger voice in international negotiations and within international organizations
- State insurance regulators are neither tasked with nor can they undertake such responsibilities

Implications of an OFC for US Insurance Groups in International Expansion

- *Concerning enhancing efficiency for US insurers in international competition, an OFC could*
 - prove a less costly system than the existing fragmented approach ,
 - make for more efficient risk management approaches for US multinationals, and
 - alter the perception outside the US that its regulatory framework lacks effective consolidated conglomerate supervision.
- A state-based system seems, on its face, to be incompatible with increasingly global markets

Implications of an OFC for US Insurance Groups in International Expansion

- *Concerning minimizing possible retaliatory measures against US interests, an OFC could address these EU concerns as to possible*
 - “equivalence” issues that could arise under Solvency II and
 - reciprocity under the EU Reinsurance Directive
- The state regulators do not seem to have been moving with much haste in the Bilateral Dialogue

Implications of an OFC for Foreign Interests seeking US Market Entry

- An OFC seems to offer the potential for rectifying all trade inconsistencies identified in our paper
- The result could have beneficial effects for:
 - US insurance buyers because of greater competition, lower prices, and new operational techniques and products,
 - The US economy and economic management by having better cooperation among federal agencies with the result that financial market risks could be better monitored, and
 - The US insurance market.

Assessment of State Insurance Regulation Against Trade Concepts

- Both *individual state's* regulatory regimes and the *totality of all states'* regimes must be examined against the four trade concepts of
 - Market access
 - Most-favored-nation treatment
 - National treatment
 - Transparency

The Trade Concepts must be Applied at *both* the Individual State *and* National Levels

- The following are necessary but not sufficient conditions for ensuring compliance with the trade concepts:

Condition 1: Each individual state treats foreign insurers as well as it treats insurers domiciled in other states in terms of market access, national treatment, MFN treatment, and transparency

Condition 2: All states entry and operational requirements are effectively the same and are applied equally to foreign insurers and insurers domiciled in other states

The Trade Concepts must be Applied at *both* the Individual State *and* National Levels

- *Condition 1* is insufficient because it is tantamount to contending that the number and variety of laws and regulations are irrelevant to ease of entry and operation
- *Condition 2* is insufficient because it is tantamount to contending that it is acceptable for a state to maintain trade barriers and discriminatory measures against foreign insurers provided it also maintains them against insurers domiciled in other states

Assessment of State Insurance Regulation Against Trade Concepts: Market Access

- We identify two classes of barriers relevant to market access
 - Those applicable to both foreign and other states' insurers and
 - Those applicable primarily to foreign insurers

Assessment of State Insurance Regulation Against Trade Concepts: Market Access

- **Barriers relevant to both foreign and other states' insurers include the following:**
 - **Number and variety of insurer licensing requirements**
 - **Monopoly insurers**
 - **Government owned/sponsored insurers**
 - **Compulsory and restrictive reinsurance cessions**
 - **Extra-territorial application of state laws**
 - **Barriers to exit**
 - **Producer and other licensing issues**
 - **Domestic preference tax laws**
 - **Retaliatory laws**
 - **Issues for commercial risks**

Assessment of State Insurance Regulation Against Trade Concepts: Market Access

- **Barriers relevant primarily to foreign insurers include the following:**
 - **Government ownership restrictions**
 - **Initial entry licensing**
 - **Citizenship/residency requirements**
 - **Seasoning requirements**
 - **Reciprocity laws**
 - **Trusted surplus funds requirements**

Assessment of State Insurance Regulation Against Trade Concepts: MFN

- No MFN inconsistencies seem to attach to state insurance regulation
- Bilateral agreements could have meaningful affect in the future
- MFN is, after all, no panacea

Assessment of State Insurance Regulation Against Trade Concepts: National Treatment

- National treatment should be understood to be more than facially equivalent treatment between foreign and domestic companies
- Issue is one of true “equality of competitive opportunity”
- We examine based on inconsistencies
 - Relevant to both foreign and other states’ insurers and
 - Relevant primarily for foreign insurers

Assessment of State Insurance Regulation Against Trade Concepts: National Treatment

- Inconsistencies relevant to both foreign and other states' insurers include:
 - Reinsurance cessions differentially affecting domestic and out-of-state reinsurers;
 - Extra-territorial state laws with differential effects;
 - Producer and other licensing issues, as administered;
 - Domestic preference tax laws creating different burdens on a state's domestic insurers from those domiciled in other jurisdictions; and
 - Commercial insurance requirements imposing differential burdens on domestic and out-of-state insurers.

Assessment of State Insurance Regulation Against Trade Concepts: National Treatment

- Inconsistencies relevant primarily to foreign insurers include:
 - Certain other restrictions discussed above
 - Credit for reinsurance and collateralization

Assessment of State Insurance Regulation Against Trade Concepts: National Treatment

- Regarding the issue of credit for reinsurance and collateralization:
 - For a US insurer to receive credit for reinsurance, the reinsurer must be authorized or post security to cover its obligations to the cedant
 - The resultant system bears down most heavily on foreign insurers and reinsurers
 - The system is virtually unique to the US
 - Direct and indirect costs are high
 - Even under proposed modifications, most unauthorized foreign reinsurers must still post collateral

Assessment of State Insurance Regulation Against Trade Concepts: National Treatment

- Difficult to estimate total direct and indirect costs of US collateral requirements, but we note that
 - the US market accounts for about one-half of total reinsurance premiums worldwide
 - 38 percent of all ceded reinsurance premiums worldwide are potentially subject to US requirements
 - Continuously collateralized guarantees for US cedants were equivalent to 70 percent of global gross reinsurance premiums in 2005.

Assessment of State Insurance Regulation Against Trade Concepts: National Treatment

- We further note that collateralization could:
 - Have potentially negative spillover effects that could raise reinsurance costs, aggravate the insurance cycle, increase the cost of capital, and cramp expansion of worldwide reinsurance capacity.
 - Have potentially negative knock-on effects for emerging markets in the form of increased volatility and higher insurance and reinsurance costs for those with the fewest alternative risk-sharing options.

Assessment of State Insurance Regulation Against Trade Concepts: Transparency

- Viewed from a state-by-state basis, the US insurance regime is transparent, in the strict sense of GATS Article III, with federal and state laws and interpretative findings freely available
- Viewed from a national basis, transparency is more ambiguous because trading partners must take account of dozens of parallel sets of changing laws and regulations
- GATS Article III: the more complex a regime, the greater a WTO member's duty to notify details to the *WTO Council for Trade in Services*.

Conclusions

- **Establishing a federal competency in insurance via an OFC seems to hold the promise of many benefits**
 - Better matches with global nature of today's major risks
 - Simplifies federal policymaking as regards insurance
 - Boosts US effectiveness in international fora
 - Allows quicker US response to international developments
 - Facilitates internationalization of US insurance markets
 - Creates level playing field among financial competitors
 - Facilitates quicker and deeper assessment of overall financial risks and policies for financial stability
 - Facilitates mutual recognition while avoiding retaliation