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How EESA Might Impact Property and Casualty Insurance

An Analysis of New Powers and Authorities

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This paper explores the ways that the Emergency Economic Stabilization Act (Public Law 110-334) might impact the insurance industry.[i] The paper focuses on things that could potentially have consequences for companies in the businesses of issuing of automobile, homeowners', and commercial lines insurance. (Nearly all companies widely identified as "insurers" have other significant interests and investments that the Act impacts.) It's important to note that the things this paper deals with are simply actions that presidential administrations *could* do.

About the Act

Although the attachment of other, largely unrelated, energy, health coverage, and tax policy measures brought the total length of H.R. 1451 to 451 pages, the actual "Emergency Economic Stabilization Act" weighs in at only 41 pages—just about a tenth of the H.R. 1451's total length. The bill has five major provisions. In particular it:

- Sets up a new federal capacity to spend $700 billion to purchase "troubled assets" (mostly mortgaged backed securities) under a Troubled Assets Relief Program (TARP);[ii]
- Establishes an insurance program for companies that wish to keep these troubled assets on their books;[iii]
- Expands federal efforts to assist people behind on their mortgages to avoid foreclosure;[iv]
- Places limits on executive compensation for companies participating in TARP;[v]
- Puts forward a number of provisions that require companies participating in TARP to grant the government stock warrants that would allow taxpayers to recover a percentage of what's spent.[vi]

Other provisions require reports on the crisis' evolution, set up oversight mechanisms, and grant Congress some control over the disbursement of funds. Although the word "insurance" appears 41 times in the EESA, none of the references in the body of the legislation refer to the activities of insurance companies directly. Instead, they refer to expansion and creation of existing federal insurance programs and include insurance companies in the definition of "financial institution." The lack of specific references to the insurance business, however, does not mean that those interested in insurance should ignore the legislation. Three particular sections deserve particular attention from the standpoint of property and casualty insurance:

- TARP, the bill's key provision, could serve as a high-level federal reinsurance capacity or "backstop";
- The new "Office of Stability" (which will likely be permanent) would likely be the central repository for federal expertise about "stability threatening" developments in the insurance industry and may well have more to say about insurance than any existing federal bureau;
- A mandated report could give Treasury the opportunity to revisit its recommendations about the shape of the financial systems.

The Nature of Assets Purchased: A Backstop?

Through TARP, Treasury has a specific authorization that could allow it purchase insurance company assets and state bonds in manner similar to that of a federal backstop[vii]. In fact, so long it has stability implications (a phrase largely left undefined), the federal government can do what it wants when it comes to purchasing assets. The language is incredibly broad. Treasury, indeed, can purchase:

> Any other financial instrument that the Secretary, after consultation with the Chairman of the Board of Governors of the Federal Reserve System, determines the purchase of which is necessary to promote financial market stability, but only upon transmittal of such determination, in writing, to the appropriate committees of Congress.[viii]

Since the phrase "financial instrument" has no definition in ESSA's opening list of definitions—it gets mentioned only in the section quoted above—*anything* is fair game. (Dictionaries typically define "financial instrument" as anything with monetary value or anything that records a monetary transaction.) Hardly anybody would dispute that this section lets Treasury purchase reinsurance and retrocession contracts, catastrophe fund bonds, policies from FAIR/Wind/Beach plans, and books of business from primary insurers. All of these things—except the last--are components of proposals for national backstop proposals that have passed the House of Representatives.[ix]

For example, if a major national property and casualty insurer, a state mandated residual market mechanism, or a large reinsurers were to become insolvent following a disaster, the potential disruptions would certainly threaten economic stability. It seems highly likely that Treasury would then use this authority to purchase bonds, provide liquidity, or otherwise keep the insurance market "stable."

The consequences of ESSA, however, will not be the same as the consequences of most Federal backstop proposals for at least three reasons. First, all but a few very large insurers could collapse in isolation without any "structural" consequences that would be expected to cause the Treasury to intervene. Second, events short of collapse with serious market implications probably do not rise to the level of structural stability as policy makers would define it: if a major property and casualty insurer had to sell a profitable life business or put a single-state "pup" into bankruptcy following a disaster, then structural stability probably would not be impacted and Treasury would not intervene. Third, and perhaps most importantly, the "backstop" exists only by implication. While some insurers might cut their rates, purchase less private reinsurance or see decreased risk (particularly timing risk) as a result of an explicit backstop mechanism, the new-found ability of Treasury to serve as a lender/securities purchaser of last resort for insurance will not change any calculations within the private insurance market. There will be no separate agency and no separate budget for the any insurance stabilization or "backstop" program Treasury might administer through TARP. No competently managed insurer would risk its capital and survival simply because the Treasury has the ability to buy bonds following an enormous disaster. On the other hand, insurers that have supported a backstop at the $200 to $300 billion level could find themselves satisfied by the authority provided under ESSA. The law's provisions would very likely result in backstop-like activity were two Katrina-like hurricanes to strike the United States during the same year. In this sense, it may have ongoing support from some elements in the insurance industry.

The Office of Stability: More Federal Insurance Oversight?

In its opening sections, the Act establishes a new "Office of Stability" within Treasury to administer TARP.[x] Although the bailout itself will end at some point, the Office itself appears permanent and the nature of the bailout suggests it could create an opening for some federal regulation of insurance companies for anything Treasury thinks is "structural." This would include certain insurance business activities.

The office's structure seems to insure its long-term existence. Under the legislation, a presidentially-appointed, senatorially confirmed Assistant Secretary will head the Office. Throughout the legislation—as is common practice in federal laws—the Secretary of the Treasury (rather than the Assistant Secretary in charge of the office) receives all of the actual power under the law and then can delegate it. It's quite likely, however, that much of the day-to-day authority will go to the office's new head. Since presidents are loathe to give up appointments, furthermore, the Office itself will very likely outlive the bailout.

If another future bailout with significant insurance implications were to become necessary—the simultaneous collapse of several large insurers, for example—it's likely that the Office of Stability would emerge as the logical default federal insurance regulator. Even if this never happens, the economic importance of insurance suggests that the Office, will, at least, study insurance-related matters. Given that the federal government does almost nothing to study insurance right now (the FTC is banned from doing so), it seems likely that the Office of Stability will do more research and reporting on insurance issues than the federal government does now. The Office wouldn't have even the modest sway of the proposed "Office of Insurance Information" but it seems undeniable that it would employ at least a few staff who dealt mostly with insurance—something Treasury does not currently do.[xi] Although the Office won't regulate insurance day-to-day, but its existence does raise the specter of more federal insurance oversight.

Reports

The Act also requires Treasury to make several reports. One, a "Regulatory Modernization Report" seems to have particular potential significance to the insurance industry.[xii] The full language of the section authorizing the report reads as follows:

> (c) Regulatory Modernization Report- The Secretary shall review the current state of the financial markets and the regulatory system and submit a written report to the appropriate committees of Congress not later than April 30, 2009, analyzing the current state of the regulatory system and its effectiveness at overseeing the participants in the financial markets, including the over-the-counter swaps market and government-sponsored enterprises, and providing recommendations for improvement, including—
>
> > (1) recommendations regarding—

> (A) whether any participants in the financial markets that are currently outside the regulatory system should become subject to the regulatory system. . .

Although certain aspects of this report—over the counter swaps and GSEs—have only tangential relevance to the property and casualty insurance business (they have great impact on insurers' investments), the report does seem to imply a mandate to look at insurance issues. The report's authors, for example, might well find a discussion of primary insurers and an optional federal charter germane since these insurers are almost certainly the largest entities "outside of the federal regulatory system." In fact, language does appear broad enough that the authors of the report could, if they wanted to, use it as an opportunity to revisit many of the recommendations in the Bush administration's "Blueprint For a Modernized Financial Regulatory Structure" and propose measures that would impact all insurers.[xiii]

Conclusion

ESSA appears to establish the possibility of a federal backstop, may increase federal oversight of insurance, and could lead to the revisiting of some of the Bush administration's recommendations for on Optional Federal Charter.

It's difficult to say if the Act will have positive or negative implications from the standpoint of those who favor a free market for insurance. Nothing in the law mandates that the government use TARP like a high-level national catastrophe fund, give the Office of Stability Regulation any responsibilities related to insurance, or address insurance in its regulatory modernization report. The most important consequences of the Act for property and casualty insurance markets will likely become apparent only when Treasury moves to make use of the vast powers EESA grants.

Notes

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[i] Public Law 110-343. It was known as H.R. 1424 prior to enactment. This paper focuses only on the Emergency Economic Stabilization Act itself which was known as "Division A" of the bill. Not the other sections of the bill. At thomas.loc.gov the final text of the bill discussed is H.R. 1424.ENR. (The version actually enrolled for signing.)

[ii] PL 110-343, Sec. 101.

[iii] Ibid, Sec. 102

[iv] Ibid, Sec 124

[v] Ibid, Sec. 111

[vi] Ibid, Sec. 113 and 134.

[vii] P.L. 110-343 Sec. 3 (5).

[viii] Sec (3)(9)(B)

[ix] H.R. 3355 (2007)

[x] P.K. 110-343 101(a)(3)(A).

[xi] H.R. 5840.

[xii] Sec 105 (c)(1)

[xiii] Department of the Treasury, “Blueprint for a Modernized Financial Regulatory Structure,” March 2008, http://www.treasury.gov/press/releases/reports/Blueprint.pdf.