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Facts About the AIG Collapse: A Response to the NAIC

An Optional Federal Charter *Might* Have Impacted AIG's
Situation

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Following the collapse of insurance industry giant American International Group (AIG), the National Association of Insurance Commissioners issued a statement—quoting NAIC president Sandy Praeger—urging that the “conversation should stay focused on the facts.” This is a laudable purpose. CEI, in forwarding its educational mission, would like to help clarify these facts.

In its released statement, NAIC takes two major insurance trade associations to task for bringing forward the idea that the AIG collapse justifies the idea of an Optional Federal Charter (OFC). NAIC makes a valid point: AIG's collapse does not *prove* that the United States needs federal oversight of insurance and there's no way to know for certain if a federal charter would have done anything to prevent the insurance company's collapse. (The insurance trade associations, however, have never definitively said that it would have.) Nonetheless, remaining focused on the facts requires an appreciation of those facts. And NAIC, in many cases, tells only part of the story. An analysis of many of NAIC's key statements follows.

NAIC: “Although AIG is generally known to the public as the world's largest insurer, in truth, AIG is a financial services conglomerate.”

Analysis: **NAIC is correct but the point it makes is meaningless.** Almost all major property and casualty insurers sell life insurance and investments. Several operate banks. Others have subsidiaries, parent, and sister companies in just about every line of business under the sun. All insurers, furthermore, engage in a variety of investments. Although bigger than its competitors, AIG's major consumer-facing businesses—automobile, homeowners', and life—were pretty similar to those of other insurers. No two companies have exactly the same business and product mix but *some* state-regulated insurance company is a major player in every line of business that AIG entered. In short, AIG is a financial services conglomerate but so are many other major insurers.

NAIC: “The 71 state-regulated insurance entities are not the problem. They are all financially sound — or, in insurance regulatory terms, “solvent” — and fully able to pay claims presented by policyholders and claimants.”

Analysis: **Unless NAIC has completed its own detailed audit of each of the 71 state-regulated insurance entities nobody knows if they really are solvent or sound.** The NAIC likely based its statement on the basis of the best publically available information and, most likely, the subsidiaries will survive and pay claims. But it’s possible that they could have yet-undiscovered problems. On September 23rd, the Federal Bureau of Investigation announced it was investigating AIG for fraud. (No concrete evidence of fraud has yet appeared.) It will take a complete review of the companies’ balance sheets to know if every AIG subsidiary actually remains solvent.

NAIC: “The problem lies with the AIG financial holding company that is subject to federal regulatory oversight by the U.S. Office of Thrift Supervision (OTS). The AIG financial holding company took on more risk than they could handle when investing in collateralized debt instruments, such as credit derivative swaps on mortgage-backed securities. It is important to note that these types of investments are financial products, not state-regulated insurance products. When the U.S. housing markets experienced a downturn, these risky investments lost lots of money for the AIG financial holding company.”

Analysis: **NAIC accurately describes the reasons why AIG failed but no federal agency really oversaw the company *in toto*.** Nobody, except the company’s own executives oversaw the stability of AIG’s entire business. But, given that most insurance companies are in a wide variety of businesses, there’s little reason to think that any one entity could or should oversee all of a company’s activities. NAIC’s argument is a red herring. An OFC would not put all of its activities under one umbrella but neither does the current system.

NAIC: “Even if there was [sic] an optional federal charter for insurers, and some or all of the 71 U.S. based AIG insurance entities had selected to be regulated by the federal insurance regulator, the problem at the AIG parent company level would not have been prevented.”

Analysis: **NAIC is dead wrong about the substance of the current legislation.** The National Insurance Act bills before the House (H.R. 3200) and Senate (S. 40) would subject all of a holding company’s operations to a degree of federal oversight if *even one* subsidiary is federally-regulated. It’s impossible to know if this type of oversight would have prevented the collapse of AIG.

NAIC: “Even throughout the AIG financial holding company’s liquidity crisis, consumers remained protected by insurance regulatory rules that prevented the parent company from simply raiding capital from its profitable and well-capitalized insurance subsidiaries. A coordinated effort by the nation’s insurance regulators ensured that no policyholder assets were used for any part of this transaction.”

Analysis: **At least one state insurance regulator—the single most important one from AIG’s perspective--was ready to authorize a raid on the company’s property and casualty insurance subsidiaries.** On September 14th, New York State insurance superintendent Eric Dinallo and Governor David Patterson announced that they were “giving AIG, in effect, the ability to provide for a bridge loan to itself” from its own property and casualty insurance subsidiaries. Had this asset raid taken place—and the current action avoids it—it might well have resulted in a collapse of AIG’s ability to pay claims. In other words, the rules would have protected consumers, but at least one state, New York, seemed willing to bend them for AIG. *Without federal intervention, the state regulatory system could well have impacted AIG’s solvency.*

NAIC: “There is no reason to believe that an optional federal charter for insurers would have done anything to address this problem. Remember: AIG is a federally regulated financial holding

company that took on excessive risk and is suffering the consequences of its poor judgment. Because this financial holding company is not an insurer, it would not have been regulated by a federal insurance regulator, if there were one.”

Analysis: NAIC is working on an incorrect premise that a federal insurance regulator definitely would not have *had the ability to prevent* AIG from going under. That’s a far cry from saying that a federal regulator would have done so; in fact, such a contention is equally hard to support. A federal regulator could have fallen down on its job or it could have actually not had the ability. Since no regulator exists, it’s impossible to say anything definitively what a federal regulator would or would not have done.

NAIC: “The solution lies in not adding more regulation by either the states or the federal government — but, rather, in making the markets for these risky securities more transparent so that the buyers of them know about the underlying elements of each bundled security that they are purchasing. . . [The country should consider creating] a transaction platform where market participants — as well as state and federal regulators — have access to view the disclosures and the transaction details.”

Analysis: NAIC is proposing significant new regulations despite denying that it has done so. NAIC has not outlined what this new “transaction platform” would look like but, as described, it sounds like it would involve significant new regulations and changes in the way the country deals with securities. It may or may not be a good idea but the collapse of AIG does not provide a compelling reason why we should do it. If

NAIC: The reason for the financial difficulties was the lack of understanding, through lack of transparency, by the AIG financial holding company regarding the financial instruments they had purchase. . . [regulators should consider] restrictions on derivative activities; limits on high concentrations in investment types; and appropriate minimum capital and surplus requirements.

Analysis: NAIC is doing what it accuses the trade associations of doing and pushing a largely unrelated agenda as result of the collapse of AIG. Some or all of these steps may not turn out to be good ideas but it’s impossible to know for sure if any of them would have prevented AIG’s collapse from taking place. Some of them, indeed, could have exacerbated the situation. Nonetheless, they still deserve careful consideration.

Conclusion

NAIC makes a valuable, valid addition to the debate. The organization’s ideas deserve careful consideration and may have helped prevent the collapse of AIG. The debate over an OFC does have a relation to the discussion of the collapse of AIG. OFC deserves consideration and reason exists to believe that it might have impacted AIG’s collapse.