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## Session 46SM
## The Issues of Financial Modernization


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**Recorder:** CRAIG R. RAYMOND



*Summary: This breakfast includes a very brief session business meeting, followed by a speaker who will address some of the current key issues in financial reporting.*


**Mr. Craig R. Raymond:** I'm very pleased to have Gary Hughes who is the Chief Counsel of the American Council of Life Insurance (ACLI) here to speak with us. Gary has been with the ACLI for about 20 years. Prior to that he was with the Federal Commerce Commission (FCC). Currently, he spends most of his time working on Securities and Exchange Commission (SEC) issues or equity product issues. He works with one of the hottest topics these days, regulation of the financial services industry. Gary is going to give us a little feel for some of the things that are going on.

**Mr. Gary E. Hughes:** As Craig said, one of the things that I've had the dubious distinction of working on for quite a number of years is the whole issue of banking regulation, financial reform, or, the current buzzword, *financial modernization*. For years and years and years, this was always sort of code for bank deregulation because it was the banking industry that felt that many of us were infringing on their turf. They'd lost short-term lending to the commercial paper market. They're looking for fee for services. The mutual funds were doing money management accounts. I think the banks really felt put upon. One of the great ironies is the insurance industry and the securities industry put laws on the books in the late 1970s and early 1980s to really try to keep banks out of their business.

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A very protectionist attitude existed back then. We find, as insurance companies, we are being kept out of the banking business because of those laws we put on the books. The laws seem to be pretty porous going the other way. Banks have made huge inroads into the insurance and securities markets, which has mainly been accomplished through the decisions of federal bank regulatory agencies. Most of those decisions were sustained by the courts, and even by the Supreme Court. In the insurance industry and the securities business, we find that we really want financial modernization legislation. The banks are kind of waiting in the tall grass saying, "Well, if it happens, it happens, but this is not something we need all that badly. Regulators have been good to us. They tend to give us these broadened powers without strings attached that you usually find in Congress." There has been a pretty significant turnabout. All of this is very important because you have great consolidation in all of these various segments of the financial services industry. I think everybody is seeing that there is a big shakeup going on. There are going to be survivors and others. How the laws work, who can do what, and how it's regulated over the next five, ten, or 20 years is going to be very important in deciding how all of this comes out.

In September 1996, the ACLI Board of Directors reversed decades of policy. For the first time, it said that it would support opening up its business to banks. It would permit banks to buy insurance companies and control them, and it would permit insurers to control banks as long as there was some rationalization of the regulatory environment in which we all operate. The ACLI Board developed a ten-point policy position. The notion was we'll agree to open up the businesses as long as these ten points are met. The points weren't intended to disadvantage banks, but to ensure that there was fair competition and adequate regulation. At that point, I think there was really a degree of optimism that, for the first time, Congress might actually be able to get this legislation done.

About ten years ago, Jake Garn of Utah was chairman of the Senate Banking Committee. He said something that I found very offensive at the time. It was something along the lines of, "In this whole area of financial services, the best Congress can do is rubber stamp what the marketplace has wrought." I thought he was terribly wrong because it seemed that of all areas, this is one where perhaps Congress ought to lead and lay down logical and rational rules of the road that everybody would follow. Over the years, I didn't agree very much with what Garn said, but I've come to believe that he was exactly right on that count. The interest groups and their political power is so immense that anybody can really block legislation. Today, Congress has basically rubber stamped what has already happened.

We did a study about one year ago, which I think prompted the ACLI board to change it's policy. It took a look at where we were ten years ago, where we are today, and where we might be five years from now. Ten years ago, banks had some small town insurance sales authority. Not that many banks were selling insurance. No banks were underwriting insurance. I don't even think the nonbank bank phenomenon existed so you really didn't have any insurance companies owning banks. A few insurers owned thrifts, but that was not a big deal. You had industries that were truly segmented. Then you look at where we've come today. Virtually every bank that wants to sell insurance can do it and can do it very broadly. It can do it without geographic limitation. We've seen things like the retirement certificate of deposit (CD) where it has been clear that federal bank regulators were more than willing to let banks perform, as a banking function, the manufacturing or underwriting of something that looks something like an annuity product. They are willing to let that happen. I think they would prefer to see that happen without any degree of state oversight.

We've seen a couple of banks, such as Citibank, have a full-blown insurance company. It's a full-service underwriter. We've seen a phenomenon lately where insurance companies have been buying thrifts somewhat for defensive purposes, but some of them have some ideas on how to use them. Things haven't been standing still. The marketplace has not been static. As banks look for fee income and as insurance companies look for distribution channels, the affiliations, at least on the sales side, have been taking place. I think companies have found themselves more comfortable with this potentially bold new world, at least as it pertains to career agents. That has been one of the impediments to this legislation. I think agents, and in some instances rightly so, feel very threatened by what's going on. But when the ACLI looked at this, it believed that it really is time to change policy. Back in 1983, the ACLI Board recommended opposing all of this. The message was, “Buy us time.” At that time the Board said, “Buy us five years so we can figure out what to do with all this.” We got them 13 years. I'm not sure whether many companies have figured out what to do yet, but the time has come.

As we look down the road, and at this project we did last year, it would seem that things have come a long way. The trend wasn't likely to stop. One of the more intriguing things that the controller of the currency has are final rules—bank operating subsidiary rules. The controller has come up with the notion that says that a bank's operating subsidiary can do things that the bank itself is prohibited from doing. It's kind of an interesting concept of just where do they derive that authority. Nevertheless, the innovative bankers are figuring that, through operating subsidiaries, if Congress doesn't constrain them, banks can do probably insurance, underwriting and securities underwriting. We would still be prohibited from

engaging in full-service banking because of those protectionist laws that are on the books.

When the ACLI board looked at all of this, it felt that the time had come to change policy. We were pretty optimistic that as our policy shifted, and I think virtually all the other major insurance groups shifted with us, we found ourselves looking at a financial services arena where all the major industry groups, except a couple, were saying, "Let's see if we can get it done." It's not quite a rubber stamp for Congress, but it is pretty close to it.

As Congress took up legislation in January, the sense of optimism faded pretty quickly. There were three main factors that served as impediments to this legislation. I touched on one earlier. Banks weren't really that interested in legislation. They've done very well with the regulators. They were worried that if Congress gave them broader powers, there would be a lot of constraints imposed on those powers. They've done very well in court on insurance sales issues. They've done very well by the regulators in broadening their securities underwriting activities. Rules were sitting there and they figured insurance underwriting wasn't too far away. Throughout the process, banks have been kind of standing back from this and saying, "Well, if it's a dream bill for us, yes, we could go along with it. If it's not, maybe we ought to oppose this." The one thing banks want is to merge the bank and thrift charters. I think banks paid $12 billion to help pay off the debt that accrued from the thrift crisis. They think they have a deal with Congress which is, if the banks pay the $12 billion, Congress would eliminate the thrift charter. The thrift charter has some advantages over a bank charter, and the banks simply wanted to eliminate that. That's their one big ticket item. As important as that may be to them, they don't want to pay too high a price to get that.

There is a second element that has been somewhat of an impediment. Banks seem to be increasingly unwilling to submit to unqualified state regulation of their insurance activity. I think that's a view that largely originated on the sales side. As many of you know, the agents have been successful in getting legislation enacted in a number of the states. It's couched in terms of consumer protection. And I'm certainly not saying that it isn't consumer protection legislation, but it does constrain the ability of banks to sell insurance products. There are limitations on who (tellers, loan officers or others) can be licensed in a bank. The insurance function has to be physically separate from the loan function. There certainly are legitimate concerns for which banks will use their credit leverage to tie the extension of credit to the sales insurance products. Those are the sorts of things that the agents have been concerned with. The banks feel that if there is unfettered authority vested in the states to regulate insurance sales, they are going to encounter legislation that's going

to be unduly restricted in this area. Certainly, there are insurance companies with distribution through the bank channel that have some of the same concerns.

What is interesting is we've seen the concern spread from a sales context to the underwriting context. A number of banks are saying that if we control a bank, even as a subsidiary of the holding company, we don't want that bank to be subject to any state rules, laws, and regulations that significantly interfere with the insurance company's operation. With a two-tiered system of regulation, those insurance companies that are affiliated with banks might say to the states, "Hang on. We're functionally regulated by you, but you can't impose these regulations or valuation laws on us because that's significant interference and you're preempted by operation of federal law." We're very concerned with the view that banks seem to have on unfettered regulation of companies. Our view is as long as you say there should be no discrimination, the state shouldn't be able to regulate a company any differently than anyone else simply because it's affiliated with a national bank.

Banks are unwilling to voluntarily give up the tools that have enabled them to make so much progress in gaining new power. There are two tools. One is preemptive authority and the other is judicial deference. Preemptive authority is fairly clear. There are some of the federal banking statutes that would give the federal bank agencies the ability to preempt state laws that conflict in any way, shape or form with the powers that they give national banks.

Judicial deference is a little more vague, but probably even more important and that says anytime there is a conflict between a state and a federal regulator and you go to court to resolve it, the courts, mainly because their dockets are so full, will look at the pronouncement of a federal regulator. If the statute was unclear on its face and the regulators pronouncement somehow falls within the realm of reasonableness, the courts defer to the regulators. They don't look at the issue on the merit.

We've seen some insurance sales decisions on which the state and the controller of the currency have differed. Some of you may be familiar with the *Valet* case where the court concluded that, for sales purposes, fixed and variable annuities were not insurance, at least for purposes of the National Bank Act. It is sort of a threshold thing that I think makes many of us uneasy. There is a reasonableness test there. How are these products really being sold? Are they being sold as protection or are they being sold for tax-deferred investments? I think you can answer that question. The court looked at it and came to a reasonable conclusion. They said, "When the controller says that these products really aren't insurance, they are a financial instrument that meets the reasonableness test." So judicial deference is a very critical point here from the perspective of banks and their regulators.

Maybe a fourth element in this is companies and agents have not been working as closely in this legislation as they have in the past. That really is more a factor of companies being more comfortable with an affiliated financial services environment than the agents are. The agents are still, I would say, a bit more protectionist than the companies are. The agendas in Congress have been a little bit different, and we haven't been working all that closely together.

In spite of all these differences, the House Banking Committee passed a bill in June that was a fairly good first step, at least from our perspective, in resolving a lot of these issues. I can briefly touch on some of the key provisions in that legislation that at least are important from our perspective. One was a definition of insurance. The federal banking agencies have been saying that if a bank does insurance, it has to be subject to state rules and regulations, but annuities aren't insurance. Fixed annuities aren't insurance. Variable annuities aren't insurance. The retirement CD, an annuity hybrid, isn't insurance. Sometimes I wonder if one day they are going to say that whole life insurance is a form of now accounts and it's not insurance either, but that's the game that the controller has been playing to great effect.

Our view was, if we're going to have true logical, functional regulation, what we need is a workable definition of insurance. Then, if Congress does lay down rules of the road and says, "All right, National Bank, if you want to sell or underwrite insurance, here's how you do it," we don't want to have the controller saying that all of these products aren't insurance and you don't have to abide by those rules. It has been a very controversial point. What is somewhat ironic is the banks are concerned that the state will overreach and sweep things into their definition of insurance. We find that a bit amusing since it has been the controller that has been taking the aggressive position. Nevertheless, banks are very concerned, especially when they look at the definition that was in the bill that the Banking Committee passed which we kind of liked. It said that insurance is whatever the states say it is. That was really the essence of the definition. Bankers looked at that and, I suppose, were a bit worried that the states might overreach.

The legislation also eliminated judicial deference by saying if there is a dispute between an agency like the controller of the currency and a state, it should be decided on the merit. In a modernized financial environment, that seems like a reasonable position to take; however, every inch of that has been won over the strenuous objections of the banking industry and its regulators.

An issue that I assume many of you have heard of that's very important in this legislation is having the ability of mutual life insurance companies to re-domesticate. When the ACLI board changed its policy positions, the one group of CEOs that were very uncomfortable were those heading mutual companies. If the

issue is having the ability to diversify and have capital to make those diversifications and to participate in the consolidation of the financial services industry, the mutuals perceive themselves at a distinct competitive disadvantage, not only in inability to get to the capital markets, but in diversifying at the holding company level. Their big concern was, to some extent, we can diversify directly downstream, but you immediately run afoul of quantitative investment limitations. It creates a pretty big hit on risk-based capital, accounting treatments for goodwill, and so on. Their view was, "We really have to get this done at the holding company level, or we can't be effective competitors." The long and the short of all of this is the ACLI came up with the notion of having a federal provision—I guess what I would call it is federal transportation—that would say that any mutual insurance company can get from a state that doesn't have a mutual holding company statute to one that does. It has been very controversial in that the provision would preempt any interference from the state that the company is leaving. It would also preempt the extra-territorial application of state law so that if, for example, New York wanted to approve the actual reorganization in mutual holding company form of somebody doing the transaction in Iowa, they would be prohibited from reviewing and approving the transaction. The National Association of Insurance Commissioners (NAIC) and the states generally now support the concept of mutual holding companies because they've been very antagonistic toward the federal transportation, but we just spent virtually all of yesterday negotiating with a group of Republicans and Democrats, and I think we worked our language at least for the next round of legislation. Suffice it to say that's a critical provision from the perspective of the mutual segment of our membership.

The legislation in the Banking Committee was surprisingly silent on the question of insurance sales by banks. That has always been a tough nut to crack and nobody has ever been able to find even the most innocuous language that can receive the support of both insurance agents and banks. I'm not sure that language exists. There is some language in the bill that would codify current federal guidelines dealing with insurance sales. It deals mainly in the area of disclosure and with such issues as a practical, physical separation on the bank premises when people in the bank are selling insurance, a consumer grievance process, a consumer acknowledgment that certain disclosures have been made. It is not terribly significant stuff, but that was about all that the House Banking Committee could deal with.

One of the major issues and one that is not working out well for us is the role of the Federal Reserve. As many of you know, Alan Greenspan, and possibly every one of his predecessors have felt that they are responsible for anyone that owns a bank. It's a payment system issue. It's an integrity of the banking system issue. That wasn't such a big problem when all bank holding companies did was control banks.

Now you're going to have financial holding companies. It may own an insurance company, a securities firm and a bank. The Federal Reserve Board is saying, we must be the umbrella regulator because we have to protect the integrity of the overall financial system. You find some very interesting things taking place. What happens if the mutual insurance company buys a bank? By definition it's a bank holding company. The Federal Reserve Board then asserts that it has the authority to impose capital requirements on that bank holding company/operating life insurance company.

The states have been very worried about what I would call some minor preemption issues. We have had a very difficult time getting them to really focus on the major displacement that they could suffer at the hands of the Federal Reserve Board. The Federal Reserve Board has this whole view of what's called *source of strength*, which means that all the components of a financial holding company system have to come to the aid of the federally insured institution: the bank. We were at least able to get language in these bills that says, "but the state can always say that those provisions aren't enforceable if it would jeopardize the financial integrity of the insurance company." But I really don't think that the states have enough authority, certainly the authority that they need, to be an effective regulator in an integrated financial environment. The Federal Reserve Board has more than enough and the states, I don't think, have nearly enough. I think that's one area to which the states are going to have to pay increasing attention, or they are going to find themselves the odd man out among financial regulators.

The last issue of banking and commerce is a terribly fractious one. There is a notion that you can mix banking with other forms of finance (insurance and securities), but the world will end if you mix banking with other forms of commerce. You can't let Bill Gates buy a bank, but it's all right for any large financial institution to control a bank. Most of the bills provide at least some relief. There is a 15% leeway provision so that if an insurance company at the holding company level has some commercial operations, like a communications arm, it could keep it while still affiliating with a bank as long as the commercial activities didn't exceed 15%. I think the test is based on gross domestic revenues. The commerce committee that's currently considering the bill was much more restrictive; it would only grandfather those situations. You couldn't grow your commercial arm. That's one of the very controversial issues in this whole legislation.

When the Banking Committee finished this bill, it had a sequential referral to the Commerce Committee. We have done quite well on the Banking Committee, which is enemy territory for us. And we got over to the Commerce Committee and we figured now we can tidy up the loose ends and come out of this with a pretty

good bill, but we weren't even close on that one. The political calculus in the Commerce Committee was the insurance industry is desperate for legislation and the support of the banks can be bought. We'll gut the insurance provision. The insurers will still support the bill. We'll give the banks everything they want and they can get on board. Neither of those things happened. The insurance industries weren't particularly pleased with their gutted bill, and the banks still didn't give the legislation their support. In one of the great turnabouts, the insurance industry, which was really supporting this, got together and pulled the whole process down on the Commerce Committee. The bill didn't have a definition. It was a disaster. We were able to have the Commerce Subcommittee on Finance and Hazardous Materials, known as cash and trash, recently put a somewhat improved bill on the table and it passed. It could go to the full committee very soon. We did much better with that bill.

Let's go through a brief scorecard on how we came out of this cash and trash subcommittee. We got in a definition of insurance, which was sort of an interesting piece of this legislation. Banks had some legitimate concerns about what came out of the Banking Committee and, as I said, insurance is whatever the states say it is. They weren't comfortable with that, and we were willing to tighten that up a bit. We entered into some negotiations with some individual banks to see if we could work something out that treated everybody fairly. What we ultimately came up with was a federal definition that reads like this: anything that the states regulated as insurance as of January 1, 1997 is insurance. That takes existing products off the table. Those retain their character as insurance. New products, such as those first offered after January 1, 1997, have always been the difficult area because you don't know what to do with the innovative hybrids? Is it banking or is it insurance? The definition says that those new products will be insurance if a state determines that it should be regulated as insurance. There's a long laundry list of traditional insurance categories or functions. You would expect to see a laundry list on life, property and casualty, and health. Then there is an exception to that paragraph. Again, this is all for new products. It says, "except if the product is" (and then there is a laundry list of traditional bank things) "a deposit, a loan, a letter of credit, a financial guarantee." If it's any of those things, it comes out of the definition of insurance and it becomes banking.

And then as only lawyers can do, there's an exception to the exception. This is where we finally made a breakthrough. Let's take the case of the retirement CD. It's treated elsewhere in the definition, but it's a good example to run through. Let's say that that came out in it's first offer after January 1, 1997. It's a blend of a deposit and annuity, so what is it? Because it's an annuity, it fits into the traditional laundry list of what's insurance. So far the insurance guys have it. Then you say it's a deposit, which, in part, it was. That means the banking guys have it. There's also

an insurance component in it that's defined as an annuity in Section 72 of the tax code; it goes back on the insurance side of the ledger. That's the way this is supposed to work. What is interesting is the banks were willing to agree to that. They said, "Look, we've never tried or asserted that products that have actual insurance tax treatment are banking and should be underwritten in the bank."

Trying to work this out was probably one of the most testy experiences that I've ever had in my life. There are a group of us that do an annual golf trip down to Myrtle Beach. These negotiations came right in the middle of this trip, but I had my priorities straight—I went on the golf trip. About nine o'clock one evening I get a phone call from a bunch of banks and they are saying there are some real problems. The conversations went on and at about 1:30 a.m., my nerves were frayed. We were still negotiating this. A colleague of mine was on the phone in the kitchen of the condominium where we were. I was pacing around and was getting pretty agitated. Somebody said something that pushed me over the edge, and I ran out of patience. So I swept up all the papers on the counter right out from under the nose of my colleague and I took them back into my bedroom. I could hear him very calmly saying on the phone, "I'm sorry you're going to have to read that to me. Gary has taken all the papers, locked himself in the bedroom, and he won't come out." It's close to the truth. We did get through it and that was a major breakthrough. I think that was the reason that we were actually able to get through the cash and trash subcommittee.

The elimination of judicial deference is still good in the current version. The structure for insurance underwriting is sort of interesting. The way it works in both the Banking Committee and the Commerce subcommittee bills is if a bank wants to underwrite insurance, it can't do it in the bank or in a subsidiary of the bank. It can only do it through a holding company affiliate. This was intended to do two things. One was to facilitate functional regulation. Anything that is in the bank or downstream of the bank is clearly within the purview of the controller of the currency. There was a great worry that no matter what Congress did, the Controller would assert some authority, if not to preempt, then to say that he is the final arbiter of solvency issues and so on.

The second point was the whole question of quantitative capital. You might have a better idea of whether the problem really exists, but a number of our Board members felt it did. Many people feel that banks, because of the federal safety nets, mainly deposit insurance and their access to the Federal Reserve discount window, have an inherent advantage in capitalizing activities. The fallout was if they are doing banking, that's not a problem, but if they are capitalizing on nonbanking things, like an insurance underwriter, they would have an unfair competitive advantage. If you can push that activity upstream of the bank into the holding

company, you have minimized that advantage. There has been a great debate raging in Washington over whether there is such an advantage. The Controller of the Currency and the Federal Deposit Insurance Corporation (FDIC) and the banks are all saying there is no such thing. There may be some growth subsidy due to the federal safety net, but it's more than offset by the cost of bank regulation. Then you have Alan Greenspan that weighs in, who says, "Not so. There's this thing called sovereign credit. It's a direct result of the federal safety net; therefore, things ought to go up into the holding company." If you step back and read between the lines, everything up in the holding company is within Alan Greenspan's jurisdiction. Anything downstream is in the Controller's jurisdiction. I think a lot of this is more about federal regulatory turf than it is about practical issues. In any event, banks can only underwrite insurance upstream at the holding company level, although insurance companies can control banks either upstream or downstream.

Functional regulation of insurance by the states is sort of an important point for companies and agents alike. The treatment is fairly good in the current bill, although there is one element in it that would say that any state regulation, even of companies, will be preempted if it significantly interferes. We are particularly concerned with that as it would apply to companies. I mentioned to you that any language dealing with an insurance sale seems to be controversial. Here is the statutory language that was put in at the request of the insurance agents: "Insurance sales by any person shall be functionally regulated." Banks hate it, but I'm not sure why. The best explanation I heard was that they don't know what it means and there's going to be litigation.. I think what happened is that the deal to put that language in was cut between the Chairman of the Cash and Trash subcommittee, Representative John Dingell (D-Michigan) and the agents. If I were a banker, I would probably react the same way. I'll have to read it. All I know is when I see those people listed, I'm not going to like it.

Mutual company re-domestication was broken as of the results of negotiations. I think that has been largely fixed. The full Commerce Committee is expected to discuss this legislation in a few days. I think we have a deal to perfect the mutual insurer, re-domestication language. I mentioned the commercial basket in the Commerce Committee is not acceptable. Any of you that have commercial operations at the holding company level wouldn't like that language. Insurers downstream and commercial investments are protected. At one point, there was some question that if an insurance company bought a bank and had a great deal of commercial investments in its portfolio, would there be a problem? The answer is no there wouldn't be a problem. The role of the Federal Reserve Board in that legislation is still a problem. There's way too much federal involvement and way too little authority of the states to regulate.

The general political outlook is I think the Commerce Committee will successfully mark legislation up in a few days. Congress is supposed to adjourn either the first or second week in November. It's probably unlikely that even if the Commerce Committee acts on this legislation, it would have to go to the Rules Committee, which would take the Banking Committee version and the Commerce Committee version and figure out how to put them together. Then the Rules Committee will send that to the House floor. If it gets to the floor, I think there is a good chance that it would pass this year. There is no chance for Senate action. That will come in the next session of Congress in 1998. I think it may happen. It's almost at the point where Congress just has to rubber stamp it. As I mentioned to a couple of groups recently that my youngest daughter is 11, so I'm in no hurry to see this thing wrapped up because I have college tuitions to pay. I could have made a career out of this. In any event, that should give you at least some sense of where things stand currently.

**Mr. Raymond:** I constantly read these articles in the paper about what's going on in banking and my eyes start to gloss over.

**Mr. Hughes:** So do mine.

**Mr. Raymond:** I have a tough time understanding them. Now I know that whenever we make progress, it's because Gary locked himself in his room. I'm starting to understand how this process works.

**Mr. William Duncan Rusk, Jr.:** I was wondering what laws are the banks currently subject to as far as valuing the insurance that they had sold?

**Mr. Hughes:** Sold or underwritten? What banks are doing now is simply selling the products that life insurance companies manufacture. I mean, they are just acting as a retail arm to someone else's wholesaler. So, they just realize a fee for doing that. For example, the Citicorp underwriter is treated and regulated just like any conventional insurance company that is fully subject to state law. Citicorp is about the only example of a bank underwriter with the expectation of some credit insurance. At least right now, you have full functional regulation. Whether that can hold is another question.

**From the Floor:** Gary, I just want to clarify something. You said that the mutual company re-domestication was fixed. I'm not sure that everybody will have the same idea of what fixing that means. I assume that means it's back in the legislation.

**Mr. Hughes:** It has always been in. Two things happened as it progressed along. One, in the Commerce subcommittee, the Democrats inserted five, what I call, federal minimum standards. It wasn't clear how they were supposed to operate. Some of them just could not have worked. For example, one of them said if you're doing an initial public offering, after you've gone through your reorganization, you can't use the federal transportation to get to a state whose mutual holding company statutes do not provide that the insurance department would determine fair value for an initial public offering (IPO). I don't know how you do an IPO if you have to turn around and go to the insurance department to get them to make a pronouncement on the price of the IPO. It wasn't clear how these minimum standards worked. Some of them clearly didn't work at all. The solution was to go through them and convert them from federal minimum standards to standards that the company's plan of reorganization would have to have. We spent all day doing that, and we restored a preemptive provision that says that only the mutual company's state of domicile (whether you re-domesticated to that state or have always been there) has the authority to approve the actual reorganization. This would cut off the extraterritorial approval of plans of reorganization. Those were the fixes.

**Mr. Kenneth W. Faig, Jr.:** If the net result of the changes in the regulation of insurance is a dual system with a federal regulator, with all financial reporting on a generally accepted accounting basis, what would your prognosis be for the ability to continue to do a nationwide business in insurance based on a state charter and statutory recording. I would cite the case of a mature mutual with a paternal connection that has no desire or need to issue stock but would like to continue to sell its products nationwide. I'm fearful that the only thing left will be the ability to sell in one's domiciliary state if, indeed, federal regulation based on GAAP is the end result.

**Mr. Hughes:** There certainly are a lot of concerns regarding federal regulation. Right now I think most of the major insurance groups are still fully supportive of the institution of state regulation. One of the fundamental things we've been trying to achieve in this legislation is to preserve the state's full ability to regulate insurance underwriters and, to a great extent, insurance sales, but mainly to regulate insurance companies. Much of the push for federal regulation is coming from the banking industry which doesn't have the same perspective as the insurance industry. The banking industry does business on an international basis with a single federal regulator. As the banking industry moves into insurance, moving from sales to underwriting, it can't imagine how you can do an effective business with 50 regulators. I think the pressure will grow if this legislation passes. Right now, I don't think there is any strong movement to shift from the notion of state regulation to one of federal regulation.

**From the Floor:** I wonder if you would comment on the source of the banks' political power. I know the insurance agents are politically powerful at the state level, but it appears that the insurance industry is coming out second best in a lot of this. Where is the power? From where are they exerting this influence?

**Mr. Hughes:** If you look at the way the agencies are set up in Washington, you see that the Treasury Department has an arm, the Controller of the Currency. There is the Treasury department at the cabinet level office. Treasury is often the administration's point agency in moving financial services reform. In Washington, what Treasury says is often extremely influential in shaping how this sort of legislation comes out. Treasury works with other Washington agencies: Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Securities and Exchange Commission. They go behind closed doors and they hammer out a lot of these things. Then you have, on top of all of that, the Federal Reserve Board, which is sort of the quintessential Washington player. The Federal Reserve Board has enormous clout with members of Congress. If committee chairs and individual members of Congress are saying, “Let's eliminate the authority of the Fed to impose capital requirements on bank holding companies,” Alan Greenspan will call them personally and say, “This would be ruinous to our economy. Don't do it.” Congress will listen. So if you sort of think of how the federal agencies are lined up on this, you better understand how the states have a hard time getting unified policy positions and then even when they get it, they have a small Washington office. They don't often have entree, and it's very difficult for them to get an equal say in how these things come out.

**From the Floor:** So is the problem the insurance industry’s lack of turf at the federal level that's doing it?

**Mr. Hughes:** When people sort of run through the laundry list of pros and cons of federal versus state regulation, one of the things that is always at the top of why we should be federally regulated is you would have a champion in Washington. You would have somebody that, when the door is closed, sits there with Congressional staff and says, “Excuse me, but if you do that, you'll be hurting the business. Let me explain.” We don't really have anybody that preforms that function now.

Speaking of the Federal Reserve Board, there is one thing that you might find interesting. We were trying to work a deal with the Federal Reserve Board pertaining to a mutual company or insurer that buys a bank downstream. We would try to make sure that the Federal Reserve Board didn't have the authority to impose capital requirements on that insurance company. The Federal Reserve Board didn’t buy into that, so we came up with a proposal that said, “If we can assure you that the insurance company is well capitalized by presenting an NAIC

risk-based capital standard that somehow roughly equates with banks being well capitalized, would you let us out from under your capital requirement?" Initially, the legal staff said, "Yes." They took this all the way up to Greenspan, and Greenspan came back and said, "No deal. My understanding is that insurance companies are more highly leveraged than bank holding companies." I don't think that's the case, but this is an example of the difficulties you can encounter in dealing with these things. It sort of relates to the question that was just asked. We don't have somebody in Washington that would sit down with the regulatory staff of the Federal Reserve Board and say, "Hang on a second. That's not right. Insurance companies are far more conservative than bank holding companies, so you don't have a monetary risk problem here." Those conversations never took place. It just wasn't something that we were able to persuade the Federal Reserve Board about.

**Mr. Raymond:** How do you feel about the awareness within the industry of these things that are going on? It seems to be confusing for many of us. It clearly seems to be a big issue for the banks, but it seems like there's a lot of things going on that many people in the industry do not understand. I think most of us realize that where we go in the long term is going to be critical. I have a very pessimistic view of the insurance industry in that I don't think we are a very forward looking industry. Do you think that there is a kind of awareness out there and sensitivity to this, particularly because we don't have the regulatory body at the national level. I know the NAIC is a little bit frustrated with the fact that they are not given the credibility at the national level that they feel they deserve.

**Mr. Hughes:** I guess the only thing that I would say is that there is clearly a different dynamic as to how a bank looks at all of this and how an insurance company looks at it. I think banks feel that they can buy a fairly small insurance company and do a lot with it. Therefore, they are interested not only in fee for services on the sales side, but also in buying an insurance company and servicing the underwriting needs and doing some other things as well. The name of the game is customer base. A big bank with a huge customer base buys a small insurance company. You think, "Well, there's lots of things you might be able to do with that." What does the big insurance company do? The big insurance company wants to buy a huge bank in order to get the customer base, but what do you think of a big insurance company buying a small bank? How badly do you want to be involved in an insured deposit taking business? Do you want your agents brokering deposits? I think there is a different dynamic. Our companies have typically perceived this issue as a few people have some innovative ideas, but for the most part, people are worried about at least preserving competitive opportunities. They might not have the ideas, but they want to make sure they can do the same thing the other guy can do. There really is a different dynamic.

**From the Floor:** With proposed bank legislation, has there been any speculation about what impact it might have on government tax policy, such as inside buildup? This is particularly an issue if there's federal regulation. Do you have any thoughts?

**Mr. Hughes:** I have not heard of anything that would suggest that there's going to be major change. The one thing that we have seen shift a bit is that banks are increasingly willing to help us defend current tax treatment. As some banks become more dependent on selling insurance products with some tax benefits, and when there are some proposals that arise that would threaten that tax treatment, we find that we now have more of an ally in the banking industry than we ever did before.

**Mr. Robert J. Johansen:** I'm Chairman of the Life Insurance Research Committee. Should we maybe co-sponsor with your section a study that would be conducted by academics to determine if life insurance companies are more heavily leveraged than banks? We're having an open meeting if anybody wants to be there. We're trying to do a weekend to take on projects that are important to the life insurance industry. We can start investigating to see if we can get the Society behind this.

**Mr. Raymond:** We'd sure like an answer. I know that. Actually, I'd like to turn that right over to Gary. Is there any area where some research and some education would be worthwhile in the process?

**Mr. Hughes:** This area is certainly the one that comes to mind. The Federal Reserve Board is holding a lot of the cards here. They know a fair amount about our business, but once they get down to a certain level, they don't know much at all. It would be extremely useful to have a credible, independent source of information on some of these financial issues that the Federal Reserve Board would look to.

**Mr. Johansen:** I would love to have a couple of actuaries and a couple of economists with a widespread reputation for analysis of this type.

**Mr. Hughes:** It would be wonderful.

**Mr. Johansen:** We'll start it.

**Mr. Hughes:** I should have come here a long time ago.