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As the second decade of the 21st century gets underway, how will the financial services industry evolve? Will innovation or stagnation characterize the marketplace? Is greater regulation a natural consequence of the near-failure of financial markets?

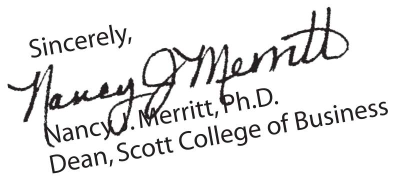
Some experts argue the financial services industry is at a crossroads and that regulation is poised to move in new directions. Others in the industry argue the financial services sector is mired in regulatory paralysis. Regardless of the perspective, no one can dispute that the industry is likely to be at the center of monetary and fiscal policy debate for years to come.

Research@Scott—Financial Services presents provocative, timely research to generate discussion, debate and additional study. The breadth of topics covered in this compilation as well as the depth of research conducted is possible because of the Lilly Endowment, Inc. support of Networks Financial Institute at Indiana State University.

For nearly a decade, Networks Financial Institute and the Scott College of Business have been at the forefront of financial services research. Our network of researchers dive into the issues that are driving today's financial and insurance markets. Individually and collectively, our national fellows and faculty are pioneering research that will help drive financial services policy and regulation for years to come.

We are committed to proactive leadership on these important issues in the U.S. financial services industry and the global marketplace. We invite your thoughts and perspectives on the accompanying research. Please contact us at Networks Financial Institute, 812-237-2442.

Sincerely,



Nancy J. Merritt, Ph.D.
Dean, Scott College of Business

James A. Leach, Chairman, National Endowment for the Humanities; former member, U.S. House of Representatives (R-IA), 1997-2007

Networks Financial Institute Policy Brief 2010-PB-04
Executive Summary

The economic trauma of 2008 was neither caused nor deepened by an inadequate financial regulatory structure, according to James A. Leach, a co-author of the Gramm-Leach-Bliley Act of 1999 (GLBA). Rather, Leach asserts the turmoil was precipitated and exacerbated by regulators' failure to use the powers bestowed upon them, and an over-reliance on risk-based models that encouraged excessive leveraging.

In his NFI *Policy Brief,* "The Lure of Leveraging: Wall Street, Congress and the Invisible Government," Leach examines the economic meltdown and its relationship to the financial regulatory structure in 2008.

GLBA—a Contributor or an Asset in the Financial meltdown?

For half a century, the financial regulatory landscape had been largely framed by the Glass-Steagall Act. In 1999, the enactment of GLBA provided enhanced opportunities for competition among financial institutions but changed little of the regulatory framework. Indeed, despite critics' calls for expanded regulation as a response to GLBA, Leach observes that GLBA actually expanded the scope of federal regulation afforded by the Glass-Steagall Act.

Without GLBA, Leach predicts that consumers would have seen even more disastrous consequences in 2008. For example, under GLBA, investment banks are required to comply with the same capital requirements, activity restrictions and general oversight as other financial institutions. Without GLBA reform, it is likely that an even greater loss of investor confidence would have resulted.

An Invisible Government's Response

The signing of the Dodd-Frank Act in 2010 has led some to believe that a lack of financial regulation was a key contributor to the economic collapse; however, Leach notes that adequate state and federal regulatory frameworks were in place to protect markets and consumers. Instead, he attributes blame for the fallout to an "invisible government," who pandered to the interests of investment banks' appetites and relied on unrealistic mathematical models that minimized risk while encouraging excessive leveraging.

This invisible government comprised of federal regulatory bodies was enticed away from relying on capital ratios, the instrument traditionally used to supervise large financial institutions. Instead, regulatory bodies bent to the pressures of financial services giants and relied on risk-based modeling that incorporated off-balance sheet and derivatives investment strategies, creating a scenario where excessive leveraging prevailed.

Housing and Finance—Precipitating and Extending the Crisis

Leach argues that Congressional accountability for the events that precipitated the 2008 meltdown is most directly tied to laws at the crossroads of finance and housing. These laws cultivated a climate conducive to economic risk taking. He notes that the captive regulator model created by statue in 1994 for Fannie

Leach says that rule-making instead of definitive law would define the breadth and scope of what could become a more comprehensive financial regulatory regime.

Mae and Freddie Mac is an egregious example of Congressional pandering to interest group pressure. Indeed, Leach argues that the regulatory structure put more constraints on the regulators than on the regulated—in this case, Fannie and Freddie.

Inadequate regulation of housing finance, particularly Fannie Mae and Freddie Mac, was a key ingredient in precipitating the meltdown. Another precipitant to the crisis was the failure to properly monitor the global marketing and insuring of mortgage portfolios, which were presumably designed to reduce costs to home buyers and risks to financial institutions.

While poor regulation of Government Sponsored Enterprises and faulty monitoring of mortgage instruments precipitated the crisis, Leach argues that the crisis was deepened and lengthened as regulators gave investment banks a green light to radically increase their leveraging ratios.

At least to date, the majority of taxpayer costs related to the bailout of industry giants will cover entities outside of the traditional bank regulatory system. Three institutions—Fannie Mae, Freddie Mac and AIG—account for the public funds least likely to be recovered. These institutions' holdings in 2008 did not reflect traditional bank products, but rather the risk-based mortgage instruments that are key components in the housing and mortgage implosion.

Could the Financial Crisis Have Been Mitigated?

"If" is a word with inherently mute powers, Leach notes. However, he points out that if Congress's industry-pandering approach to regulating Fannie and Freddie had been structured more prudently; if swap clearing facilities had been created in a manner that provided a central clearing mechanism for derivatives (such as existed in the statutory framework before the crisis); and if mortgage fraud had been more diligently pursued and mortgage portfolios properly valued, the depths and consequences of the financial crisis would have been substantially mitigated.

Dodd-Frank Won't Be the Panacea, but What's Next?

While the Dodd-Frank Act will fill in certain regulatory gaps and could help deter some future financial problems, Leach cautions it is misleading to assume that the problems in 2008 were created due to an absence of adequate financial regulation or the power to enforce such regulations. He notes that the Dodd-Frank legislation passed in 2010 maintains the framework of Glass-Steagall as modified by the GLBA. Assuming regulatory changes occur, Leach notes their nature will be more judgmental and rule-making oriented rather than organizational.

Under this scenario, Leach says that rule-making instead of definitive law would define the breadth and scope of what could become a more comprehensive financial regulatory regime. This context would also make a compelling case for the Federal Reserve to oversee derivatives clearing facilities at large banks. Finally, Leach notes that the revoking of critical authority from the two principal banking regulators (the Federal Reserve and the Federal Deposit Insurance Corporation) represents a bureaucratic win for the Commodity Futures Trading Commission and an interest group victory for the trading groups it oversees.

The complete policy brief may be accessed at **www.networksfinancialinstitute.org/lists/publication library/attachment/162/2010-PB0-04_leach.pdf**.

EQUITY PRIVATE PLACEMENTS AND LONG-TERM POST-ISSUE OPERATING FLOW UNDERPERFORMANCE

Eurico J. Ferreira, Professor of Finance, Scott College of Business, Indiana State University

Leroy D. Brooks, the Edward J. and Louise E. Mellen Chair in Finance, Boler School of Business, John Carroll University

Journal of Business and Economic Perspectives. Volume XXXV, No. 2, Fall/Winter 2009, pp 6-25.

Do Private Equity Investments Produce Attractive Long-Term Results?

Investors' commitments to private equity partnerships soared from $10 billion in 1991 to $180 billion in 2000. Such impressive growth underscores the potential importance of private equity investments to the financial services industry and the economy as a whole. However, while private equity investments have continued to rise, we have little understanding of their returns, capital flows, and interrelation, chiefly due to the fact that these investments are largely exempt from public reporting disclosures.

Private equity investments are equity securities in operating companies not publicly traded on a stock exchange. Common types of private equity investments include venture capital (VC) and buyout investments (LBO). Eurico J. Ferreira, with Leroy D. Brooks, recently conducted research supplementing earlier analysis of private equity issuers' long-run operating and share-price performance. Previous studies focused on the value of equity-private issuing firms' returns at the announcement date. Ferreira's and Brooks' research goes further, looking at the period before, during and following the announcement. It also explores long-term company operating performance and stockholder returns.

Ferreira and Brooks reinforce earlier research conducted by Hertzel and others in a 2002 *Journal of Finance* article. They find that public investors' positive response to equity private placements does not appear to be justified. Nor does the research confirm long-term post-issue performance benefits from companies having equity private placements.

The industry-adjusted median operating cash flow to book value ratio is -17.53 percent in the year preceding the announcement for equity-private-placing companies. From the announcement year to three years following, the operating cash flow to book value ratios are, respectively, -17.38 percent, -16.13 percent, -9.60, and -7.31 percent. Over this period, the material operating underperformance of the private equity placement companies matches the post-issue cumulative negative abnormal returns of over 50 percent.

Throughout this same period, non-issuing companies in the same industry and with the same poor pre-announcement operating performance do not suffer value losses. They also do not have significantly different operating performance during and in the three post-issue- announcement years. This indicates a market mispricing of private equity placements.

Eurico J. Ferreira

Leroy D. Brooks

Selection Bias?

The evidence in the findings is consistent with a violation of a semi-strong form of efficient markets, violation where investors unsoundly overvalue companies prior to issue and further over-price issuing companies' stocks.

Akerlof's lemons phenomenon and a Myers and Majluf adverse selection problem are evident. Poorer performing companies that are overpriced, and thus likely unable to issue public equity, can use a private equity placement to issue overvalued stock, while other equally poor performing firms and over-valued firms in the industry choose not to issue.

In this environment, rational private investors are still willing to finance the placement of private equity, as long as the share-price discount they receive to buy the stock is sufficient to cover their costs, and to provide an adequate risk-adjusted return from their purchase date to their point-of-sale.

If outside investors reacted properly to the company and equity placement issue characteristics, though, much lower levels of private placements would occur and share prices would likely decline at an announcement of private equity placement.

The complete article may be accessed at **http://sapphire.indstate.edu/~eferreira/JBEPfall_winter2009.pdf**.

While private equity investments have continued to rise, we have little understanding of their returns, capital flows, and interrelation.

MONITORING AND MITIGATING THE SAFETY-NET CONSEQUENCES OF REGULATION-INDUCED INNOVATION

Edward J. Kane, NFI Senior Fellow and James F. Cleary Chair in Finance, Carroll School of Management, Boston College

Networks Financial Institute Policy Brief 2009-PB-08C
Executive Summary

As financial researchers examine the regulatory environment in context with the 2008 economic meltdown, some questions come up repeatedly:

- Did the exclusionary regulations that existed before the Gramm Leach Bliley Act of 1999 and their progressive relaxation motivate some institutions to exploit the safety net provided to institutions deemed "too hard to fail and unwind"?
- Will additional legislation–such as that called for under the Dodd-Frank Act of 2010 –reduce future losses from safety-net funds?
- What can private and government supervisory systems in the U.S. and around the world do to avoid future abuse of the safety-net support system?

Edward J. Kane, Ph.D., authored a policy brief entitled "The Importance of Monitoring and Mitigating the Safety Net Consequences of Regulation-Induced Innovation" that expands upon these questions and provides thoughts on what effective regulatory reform for too hard to fail and unwind institutions might look like.

Why Restoring Glass-Steagall Won't Work in Today's Environment

While acknowledging that the Gramm-Leach-Bliley Act played a role in contributing to the financial crisis, Professor Kane notes that a return to the strategy of compartmentalizing the activities of depository, securities and insurance firms would not prevent future crises. Kane argues that worldwide advances in communication and technology make it easy for institutions to create effective substitute products and circumvent one another's rules through a network of regulatory loopholes, tolerated by regulators and legislators. He advocates not for more regulations per se, but for more effective monitoring to detect safety-net exposure and more aggressive deterrents to safety-net abuse.

Government Regulators and Inherent Conflicts

Kane notes three primary sources of incentive conflict for government officials charged with regulating large financial institutions. First, no one is charged with measuring and monitoring safety-net subsidies per se. Second, top government officials generally focus their efforts on a much shorter timeframe than the long-term interests of the citizens they serve. Finally, ordinary citizens' and taxpayers are not the regulators, only principals. Citizens' interests are balanced against those of other principals including lobbying groups.

Kane notes that these other principals served by government regulators differ in four important ways:

- Their understanding of the duties regulatory officials owe them;
- Their ability to influence policy decisions as they are being made;
- Their ability to understand the consequences of alternative policy decisions; and
- Their ability to offer rewards for bending policy decisions in the directions they prefer.

Along with safety-net subsidies, loopholes created to serve special interest groups can motivate institutions to engage in excessive risk-taking, reduced due diligence and the exploitation of regulation-induced innovation. Coupled with the limited liability that their stockholders and counterparties enjoy, financial managers may be motivated to exploit safety-net subsidies to leverage risk-taking.

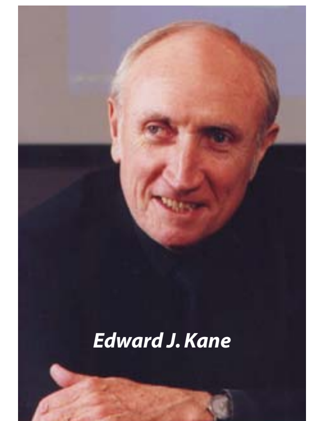
In a Global World, Who Is Accountable?

Large financial institutions around the globe operate in a complex system comprised of multiple regulators. In an arena where no one is sure whose taxpayers will be responsible for safety-net losses, accountability for mistakes is reduced and both politicians and regulators are incentivized to compete aggressively for footloose financial institution capital and employment. Such an environment is ripe for finger pointing among regulators when a multinational financial firm becomes distressed.

Kane states that, in proposing effective regulatory reform, the Obama Administration must address the sources of the incentive conflicts. In order to be effective, he calls for financial regulatory reform that goes beyond adjusting the structures outlined in the Dodd-Frank Act of 2010 and works to improve the global system used to govern financial managers and safety-net officials.

How to Strengthen the Financial Safety New System

Better information, better ethics and better incentives must all contribute to more effective management of the financial safety net. Meaningful deterrents must be in place to discourage institutions



Edward J. Kane

from abusing the safety-net support. Additionally, government supervisors must be made accountable for accurately targeting and pricing safety-net benefits. Kane states that, while pursuit of safety-net subsidies can never be stopped, the practice can be mitigated by changing top officials' oaths of office and changing how officials are trained, recruited, and evaluated. He also calls for measuring changes in financial institution performance, reporting responsibilities, and compensation structure. Further, Kane advocates for changes in the kinds of securities issued by institutions deemed too difficult to fail and unwind.

Making Exposure to Loss Easier to Detect

The high cost of insolvency demands that large institutions improve how they identify safety-net loss exposure and reduce resolution costs. Effective planning prior to an actual loss is one method of minimizing exposure. Another approach is to re-establish extended liability for at least some owners. Kane notes that a significant source of incentive conflict in industry risk-taking and subsequent loss is the limited liability that stockholders enjoy. With less of their own capital on the line, Kane notes safety-net support becomes more attractive to stockholders as well as their creditors and counterparties. By extending stockholder liability, holders of shares in a liquidating firm would be responsible for covering some layer of losses beyond the value recovered at the corporate level.

Measuring and Monitoring Safety-Net Risk

Kane calls for the development of explicit metrics for measuring the value of safety-net support at large institutions. Large institutions would also have to measure the value of safety-net support to their institution and regularly report this value to regulators. Kane calls for a new federal entity (a Safety Net Accountability Office) charged with measuring and monitoring safety-net costs and benefits. Unlike the Financial Stability Oversight Council and Office of Financial Research established by the Dodd-Frank Act, this office would be controlled outside the span of existing agencies and perform only an information function. Kane concludes that an Accountability Office, independent of agencies responsible for administering the safety net, would result in a more transparent environment conducive to detecting and resolving problems, rather than covering them up.

The complete policy brief may be accessed at **http://www.networksfinancialinstitute.org/Lists/Publication%20Library/Attachments/149/2009-PB-08C_Kane.pdf**.

Did the exclusionary regulations that existed before the Gramm Leach Bliley Act of 1999 and their progressive relaxation motivate some institutions to exploit the safety net provided to institutions deemed "too hard to fail and unwind"?

John A. Tatom, Director of Research, Networks Financial Institute

The United States economy has suffered over the past four years from crises in mortgage foreclosures and in financial markets, as well as a long recession that some have referred to as the Great Recession. The links between these events, or more broadly the causes, extent and effects of these developments, are sources of continuing controversy and uncertainty. The foreclosure crisis began in late 2006 when housing starts and housing prices peaked and began a steep decline. The broader financial crisis has been variously dated from the beginning of the foreclosure crisis, to spring 2007, when several hedge funds and single issue mortgage and bond insurers either failed or had their own credit quality seriously downgraded; to summer 2008, when Bear Stearns failed and Fannie Mae and Freddie Mac were put into government conservatorship; or to September 2008, when Lehman Brothers and Merrill Lynch failed, Wachovia was forced into a takeover ultimately by Wells Fargo, and American International Group (AIG) almost failed before a federal and Federal Reserve bailout injected some $180 billion into the firm through a variety of loans and equity infusions. Regardless of when it began, it appears to have been a follow-on to the mortgage foreclosure crisis because the failures were largely associated with the direct holdings of mortgages or mortgage backed securities.

John A. Tatom

The financial crisis presumably ended in late 2009 with some return to normalcy, or at least an end to mortgage related failures of investment banks. Some would argue, however, that the financial crisis has not ended because the market for securitized lending has not recovered. The recession began in the fourth quarter of 2007, a year or more after the onset of the mortgage foreclosure crisis and before the financial crisis began. The recession ended in mid-2009, after the financial crisis, but well before the end of the mortgage foreclosure crisis.

The Changing Face of the Mortgage Foreclosure Crisis

Initially, the surge in foreclosures was driven by foreclosures on adjustable rate, subprime loans. Many of these borrowers came late to the mortgage interest rate cycle as the mortgage rate outlook was deteriorating and informed borrowers knew that adjustable rates loans were set to re-price upward, making marginal loans unaffordable. Some of these borrowers were more speculative and took out such loans anyway, planning to sell their houses and repay the loans before they were re-priced. When the recession began, the situation changed, as individuals with relatively high credit ratings began to lose their jobs and income, and, as a result, enter the foreclosure process.

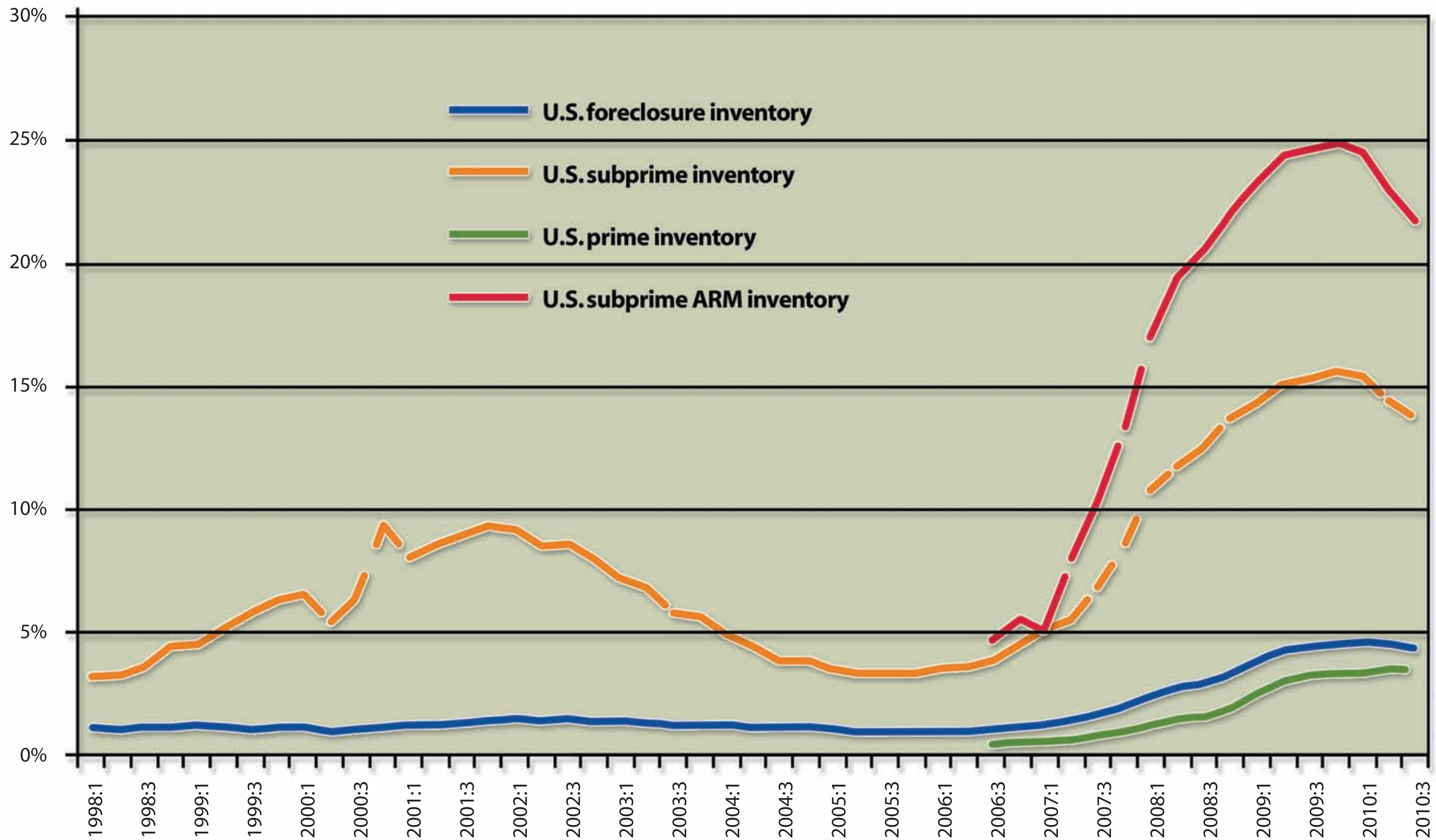
The chart at right shows the explosion in mortgage foreclosures for various types of mortgages from 1998 to the third quarter of 2010, except for adjustable rate subprime loans and prime loans series which are shown here beginning in the third quarter of 1996. The foreclosure inventory includes all mortgages at any stage of the foreclosure process. The mortgage crisis does not appear to have caused the recession because the recession did not begin until more than a year after the beginning of the mortgage crisis and it ended eighteen months ago, despite the continuing foreclosure crisis.

The mortgage and financial crises were the result of poor regulation of new financial products created largely outside the traditional bank regulatory structure. One of the ironic policy responses of the financial crisis was the notion that it was a banking crisis.

Were the Mortgage and Financial Crises Part of a Banking Crisis that Caused the Recession?

While the mortgage crisis did not cause the recession, it certainly did create, or morph into, the financial crisis. The financial crisis also did not cause the recession, but it and the mortgage foreclosure crisis could have made the recession worse. The mortgage crisis arose because of the growth of subprime mortgage

Foreclosures as a Percent of All Loans in Class



Subprime mortgage foreclosures are falling, but total foreclosures remain high

Source: Mortgage Bankers Association

and securitization products developed by mortgage bankers and investment banks, largely outside the regulatory structure that governs bank holding companies and commercial banks or commercial banking laws. Significant pressure from Congress, supported by mandates and federal subsidies to foster homeownership, accelerated the development and growth of subprime products.

As a result of the growth in home ownership and especially the growth of subprime mortgage assets, incentives were created for investment banks to develop financial products to leverage and manage their mortgage portfolios. These products were often created by nontraditional companies and thus marketed outside of traditional regulatory structures. These new products included subprime-based mortgage backed securities, collateralized debt obligations, collateralized loan obligations, auction rate securities and credit default swaps. While some of these products were sound, many were complex and confusing, creating a misunderstood risk profile. During the crises, the large failures of institutions occurred among non-bank financial conglomerates such as Bear Stearns, Lehman Brothers, Merrill Lynch and American International Group (AIG). In short, the mortgage and financial crises were the result of poor regulation of new financial products created largely outside the traditional bank regulatory structure.

One of the ironic policy responses of the financial crisis was the notion that it was a banking crisis. The Treasury Secretary and the Chairman of the Federal Reserve teamed up to convince Congress of precisely this point and to pass the Troubled Asset Relief

The notion of a banking crisis requiring massive bailouts of bad assets of the largest commercial banks was never justified.

Program (TARP), a $700 billion program, originally intended to purchase troubled assets from supposedly failing financial institutions. TARP began by forcing banks and a few non-bank financial institutions to accept government funds without public evidence that they were confronting any meaningful liquidity or solvency problems. Most of the banks paid back these funds as soon as they were allowed. In the end, the program was used to inject about $386 billion into capital of firms, but only $245 billion of that went into banks, $169 billion was paid back by the end of the program in October 2010 and only about $20 billion is expected to be lost due to failure of commercial banks. The rest of the disbursements and losses of up to $30 billion will come from loans and capital injections to automobile companies and AIG. The notion of a banking crisis requiring massive bailouts of bad assets of the largest commercial banks was never justified.

Another perspective on whether there was a bank-induced financial crisis is that the failure experience of depository institutions (banks and thrifts) has not risen to the level of the last real crisis, the savings and loan (S&L) crisis of the late 1980s and early 1990s. In a new broad historical review of financial crises, Carmen Reinhart and Kenneth Rogoff (see *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009) refer to the S&L crisis as a "bank-centered financial crisis" and they include it in their comparison of the subprime crisis to such crises. It must be noted that they use the term "milder," and not their terms "severe" or "systemic," in referring to the S&L crisis, and they conclude that the subprime crisis was worse than other banking crises in advanced countries or than the five crises that they call the "Big Five" severe and systemic crises. Certainly this suggests that the subprime crisis was the worst since at least Great Depression, but one natural indicator that Reinhart and Rogoff do not review, the number of bank failures, suggests otherwise.

In 2008-09 there were 165 failures (there were only three in 2007, the first year of the crisis), and it is likely that there will be about 160 failures in 2010. But a total of 330 or so failures for 2008-2010 pale in comparison with the over four times larger number during the worst three years of the S&L crisis (1412 in 1989-91) or with the full 13-year period of elevated bank failures from 1981-93, when there were 2,335 failures, seven times as many as are likely in and following the recent subprime/financial crisis. Two of the largest thrift failures on record occurred during the recession, but bank failures have generally been much smaller than in the last banking crisis. At least for this indicator of banking crisis, the recent mortgage and financial crisis is hugely dwarfed by the so-called mild S&L bank-centered financial crisis.

Whether there was a banking crisis is important because Reinhart and Rogoff find that banking crises lead to very long periods of recession and recovery, much longer than the six quarters of the recent recession and six quarters of recovery. Their study of crises suggests that the real economic effects of a recent crisis would last far longer, supporting the notion of a "double dip" recession with the economy slumping back into recession and subsequently experiencing very slow growth for several years. Carmen Reinhart and Vincent Reinhart recently argued that even severe economic dislocations over the past 75 years show the same very slow recovery and subsequent slow growth as banking crises (see "Beware those who think the worst is past," *Financial Times*, August 31, 2010). The evidence of the past six quarters, though limited, does not support such a dire view of the prospects for the economy.

There are other reasons, beyond the mortgage foreclosure crisis that could have caused the Great Recession. For example, there were large surges in energy prices in late 2007 and in the summer of 2008

The failure experience of depository institutions (banks and thrifts) has not risen to the level of the last real crisis, the savings and loan (S&L) crisis of the late 1980s and early 1990s.

that were larger than the energy price increases before the two earlier great recessions in 1973-75 and 1981-82; these recessions lasted only two months less than the recent recession. In the latest recession, the unemployment rate reached 10.2 percent, which was lower than the peak 10.8 percent reached at the end of 1982. One of the most important recession indicators is the sharp slowing in monetary growth leading up to the recession. By the end of 2007 when the recession began, the monetary base, a measure of Federal Reserve actions to influence monetary aggregates, spending and economic activity, had slowed to 1.4 percent over the previous year, insufficient to support the existing inflation rate, not to mention normal economic growth. Subsequent monetary stimulus pushed this growth, after removing the sterile surge in excess bank reserves, to 12.1 percent over the next year. Unfortunately, the latter measure slowed to a 3.6 percent rate in August 2010.

The mortgage foreclosure crisis and its related financial crisis, may have contributed to the recession in its worst phase at the end of 2008 and early 2009, but dramatic expected shifts in economic policy could equally have explained the extreme recession developments from October 2008 to June 2009. Many analysts believe that the financial crisis was a banking crisis and as such is likely to have led to an extended recession, now including a "double dip," and relatively slow growth for several years. The continuing recovery and bank failure evidence do not support that view, however.

RETHINKING CONSUMER PROTECTION REGULATION IN INSURANCE MARKETS

Sharon Tennyson, NFI Fellow and Associate Professor of Policy and Management, Cornell University

Networks Financial Institute Policy Brief 2010-PB-07
Executive Summary

The recent spotlight on consumer protection in the financial services environment has naturally extended to include the insurance sector. As regulators seek to ensure that insurers' marketing, pricing, underwriting, policy cancellation, non-renewal terms, and claims settlement practices are fair to consumers, some charge that excessive regulation increases the industry's regulatory costs and poses anti-competitive threats.

In the Policy Brief "Rethinking Consumer Protection Regulation in Insurance Markets," Sharon Tennyson reviews the major forms of consumer protection regulation operating in today's insurance market and evaluates each form from an economic perspective. Tennyson then presents three principles that would serve to balance the interests' of regulators, the insurance industry and consumers.

Principle One: Target Regulations to Address Specific Failures

By developing regulations that address specific market failures, Tennyson asserts that regulators and insurers can better serve consumers while reducing the costs of government intervention. This principle suggests that consumer-focused regulations should be concerned less with price regulation or market access and more with improving insurance disclosures and policing insurance quality. She argues that, in a competitive marketplace, price regulation encourages some insurance providers to exit the market, resulting in reduced insurance product availability and higher costs for consumers.

In a competitive marketplace, price regulation encourages some insurance providers to exit the market.

Principle Two: Motivate the Market to Comply with Regulatory Objectives

Sharon Tennyson

Tennyson's second principle calls for regulations that motivate insurers to engage in behaviors consistent with regulators' objectives. This principle suggests that the exhaustive prior approval process for insurance products should be replaced with regulations that increase insurers' incentives to offer more straightforward, transparent coverage and pricing. Creating more effective and user-friendly insurance disclosures coupled with regulatory enforcement that penalizes insurers for misleading, unclear or unfair product features would motivate insurers to develop simpler, more transparent contracts. Additionally, Tennyson argues that this regulatory principle would provide opportunity for product innovation and facilitate consumer choice.

Tennyson's second principle is consistent with a risk-based market conduct system that directs the most stringent regulatory oversight on those insurers most likely to thwart the system or engage in conduct harmful to consumers. By focusing regulators' scrutiny on those insurers identified as red flags, the supervisory burden for compliant firms is reduced and potential problems may be detected earlier. The market conduct annual statement is an important standardized instrument for monitoring conduct across the marketplace. Tennyson argues that such a statement should be required and implemented as an input in the risk-based supervisory decision process.

Principle Three: Regulations Should Strengthen Market Discipline

A third principle, and the one deemed most important by Tennyson, is that regulations should strengthen the forces of market discipline rather than serve as disciplinary substitutes. For example, she points to recent surveys that suggest consumers have a poor understanding of policy language and terms used in insurance disclosures. Given the large body of literature in marketing, psychology and economics related to consumers' use and understanding of labels and warning statements, Tennyson says the necessary information is available to improve insurance disclosures.

Providing the public with a metric that essentially "scores" an insurers' conduct is another tool Tennyson says could improve market behavior. By regulators assigning a public rating of insurers' conduct, insurers would be motivated to monitor and improve their internal standards. This model has been used successfully in other environments, such as the public health ratings posted in restaurants.

Finally, Tennyson says that creation of a public ombudsman to settle consumer disputes could strengthen public discipline. Insurers would be legally bound to the ombudsman's decisions and would be charged a fee for each complaint handled. Tennyson's paper notes that such a system would aid in attaining voluntary settlements, while offering the added benefits of greater transparency during the complaint resolution process and promoting greater public understanding of insurance.

The complete policy brief may be accessed at **http://www.networksfinancialinstitute.org/Lists/Publication%20Library/Attachments/165/2010-PB-07_Tennyson.pdf.**

David VanHoose, NFI Senior Fellow and Professor of Economics, Lay Professor of Private Enterprise, Baylor University

Networks Financial Institute Policy Brief 2010-PB-06
Executive Summary

Since passage of the Economic Stabilization Act of 2008, the federal government has been explicitly and implicitly regulating the compensation of top managers at a number of U.S. banks. Moreover, the sweeping provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 have tasked the Federal Reserve with establishing standards for evaluating the risk implications of bankers' pay. Even the Federal Deposit Insurance Corporation (FDIC) has weighed in, proposing that management compensation be factored into banks' deposit insurance premiums.

Does Equity Performance Pay Provoke Excessive Risk Taking?

Fundamental to these issues is the question of how the structure of bank management compensation—increasingly based on banks' equity price performance—relates to an increased tolerance for risk taking. David VanHoose addresses the issue in his 2010 NFI Policy Brief, "Regulation of Bank Management Compensation."

This question has yielded a mixed bag of answers to date. Some studies find no evidence of association between equity performance pay and greater risk taking. Others maintain that increasing the share of management compensation derived from salaries and bonuses actually reduces risk. Still others conclude that linking pay to equity value leads bank executives to engage in greater risk taking, such as value-reducing mergers. Banks have moved toward basing executive pay on equity returns since banking deregulation began in the 1980s. While yielding contradictory viewpoints, the literature does conclude that the link between pay packages and risk taking ultimately hinges on other factors that vary across countries and even across individual institutions within any given nation. There is also evidence that risk-taking behavior depends on how much management control a few large equity holders exercise and on whether management compensation is deferred.

David VanHoose

The Role of the Regulator in Curbing Risk

Some research indicates that bank risks can be influenced by the structure of deposit premiums. These studies suggest that the presence of a federal safety net—such as the FDIC—encourages management to take greater risks, since depositor losses will be covered by insurance. Obviously, this unnecessarily puts the government and taxpayers in jeopardy.

In the end, regulation aimed specifically at restraining bank management compensation has clear pitfalls. Efforts to enact salary ceilings could create a shortage of bank management talent. In a tight economy, individuals with the necessary risk-management skills would likely be motivated to pursue positions in firms that do not impose caps on compensation. In turn, too, banks challenged by a shortage of available talent would likely find ways to circumvent the compensation caps.

At best, VanHoose concludes, the potential benefits to society of even the most skillfully crafted compensation regulations currently remain uncertain.

The complete policy brief may be accessed at **http://www.networksfinancialinstitute.org/Lists/Publication%20Library/Attachments/161/2010-PB-06_VanHoose.pdf.**

In the end, regulation aimed specifically at restraining bank management compensation has clear pitfalls.

BANK

AVOIDING THE PITFALLS OF CERTIFICATES OF INSURANCE

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Procuring commercial insurance products can be a complex and time-consuming process. For these reasons, some businesses choose to shift responsibility to an agent producer. While outsourcing coverage procurement can be a cost-effective strategy, this choice is not without risk.

Relying exclusively on a certificate of insurance can present opportunities for risk in the event of an uncovered loss. For example, if the commercial property/casualty coverage included in the policy does not reflect what the purchaser inferred based on the certificate of insurance, the firm may find itself underinsured. This situation has resulted in litigation.

A certificate of insurance certifies that a business has procured insurance coverage and includes basic coverage data including the identification of the insured and the certificate holder, the policy limit, the deductible, the identification of the producer and insurer, the inception and expiration dates of the insurance policy, the type of insurance that is applicable (e.g., general liability, workers compensation and employers liability), and policy number(s).

To Avoid Unwelcome Surprises, Read the Disclaimer and the Policy

Businesses that rely only on the certificate of insurance and do not review the actual policy and accompanying disclaimer may experience unwelcome surprises in the event of a loss. Unwelcome surprises may occur when:

- The coverage data contained in the certificate does not match the corresponding coverage data contained in the insurance policy, or it contains data suggesting the absence of a particular coverage limitation that is contained in the insurance policy.
- The certificate of insurance does not disclose all of the coverage limitations that are contained in the insurance policy and important exclusions that severely restrict coverage are not disclosed.

Businesses that rely only on the certificate of insurance and do not review the actual policy and accompanying disclaimer may experience unwelcome surprises.

Of course, insurers are well aware of these issues, so a certificate of insurance typically contains a disclaimer stating that a certificate of insurance is issued for information purposes only and confers no legal rights upon the certificate holder. The certificate does not amend, extend or alter the coverage afforded by the insurance policy.

Is Litigation an Effective Response to an Uncovered Loss?

Litigation may or may not be an effective response to an uncovered loss that is mentioned in a certificate of insurance disclosure. If the certificate does not contain coverage data (1) that is diametrically different than the coverage data contained in the insurance policy, or (2) from which the certificate holder could infer that the insurance policy does not contain a particular coverage limitation, one may not reasonably argue that the insurer is prohibited from relying upon this particular coverage limitation. In these types of cases, the courts have uniformly held that the insurer did not have a duty to disclose the coverage limitation in the certificate of insurance.

On the other hand, if the certificate of insurance does contain coverage data (1) that is diametrically different than the coverage data contained in the insurance policy, or (2) from which the certificate holder could infer that the insurance policy does not contain a particular coverage limitation, the prospect for success in litigation depends on the jurisdiction in question. A compelling case can be made that both the producer who completed and issued the certificate of insurance on behalf of the insurer, and the insurer, bear substantial responsibility for the discrepancy.

Verifying the Accuracy of Policy Data

Retail insurance agents offer a value-added service of verifying the accuracy of data contained in the certificate of insurance. Insurers understand that furnishing a certificate of insurance is an integral component of the insurance transaction. The servicing of an insurance policy not only includes the actual delivery of a certificate of insurance confirming that a client has fulfilled an agreement to procure coverage, but also verifies the accuracy of the data contained in the certificate.

The certificate holder who has secured verification services from a producer reasonably relies on both the producer and the insurer to verify the accuracy of the data contained in the certificate of insurance. In this instance, the certificate owner bears minimal, if any, responsibility for coverage omission or requesting a copy of the insurance policy to ensure that the certificate was accurately completed.

Proceed with Caution

Claiming ignorance is not an option for certificate holders who claim they were blindsided by coverage limitations. Certificate holders should keep the following caveats in mind when relying on certificates of insurance as an option for reducing insurance costs:

- Those who take a certificate of insurance at face value and do not examine the policy for exclusions, do so at their own risk. A certificate holder should not only insist on receiving a copy of the insurance policy, but also should carefully scrutinize coverage limitations contained in the document. The law is well settled in cases where the certificate of insurance contains no information upon which the certificate holder could reasonably infer that the insurer's coverage limitation was not contained in the insurance policy.

William Warfel

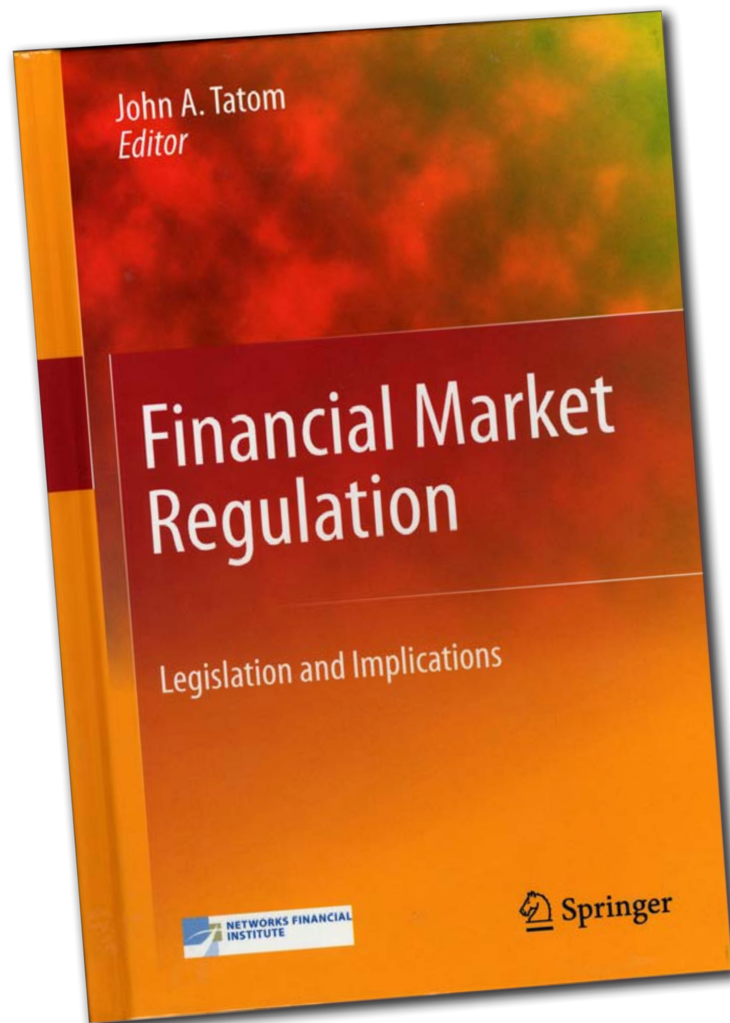
Stanley Adamson

- Depending on the jurisdiction, successful litigation against a producer and insurer is possible when there is a conflict between what is stated on the certificate of insurance and the insurance policy, or at when there is at least a factual question concerning the conflict issue.

Procuring insurance can be time consuming and cumbersome, but certificate holders have a responsibility to verify that the coverage they purchase provides the desired protection in the event of a loss.

The completearticle may be accessed at **http://isunetworks.org/thoughtleadership/publications/Pages/Research_Scott.aspx**.

While outsourcing coverage procurement can be a cost-effective strategy, this choice is not without risk.



FINANCIAL REGULATION: LEGISLATION AND IMPLICATIONS

John A. Tatom (ed.)
Springer Publishing Co., January 2011

This book offers the first long-range examination of the most important financial legislation in the last 75 years, the Gramm Leach Bliley Act, also called the Financial Modernization Act of 1999.

The tenth anniversary of this sweeping financial reform is a natural benchmark for assessing the effects of the law and for questioning whether changes to this historic legislation are necessary. Includes contributions from Congressman James Leach.

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