

The Problem with Regulatory Arbitrage

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Allstate ([ALL](#)) CEO Tom Wilson recently wrote an [op-ed](#) in the New York Times, entitled “Regulate me, please.” This opinion contains misleading statements about [AIG's](#) CDS problems: it attributes them to the weakness of state insurance regulators, and uses this misinformation as a pretext to call for Congress to eliminate the state regulation of insurance.

Wilson's article, despite its title, is self-serving – an example of attempted regulatory arbitrage. In its larger context - the debate over regulatory reform – it is yet another troubling sign. As the financial crisis enters its next phase, the ongoing quest for the opportunity to choose one's regulator may interact with and feed into the ongoing drive for political and regulatory power in destructive ways.

Here is Wilson's opinion:

The insurance companies that wrote credit default swaps were happy not to be regulated. Insurance regulators didn't expand their oversight to ensure the solvency of these companies. Banking regulators, banks and credit rating agencies did not properly assess the strength of issuers and readily accepted these complex derivatives.

Insurance is defined as coverage by contract in which one party agrees to indemnify or reimburse another for loss. The credit default swaps written by American International Group are clearly insurance since they are a contractual obligation by A.I.G. to pay should there be a default on a security.

Unlike banks or investment houses, insurance companies are not regulated by the federal government. Instead, they are regulated by individual states, which lack the expertise to properly oversee rapid innovation or systemic risks. Business leaders must work with the government to create a new regulatory structure. All companies that create risk for the financial markets need to be in “the pool” of federal regulation, including companies like Allstate. A good start would be for Congress to eliminate the hodgepodge of state regulatory systems by establishing a federal regulator for national insurance companies.

The facts - AIG's CDS operations were performed under the regulation of the Federal Office of Thrift Supervision (OTS), and evaded state regulation, either as insurance or as gambling, by virtue of an exemption granted by Congress at the behest of lobbyists and special interests. If AIG's CDS had been written under the supervision of state insurance regulators, they would have been backed by adequate capital and would not have contained the collateral posting requirements that led to the company's demise. In this instance, Federal regulation proved inept: the OTS was an easy target for the slick operators at AIG, who used regulatory arbitrage to finesse their way to disaster.

AIG's problem was regulatory arbitrage – AIG's problems arose because the company was able to pick its own regulator. By the expedient of buying a small thrift, they gained the ability to select the OTS as their primary regulator. That Federal agency, lacking the skills and perspective that state regulators and specifically the NY State Insurance Department would have brought to bear on the problem, permitted AIG Financial Products to write the business that brought it into a liquidity or solvency crisis.

Congress' role in creating the problem – the entire CDS problem was enabled by Congress, who specifically granted that portion of the financial industry a carte-blanc exemption from any regulation. Speaking of regulatory arbitrage, that's the holy grail - “none of the above.” This occurred with the passage of [CFMA](#) in 2000, at the instigation of lobbyists for Enron, among other special interest groups, on the last day before the Christmas break, as an add-on to an appropriations bill, and with no debate in either house.

In order to achieve its lofty purpose of furthering innovation, Congress in enacting CFMA saw fit to specifically exempt the writing of CDS from state bucket shop or anti-gambling statutes, which dated back as far as 1907. These laws were passed in order to prevent gambling, speculation and manipulation in the markets, which at the time had caused a terrible crash and contraction of credit, very similar to what we have today. But your elected servants saw fit to over-ride these considerations, by a stealthy series of back room machinations and parliamentary maneuvers.

With this information as background, there is every reason to look very, very carefully at calls for Congress to eliminate any form of state regulation.

The NY State Insurance Department response – Eric Dinallo, Superintendent of the NYSID, backed by NY State Governor Paterson, was the first regulator to sound the alarm on CDS. In spite of the exemption granted by Congress, he has displayed a rare combination of political courage, tact and restraint in pushing for change and adequate regulation.

Only after Dinallo offered to regulate CDS that are backed by an insurable interest, with an effective date of 1/1/09, and Governor Paterson correctly asserted that naked CDS (those that are not backed by insurable interest) are gambling contracts, did Christopher Cox of the SEC ask Congress for authority to regulate CDS. That authority was not forthcoming, as you can imagine, given the role that body played in creating the loophole that opened Pandora's box. But the point is, state regulators were way ahead of their Federal counterparts on this issue.

Due in large part to the impetus created by Dinallo's actions, Geithner and the Federal Reserve have applied pressure to bring CDS onto an exchange, promoting limited transparency and bringing them within reach of regulation. Dinallo, realizing that CDS are a national and indeed an international problem, has deferred to the possibility of Federal regulation. At this point in time he is advocating a process whereby the Federal Systemic Risk Regulator, when this position is created, would carefully review all financial products and services to see if they should exist at all; and if so, under what conditions. The proper result would be that naked CDS would be abolished or limited to a carefully defined role as hedges for other positions, and that all issuers of CDS would be required to be adequately capitalized.

Predictably, Dinallo [responded](#) to Wilson's op-ed by setting the record straight:

The Department is responding to an opinion article in the April 16, 2009 New York Times by Allstate C.E.O. Tom Wilson. In the op-ed, Mr. Wilson wrote, referring to Allstate, “we played only a small role in unregulated insurance markets....” He also wrote, “The insurance companies that wrote credit default swaps were happy not to be regulated.”

“In New York and in other states, it is illegal for an insurance company to write a credit default swap unless approved by the state insurance regulator under limited conditions. If Allstate broke the law or is aware of any other insurance company that broke the law, Allstate should immediately report that conduct to the appropriate state insurance regulator. I have asked Allstate’s New York companies to report immediately any inappropriate or unregulated use by them of credit default swaps,” Dinallo said. “I have said for more than a year that credit default swaps should be regulated and that those who write them should be required to hold adequate reserves. But one thing should be clear. While the credit default swap market is not regulated, insurance company use of credit default swaps is. In New York, no insurance company can use credit default swaps except under very specific and limited ways and only with approval,” Dinallo said.

The Allstate opinion article argues for federal regulation of insurance based on a number of inaccurate and misleading statements: that credit default swaps are insurance; that A.I.G. sold credit default swaps

as an insurer; and that insurance companies were unregulated in selling credit default swaps. In fact, most credit default swaps are not insurance because most buyers were not insuring something they owned, which is a requirement for insurance. A.I.G. purposely sold huge numbers of credit default swaps through a federally-regulated non-insurance subsidiary because it would not have been allowed to sell swaps with no limits, no controls and no reserves through a state-regulated insurance company.

Insurance company sales of credit default swaps are highly regulated and limited.

Dinallo continues willing to participate in constructive debate about the proper role of the Federal Government in the regulation of insurance.

Regulatory arbitrage - Allstate's Wilson, bedeviled by State regulators, would no doubt find it easier to answer to a Federal regulator, one who would be untroubled by harsh and arbitrary cancelations, unfair and deceptive claims practices, twisting in the Life insurance sales process, price-gouging and price-fixing, so on and so forth. Certainly not one who would be concerned with whether insurance rates were excessive or inadequate in a given county or city. A Federal regulator very likely would take a broad view, not one that would be concerned with the nitty-gritty of consumer protection. So Wilson's call for Congress to eliminate the "hodge-podge" of state regulation needs to be seen for what it is, a thinly disguised attempt at regulatory arbitrage.

We need to be very careful to be sure that the outcome of regulatory reform is more effective supervision of all financial companies, responsive to the needs of Main Street, and not beholden to special interests.

Implications for investors – the financial crisis has created a mandate for stronger and more centralized regulation of the financial industry, to include insurance companies. Human nature is such that this will be accompanied by a drive for power from politicians, together with efforts to secure lenient regulation by members of the industry. Investors who look forward to strong and effective regulation will have a long wait unless they make their opinions part of the political process.

The danger is a federal super-regulator who sees his mission as catering to the desires of the largest and most politically connected industry participants. Such a regulator would be unlikely to take a hard look at the CDS market, or the futures market, or securitizations if and when that market is restored. If this regulator requires industry support to get appointed, the stage is set for the final capture.

As a concerned citizen who is also an investor, I suggest you apply political pressure wherever you can, to shape regulatory reform of the financial services industry by adding the following items to the consensus agenda:

1. No opportunity for a financial company to select its own regulator.
2. An analysis of the systemic risks and social benefits or costs of all financial products, services or transactions, starting with CDS and other derivatives. Those that do not serve a function useful to society should be eliminated.
3. A respect for the expertise and competence of state regulators and legislators, and for the purpose and relevance of state laws and administrative regulations.

After all this talk about regulation, the age old question comes up. And the answer is simple, not a nested box of paradoxes and conundrums. This is the USA, a democracy, and the ultimate guards are we the people. The laws and the regulations and the enforcement that we get will be what we require of our elected servants, the Congress and President of the United States.