What Lessons Does the CRA Offer the Insurance Industry?

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In light of the $150 billion bailout of AIG, there has been a renewed call for increased federal involvement in the insurance industry, including a proposal to extend something similar to the Community Reinvestment Act (CRA) to insurance providers. Although that seems fair at first glance, simply applying the banking model to insurance is problematic for several reasons: (1) it contradicts the core business model of insurance; (2) it would not address the existing deficiencies in serving the low- to moderate-income market; and (3) the current fractured regulatory structure has no capacity to administer, uniformly and cogently, a national program such as a new CRA-like requirement. A greater opportunity exists in leveraging what insurance does best: mitigating risk to encourage investment and innovation and smooth unpredictable losses.

Why the CRA for Banking Does Not Work for Insurance

Historically, the CRA was a response to a specific deficiency in the practices of some banks—extracting value from a geographic area without an equitable exchange of goods (credit) or services. This rationale for the CRA in banking does not necessarily apply to insurance because the core business model of insurance returns value in the form of claims to the communities from which it collects premiums. And the adequate return of claims dollars, the "loss ratio" statistics of companies and types of policies, are closely monitored to ensure that policies are fair and that the vast majority of premiums are paid back out in claims. Thus, the existing practice of the business ensures an exchange of value that is equitable for the consumer. In other words, there is no insurance equivalent to redlining.

If the goal, however, is to increase low- and moderate-income (LMI) household financial stability, tremendous benefits can be gained by leveraging the vast engine of the insurance industry. The three main assets that contribute to the stability of LMI households are wages, homeownership, and retirement savings. There are clearly deficiencies in the way the market and government provide insurance for these assets; however, those weaknesses cannot be rectified by CRA-like regulation because there is no single set of providers, such as banks, to regulate. Insurance is provided by employers, lenders, various agencies of the state and federal government, and other financial services providers. The solution needs to use both the market and public policy to address these various providers. The best way to develop these new products is to create incentives and changes in tax and other policies, rather than to set quota requirements for numbers of policies defined by geography.

What Will Work for Insurance?

For individuals, especially those in LMI households, events such as foreclosure, job loss, and pension failure can be catastrophic. These events are exacerbated because neither the industry nor the government has achieved success in offsetting risk on a household basis (as purchased by individuals), comparable to the success achieved at the group or large commercial level, (as purchased by large employers, corporations, or unions). In proposing solutions, it is important to consider that the insurable assets of LMI households (household income, homeownership, and retirement savings) are addressed by a government insurance program or tax subsidy (or both). The government alone cannot provide an adequate level of protection for consumers. Thus, the market, encouraged by public policy, has an opportunity to create the optimal balance between protection and investment.

The Role of Insurance in Addressing the Needs of the LMI Household

The most significant asset of LMI households—current and future wages—is exceedingly vulnerable to the vicissitudes of physical ability, industry health, and macroeconomic stability. The private market insurance response to those issues—life, unemployment, and long- and short-term disability—are unable, in their current forms, to adequately replace household income for the LMI population. The government solution, unemployment insurance, is structurally flawed. Less than 45 percent of the U.S. workforce is qualified to receive unemployment benefits in the event of job loss because they work too few hours (part time or seasonal). In addition, the benefits max out at an average of $260 per week, below the poverty line for a family of three. Nongovernment unemployment insurance is not widely available with one of the few examples being insurance connected to payday loans.

Smoothing Household Income

When asked about life insurance, LMI respondents to a recent Federal Reserve survey referred to life insurance positively as "forced savings" that allowed them to save for a targeted time after the loss of a wage earner more effectively than in a traditional savings account.[1] Although life insurance is a highly efficient income-smoothing tool, there are very low take-up rates among LMI households for the whole or term life products that meet this need. Several reasons explain this situation. First, the distribution channel for life insurance—agents—is not cost-effective under the current licensing and regulatory structure. There is clearly a way to offer a streamlined license for agents selling targeted, proscribed policies, similar to how many auto policies are sold. This would be most effective on a national basis because state lines create no difference in the need of buyers for specific life products. Second, the tax benefits of life insurance are less relevant for lower-income households, but this too could be rectified, possibly by attaching a life-insurance purchase to the Earned Income Tax Credit refund process. Finally, there is the issue of Long & Short Term Disability. As the hard economic times or shrinking retirement accounts have kept many older employees working past 65, they are now realizing that a widely used income-protection tool—disability insurance—is rarely available to workers over 65. As with difficult-to-place auto or worker's compensation, market supply could be increased by the implementation of a FAIR plan, an assigned risk pool, or other pooling mechanism to control for adverse selection. This is an issue that should be highlighted by policymakers to draw attention to the need for increased market supply.

If we know that securing the wage stream is vital to household stability, we can either lower the barriers to entering the market via regulatory streamlining or reduce the ultimate cost of the product by creating incentives to purchase, especially through the tax code. While there would be an increased cost to providing this incentive, it goes a long way toward keeping LMI households economically secure. It is also an opportunity to extend protections and benefits throughout the economy, since government already provides a hefty subsidy to middle- and high-income households through mortgage interest deductions and 401(k)/pension/healthcare pretax contributions. Properly conceived, more targeted insurance products could do much to "smooth" household income.

Housing – PMI for Borrowers

Home-ownership rates currently stand at historically high levels for all segments of the U.S. population, including LMI households. Record high foreclosure levels and more than two million seriously delinquent mortgages have prompted greater scrutiny of the lending process. Several risk factors have become apparent; the most important among them is agency risk that results when mortgage underwriters can securitize their way out of bearing the long-term risk. The "insurance" product with the greatest take-up rate among less financially secure borrowers is Primary Mortgage Insurance (PMI), which only protects the lender. The higher yield of these loans coupled with PMI is meant to mitigate the cost of default for the lender, but while the full cost of the interest and PMI is born by the borrower, the borrower receives none of the protection. There is also mortgage life insurance, which is activated only upon the death of the mortgage holder.

The current foreclosure crisis has made apparent the high—and in many cases avoidable—costs when a mortgage moves from delinquency to foreclosure. Many homeowners are not sure of their options and find it difficult to navigate the banking system to advocate for themselves. As a result, many homeowners have simply walked away from their mortgages. Creating a PMI for borrowers could provide short- or longer-term payments in cases of job loss or other economic

1 *Robin Neuberger, "Insurance and Asset Building," Chicago Federal Reserve Board, 2008.*

difficulty to bridge temporary loss of income. It also has the benefit of bringing a third payor with a longer investment horizon and a separate underwriting methodology to the mortgage. In addition, embedding insurance into the credit decision and mandating its purchase by high-risk borrowers will give borrowers and all parties protection in the case of financial disaster. This effectively increases the take-up rate, or the percentage of people purchasing mortgage insurance, although it is a version that broadens the life/economic events that qualify for payout beyond that of traditional mortgage insurance. Since we are unlikely to revert back to the presecuritized environment, submitting a greater swath of mortgage lending to an additional underwriting protocol— PMI for borrowers—would create additional protection against default and predatory lending. Doing this might lead to slower increases in homeownership at the lowest income levels, since even $50 to 100 a month in increased payments will make home purchase more expensive relative to renting. However, the increased cost of borrowing should accurately reflect risk and the social cost of foreclosure.

Retirement

Retirement gets the least attention when discussing financial services for LMI households. Insufficient savings rates, difficulty managing both investment risk and longevity risk (how long you will live postretirement), and tax policy that accrues benefits disproportionately to high wage earners have all led to a scenario where 43 percent of households will not have enough income in retirement to maintain their preretirement standards of living.[2] This is exacerbated by the fact that only nine percent of all workers saved the maximum allowed, $15,500 in a 401(k), and nearly 20 percent had a loan outstanding against their retirement account. Knowing that Social Security alone cannot provide adequate retirement income indefinitely and that individuals rarely save enough or invest prudently, the alternative is both to mandate and incentivize current workers to more realistically participate in their own retirement. The good news is that the insurance industry already has the products and structure to meet these needs.

Perhaps the most important retirement product is the fixed annuity. A fixed annuity is purchased before or at retirement for a lump sum and then pays out a fixed monthly payment. The payment of a fixed annuity does not fluctuate based on investment return; it is fixed in amount and duration. Annuities can be purchased throughout a career, with payments delayed until a predetermined age. Teresa Ghilarducci, the noted pension economist and academic, has proposed further encouraging retirement savings by mandating a five percent annual savings rate for all workers who purchase slices of annuities—future monthly payments—throughout their working lives. At retirement, this annuity payment would be a supplement to Social Security, bringing the majority of workers above a 70 percent replacement rate of their preretirement income.[3]

Retirement planning and savings need to focus much more forcefully on stable investment vehicles such as fixed annuities. As the past months have shown us, we are gambling with the growing segment of future retirees who will rely solely on a 401(k) to deliver retirement security. What retirees and our economy need is a vehicle, coupled with targeted savings rates, that delivers stable retirement income, not just retirement wealth contingent on the performance of the stock market. This vehicle, fixed annuities, while a proven, flexible, and efficient means for delivering retirement security, suffers from confusing pricing and the fear of the unlikely event of dying too soon and losing the value of the annuity. Many other countries, the UK and Chile most notably, integrate annuities into their public pension systems and create a way to stabilize retirement income.

The dramatic shift from fixed, annuitized defined benefit plans to variable 401(k) plans in recent years has added urgency to the debate. Short of another bailout or a Retirement Stimulus Plan for 401(k) holders, increased retirement stability will be possible only with a rethinking of the retirement tax and policy structure. Plan sponsors have been freezing or terminating defined benefit plans at a steady pace for more than twenty years, having determined that the combination of changing demographics and long-term investment risk was too uncertain and volatile for a corporation's balance sheet to bear. So while the 401(k)-only solution has clearly been found

2 *The Center for Retirement Research at Boston College, various publications, 2008, available at http://crr.bc.edu/index.php.*

3 *Teresa Ghilarducci, When I'm Sixty-Four: The Plot against Pensions and the Plan to Save Them (Princeton: Princeton University Press, 2008), 124–25; 62–63; 54–56.. Pension Rights Center, available at http://www.pensionrights.org/policy.html.*

lacking and defined benefit plans are covering a shrinking minority, the federal government continues to spend roughly $115 billion annually to subsidize this system. Based on marginal tax rates and levels of savings, those benefits accrue largely to middle- and high-income earners, who may save regardless, and ignore the LMI population that cannot. Since the government is truly the insurer of last resort here, the public policy around annuities and strong incentives for retirement savings in the United States needs a strong push on the policy front to become part of the retirement security toolbox.

Obstacles to Success

An additional obstacle to the insurance industry's ability to create new products for LMI consumers is the industry's confusingly decentralized regulatory structure. Insurance companies and brokers who wish to do business nationally must operate under 56 separate state and territory reporting agencies with thousands of regulators and staff, but with little to no common sense consistency. There is certainly a need for more uniformity, which would not only be easier to follow, but also would be easy to regulate. This is true for large-scale policy efforts like the ones outlined in this article, but also it would protect consumers by insisting on better price transparency and consistent requirements to disclose the fees and commissions paid to intermediaries.

The heavy administrative burden in response to the lack of uniform regulation acts as a tax on innovation. The cost and regulatory burden to launch a product—and have it approved by the 56 different agencies—is staggering and dampens new product development, especially in riskier, lower-margin areas that might best address the needs of LMI households. Exacerbating the situation, the position of State Insurance Commissioner is a political appointment or elected office that does not require any insurance expertise or knowledge of the law or the industry—in fact, the requirements are less stringent than what is required to obtain a basic insurance license! The leadership of the National Association of Insurance Commissioners, while thoughtful, changes annually, making progress on long-term issues difficult. Since little institutional insurance expertise, operational or policy, exists at the federal level, it is impossible to contemplate how a national policy or a regulatory regime, the CRA or otherwise, would be implemented.

Conclusion and Next Steps

Addressing systemic financial risk and strengthening consumer protection are tasks that have been avoided for two generations, a task not made any easier within a system that failed to consider the "100 year storm event."[4] Widespread underwriting failures, lack of consideration for systemic risk in the insurance industry, and a convoluted and opaque regulatory structure generated a tremendous tax on our economy. The path forward will need to correct for those failures without stifling the benefits of innovation and new market development.

In a recent speech regarding the CRA, Federal Reserve Chairman Ben Bernanke asserted that one of the goals of the CRA was to lower the "first mover risk" of entering new territories.[5] Similarly, to address household financial stability, tax policy and regulation should be engaged to reduce the risk of entering these new markets and leverage the development capacity and risk-management expertise of the insurance industry to meet the gaps in the current structure.

The following actions are suggested to start this process:

1. Start a conversation on how the insurance industry can play a role in promoting the economic health of LMI individuals and communities.

2. Create a national regulatory structure. As recently proposed by the "Group of 30," headed by Paul Volcker, "for those countries lacking such arrangements, a framework for national-level consolidated prudential regulation and supervision over large internationally active insurance companies should be established."[6] One model is the Optional Federal Charter, a structure that would allow insurance companies and brokers the option of being federally regulated with one national standard, or remain state-regulated, which is the current system. Large national and global firms, whose complexity and reach create opportunity for systemic risk, would

4 *Alan Greenspan, Testimony before the House Oversight and Investigations Committee, October 23, 2008.*

5 *Chairman Ben Bernanke, Board of Governors of the Federal Reserve System, "The CRA at 30 Years," Speech given at the Community Affairs Research Conference, Washington, DC, March 30, 2007.*

6 *Group of 30, "Financial Reform: A Framework for Financial Stability," January 15, 2009, 59.*

likely be regulated by a sophisticated federal regulator housed within the Treasury or other financial oversight body. Small companies, mutuals, and brokers may choose to remain state-regulated, continuing their close access to local regulators. Regardless of form, no serious discussion of addressing systemic risk or encouraging innovation can go far without modernizing the regulatory structure and the engagement of the federal government.

3. There needs to be a rigorous examination of what best serves consumers as either the primary insurer (the first firewall against job loss, illness, or foreclosure) or the re-insurer (the second line of defense for mortgage, wage, health, and retirement insurance). Currently, the government is the primary insurer for those who will depend solely on Social Security, Medicare, or Unemployment Insurance. The public sector has also become the insurer of last resort for the mortgages held by government-sponsored enterprises (GSEs). We must determine if the existing structure meets the needs of an aging population in a globalized economy and, if not, whether the policies and incentives discussed here are the appropriate hybrid.

4. In a time of financial crisis, we have to be confident that every tax dollar deferred for retirement savings, health care, or mortgage interest is creating value for the economy that would not have been created by private markets or individuals alone. If tax dollars are deferred for retirement savings or housing purchases that would have otherwise occurred in the private market, we are not effectively using those funds as an incentive for "first mover" innovation or to support less financially stable populations that may require future public support. The existing asset-based tax policy needs to be thoroughly examined for fairness, effectiveness, and a demanding return on capital.

5. Federal policy should encourage innovation and expertise and be housed in a new institution, something like a federal center of insurance expertise. The events of late 2008 exposed the fact that not only did no one regulator have a full picture of the financial health of large international insurers, but there was also little insurance expertise at the federal level to adequately address the relevant issues. In addition to gathering information, the center could act as an incubator to accelerate new product development with the carrot of a single, national review and approval of new products, avoiding 56 separate state requirements. The center could also administer a national insurance license for insurance brokers and agents. Both of these functions could lower costs for consumers without compromising oversight. Finally, this institution could also enforce CRA-like regulation.

Now is the time to creatively and rigorously assess what combination of the public sector and industry most effectively and efficiently will meet the financial needs of both LMI households, which have a tremendous need for cost-effective ways to manage income, debt, and retirement risk, and an aging population with stagnant wages, depleted assets, and little savings but staggering debts. Although that does not look like a CRA, it does create ample opportunity to leverage the capacity within the insurance industry to offset risk and employ its expertise to find the most efficient and effective methods, whether public or private. ■

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