5. (3.5 points)

   a. (0.75 point)

      Briefly describe each of the following reasons for regulatory failures:

      - Regulatory fallibility
      - Regulatory forbearance
      - Regulatory capture

   b. (0.75 point)

      Briefly describe each of the following elements of an effective insurance regulatory system:

      - Duplication
      - Peer review
      - Diversity of perspectives

   c. (1.5 points)

      Describe how each element in part b. above can successfully address one of the failures in part a. above.

   d. (0.5 point)

      Discuss the likelihood of federal bailouts of insurers under the current regulatory structure.

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b. Most candidates knew how the Clayton Act applied to tying. Some candidates made the mistake of trying to stretch the Clayton Act to cover boycotting, even though boycotting is not addressed by Clayton.

c. Most candidates knew the definition of the McCarran-Ferguson Act.

d. Most candidates knew how boycotting would be addressed under McCarran and the federal regulation of insurance.

5. <u>Sample Answers</u>

a.

Fallibility → regulators are human, human makes error
Forbearance →regulators may be unwilling to take action promptly on troubled insurers
Capture →tendency for regulators to side with interested party

b.

Duplication (any one of the following):

- Multiple states have the authority to regulate an insurer
- Different regulators can perform several of the same regulation activities, to avoid potential errors

Peer review

- Other regulator can request regulator to take action; peer pressure

Diversity of Perspectives (any one of the following):

- An effective system considers diversified perspectives and strikes to reach compromise
- Regulators having different viewpoints on issues and hopefully reaching centrist solutions
- Extreme outcomes are unlikely due to shared information and common ground

c. For each of the regulatory failures, any one of the descriptions:

Duplication counters fallibility

- More than one set of eyes so less chance of human error
- Less likely that the same error is made by different people

Peer review counters fallibility

- Sometimes regulators do not have a perfect system in place to regulate effectively. When other regulators review and critique them, it improves their processes and leads to better regulation overall.

Duplication counters forbearance

- One regulator may not take action but another might

Peer review counters forbearance

- Peer review puts pressure on regulators to take action, so effectively reduces regulatory forbearance

Diversity of perspectives counters forbearance

- Div. of Perspectives can address regulatory forbearance through communication/ discussion & bringing a reluctant regulator to a more reasonable position (if the majority of players believe the insurer is troubled)

Duplication counters capture

- Others may not have the same political influences that created the capture problem

Peer review counters capture

- Peer review would address regulatory capture as other unbiased agencies would make sure an agency is not playing favorites by ignoring a company's issues

Diversity of perspectives counters capture

- This applies to capture, those that are at one end of the spectrum watch those that are likely to be influenced by the industry
- Many perspectives ensure that no faction is favored over another and reduces regulatory capture

d. Any one of the following arguments:

Not likely:

- Under the current system, states still regulate the insurance industry so it is unlikely to be bailed out by the Federal Government. Dodd-Frank was enacted in 2012 but the FIO has not produced the report on the insurance industry regarding systemic exposure. So at this point Dodd-Frank is mute on the subject of Fed bailouts.
- Unlikely, since insurance is regulated at the state level and there are Guaranty funds specifically for insolvent insurers.
- The chance is low due to less regulatory errors, peer pressure and ongoing collaboration in the insurance industry. Compare to the 2008 financial crisis, insurers are performing much better than financial industry due to the good regulations in place.
- Likelihood of federal bailouts under current regulatory structure is low because the states don't have direct access to federal funds (AIG and the two insurers helped by TARP are exceptions). This restricted access to federal funds reduces moral hazard in insurance.

Likely:

- "Too big to fail" was an ideology used by the government when bailing out banks after the 2008 financial crisis. While, for the most, insurers escaped clean and did not require bailouts at the time, there is nothing to say that bailouts wouldn't be available for large insurers should there be turmoil in the future.
- Likelihood of federal bailouts of insurers is likely to happen if needed. Recent Dodd- Frank Act opens door for federal regulation as Federal Insurance office is created within Department of Treasury. FIO may assess the insurance industry and will try to reduce insolvencies to protect the public. Hence, federal bailout will likely occur if needed.

5. <u>Examiner's Report</u>

Parts a, b, and c of this question are fairly straightforward. Part d is more difficult since it requires the candidate to give an opinion and support it, which can't be adequately answered by simply memorizing the syllabus readings.

For parts a and b, most candidates were able to briefly describe each of the reasons. For part c, some candidates made the proper link between the problem and the remedy, but did not explain HOW that remedy solved the problem. For part d, some candidates only provided a brief statement rather than a discussion.