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Clumsy Regulation Puts Insurance at Risk

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The Senate Banking Committee convened this week to examine recent moves by federal regulators against insurance companies. There exists considerable confusion on and off the Hill about Washington's place in what has always been the states' regulatory domain—confusion produced by lawmakers' careless crafting of the Dodd–Frank statute. Absent a congressional fix, unwarranted regulatory actions threaten to disrupt the insurance industry, with costly consequences to consumers and the economy.

Targeting Insurers. Insurance was regulated solely by states prior to 2010.[1] Thereafter, Dodd–Frank spawned a Federal Insurance Office within the Department of the Treasury, as well as new rules on reinsurance and specialty lines. The act also established a Financial Stability Oversight Council[2] (FSOC) tasked with, among other things, designating for heightened regulation any "nonbank financial companies" whose failure could supposedly present systemic risk to the economy.[3]

This enhanced federal regulation of insurers, asset managers, and other so-called nonbanks was intended to shield taxpayers from any more of the multibillion-dollar bailouts that resulted from the 2008 financial crisis. In reality, the new regime further entrenches the dubious notion that some firms are "too big to fail," thereby setting the expectation of future bailouts.

The insurance industry is widely regarded as blameless for the housing bubble, its burst, and the ensuing economic calamity.[4] Making it a regulatory target exposes the degree to which both Congress and federal regulators have misinterpreted the real causes of the crisis.

The first nonbanks singled out by the council have all been insurers, including American International Group (AIG),[5] GE Capital, and Prudential Financial. All three are sizable enterprises, to be sure. But size alone is not a reliable predictor of risk; a big firm may fail without systemic consequences.

Indeed, "too big to fail" is more of a political doctrine than an economic one. Business failure is both unavoidable and necessary; it rids markets of inefficiency and creates opportunities for innovation. In the absence of objective criteria, the screening process for systemic importance has been left largely to the whims of the council, to whom Congress delegated unconstrained powers.

Insurers are understandably concerned about falling under the regulatory control of the Federal Reserve Board. Their designation as so-called systemically important institutions subjects them to costly and intrusive regulation, including data sharing, stress testing, and copious reporting.[6] And the Fed's structure as a self-financing entity deprives those it regulates from direct redress through Congress.

The Collins Amendment. Of particular concern is the so-called Collins Amendment, which Fed officials interpret as requiring capital and leverage

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requirements on insurers designated as systemically important. As currently written, the requirements are "bank-centric" and thus conflict with the principles of insurance investment. (The differences between the two industries are one of the reasons they have been regulated differently for decades.)

Capital requirements for banks are designed to maintain a cushion against losses that may result from short-term liabilities. But unlike bank deposits, there is no real risk of a "run" on insurance company assets. Insurance liabilities are *intended* to be "illiquid." In the event of insurer insolvency, loss payments come due only over the course of years. Insurers engage in long-term investment to complement these long-term liabilities and also rely on time-tested actuarial science to determine the level of adequate reserves.

Whether the Fed has the authority to tailor a more relevant set of standards for insurers is a matter of debate. Fed chairwoman Janet Yellen has acknowledged that the banking standards are ill-suited to the insurance industry but maintains that the statute restricts the flexibility of the Fed to design more appropriate requirements.[7]

In contrast, Senator Susan Collins (R–ME), who authored the amendment, argues that Congress never intended for regulators to apply bank-centric capital standards to insurance entities, which are already regulated by the states.[8] To "clarify" the issue for the Fed, Collins has introduced legislation to make plain that the Federal Reserve is not required to impose the capital requirements upon insurers so long as they are regulated at the state level.

There is no shortage of regulatory oversight nor any reason for the Fed to regulate the insurance industry. Each state oversees a guaranty fund financed by insurers to cover the claims of insolvent firms. State regulators have also established proven resolution procedures in the event of insurer insolvency.

Ironically, the efforts of federal regulators to usurp states' oversight could actually destabilize the industry rather than reinforce it. A too-big-to-fail designation may erode company discipline under the assumption that the government will remedy future problems. There is also concern that distinguishing an insurer as systemically important will give an unfair advantage to firms that are regarded as protected by the federal government.

Insurers Are Not "Too Big to Fail." The current debate in Congress is fixed for the moment on the Collins Amendment. The real problem, however, is the council's designation of insurers as systemically important. Under any plausible set of criteria, traditional insurance products, as long-term liabilities backed by long-term investments, cannot pose a systemic risk to the nation's economy. The best remedy, therefore, is legislation to bar the council from going after insurers.

Consumers, of course, will ultimately bear the costs of this unnecessary regulation. But the intangible costs may well exceed the billions of dollars in higher premiums that the regulatory burden would cause. Among the many flaws of Dodd–Frank is federal interference in states' regulation of insurance. The federal government already wields punishing control of the U.S. economy and Americans' lives.

1. States collaborate on uniform standards through the National Association of Insurance Commissioners.
2. The FSOC is composed of 15 members—10 voting seats and five nonvoting positions. The 10 voting seats are filled by the heads of nine federal agencies, including the Treasury Secretary and the chairman of the Federal Reserve, plus one presidential appointee. The five nonvoting slots are occupied by two federal agency heads and three state regulatory officials.
3. The statute also singles out bank holding companies with assets exceeding $50 billion for enhanced supervision by the Federal Reserve Board.
4. The term "life insurance" appears only once in the entire 663-page analysis of the Financial Crisis Inquiry Report. Steven A. Kandarian, chairman, president, and CEO of MetLife, comments at the Capital Markets Summit, April 10, 2013, https://www.metlife.com/assets/cao/pr/Capital-Markets-Summit-Remarks-FINAL.pdf (accessed March 18, 2014).
5. The taxpayer bailout of AIG was unrelated to its insurance business. The losses stemmed from its Financial Products division, which engaged in credit default swaps on subprime mortgages.
6. Deloitte Center for Regulatory Strategies, "SIFI Designation and Its Potential Impact on Nonbank Financial Companies," http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/us_aers_grr_crs_SIFI%20Designation%20%20_0313.pdf (accessed March 18, 2014).
7. Cheyenne Hopkins, "Insurers Urge Lawmakers Not to Impose Bank Capital Requirements on Industry," *Insurance Journal*, March 11, 2014, http://www.insurancejournal.com/news/national/2014/03/11/322901.htm (accessed March 18, 2014).
8. News release, "Finding the Right Capital Regulations for Insurers," office of Senator Susan Collins (R–ME), March 11, 2014, http://www.collins.senate.gov/public/index.cfm/2014/3/finding-the-right-capital-regulations-for-insurers (accessed March 18, 2014).

To the extent regulators focus on phony risks, they will overlook the real threats.

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