Insurance Needs a Federal Regulator — But Not the Fed*†

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The Financial Stability Oversight Council's recent designation of AIG and Prudential for enhanced regulation and supervision by the Federal Reserve Board invites a reexamination of proposals for federal insurance regulation.

Prior to the financial crisis, bills had been introduced in both the House and the Senate to create a federal insurance regulator and an optional federal insurance charter. Following the crisis, however, industry interest in that legislation waned, and one of the lead sponsors of the legislation, Rep. Melissa Bean, is no longer in Congress. Yet, with the designation of AIG and Prudential, large insurers are facing the worst of all regulatory worlds — dual regulation by the Federal Reserve Board and state insurance authorities.

At the same time, there are growing international demands for a more modern insurance regulatory system in this country. In its most recent assessment of U.S. financial regulation, the Financial Stability Board acknowledged that our state-based system of insurance regulation is generally thorough and effective, but concluded that the system lacks uniformity and a sufficient focus on all parts of an insurance group. Accordingly, the FSB recommended that the U.S. confer additional powers and resources at the federal level and enhance supervision of insurance groups.

The problem with the dual regulation by the Fed and individual states is the lack of symmetry between the two distinct regulatory systems. In other words, the systems are designed for entirely different purposes. State

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insurance regulation is focused on insurance risks, whereas the Fed traditionally has been focused on banking risks and, for the most part, has no real experience or deep expertise in the insurance business. These risks are fundamentally different and demand different approaches to effective regulation. Forcing insurance companies into a bank-centric model of regulation simply will not work.

The business of insurance is based on long-term insurance policies (liabilities) and matching investments in securities and other long-term investments in property and infrastructure (assets). Even if an insurer is experiencing financial difficulties, the risk of a policyholder "run" is remote since the insurance policies are tied to life events, not immediate daily needs like getting cash out of an ATM. As a result, state risk-based capital standards for insurers are tied to a range of factors including asset quality, liability risk, interest rate risk, and underwriting risk.

In contrast, the business of banking is based upon mostly short-term deposits (liabilities) and loans and other investments with a range of maturities, from short-term to longer-term (assets). The short-term nature of deposits exposes banks to the potential of depositor runs and the risk of a fire-sale of its assets to satisfy the demands of depositors and creditors. As a result, bank capital rules are tied primarily to a bank's risk-weighted assets and are designed to ensure that funds are available in the event of a run. Newly proposed liquidity rules for banks will reinforce this fact even more once they are fully in place.

Congress correctly recognized the potential for conflict between these two regulatory systems when it gave the Fed the authority to regulate non-banking companies designated by the FSOC. Section 165 of the Dodd-Frank Act specifically authorizes the Fed to "tailor" regulations for different business models. Yet, the insurance industry found little, if any, evidence of "tailoring" for insurance operations in the final Basel III capital rules from the bank regulators. Moreover, the Fed has interpreted the Collins Amendment (Section 171 of the Dodd-Frank Act) to require it to impose banking capital standards on designated insurance companies as if they were banks.

Federal insurance regulation would solve the problems inherent in our insurance regulatory structure. A federal insurance regulator could implement a uniform supervisory and regulatory structure specifically designed for the risks associated with the business of insurance. A dedicated federal

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insurance regulator also could serve as the systemic risk supervisor for insurance companies designated by the FSOC. An insurance company designated as systemically important by FSOC could be required to operate under a federal charter and be subject to federal supervision and regulation by this federal insurance regulator. This approach would include supervision of all parts of an insurance group, something that has been lacking in the state-based insurance regulatory system. Other non-systemic insurers also could choose either a federal charter or a state charter, much like banks choose either a state or national charter.

If we are going to pursue a path of naming large insurance companies for tougher regulation to protect financial stability and prevent systemic risk, then we also should consider what is in the best interests of insurance consumers and the companies they depend on for their protection and investment needs. Federal insurance regulation that is geared to address the risks associated with the business of insurance and is in line with international supervisory standards would achieve that goal.

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