Dodd-Frank Comes for the Insurers

Bank-style regulation on the industry will encourage risky behavior.

By Ben Nelson
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For nearly 150 years, states have regulated America's insurance companies. In all that time, even during the 2008 financial crisis, this stable industry has fortified the broader economy. Now the federal government has set out to fix something that isn't broken, foisting federal banklike regulation on insurance companies.

The change comes courtesy of the 2010 Dodd-Frank law, which created the Financial Stability Oversight Council to identify nonbank financial institutions whose failure "could pose a threat to the financial stability of the U.S." These "systemically important financial institutions" (SIFIs), such as AIG and Prudential, PRU.LN -0.31% will now be supervised by the Federal Reserve in addition to state insurance regulators. Dodd-Frank also empowers the Fed to regulate certain insurance companies that happen to own a savings and loan institution. This could mean that the central bank could end up the consolidated regulator of some of the nation's largest insurers.

It's important to get insurance regulation right. Life-insurance companies in the U.S. pay out $350 billion a year in benefits, replacing income lost by death, disability or retirement. Property and casualty insurers, meantime, paid more than $300 billion last year to help individuals and businesses repair their cars, and rebuild their homes and buildings, after natural disasters. Every dollar these insurers furnish is one fewer taxpayer dollar at the whims of federal disaster-relief grants.

Calls for bank-style oversight of insurers are especially ironic considering the state-regulated insurance industry served as a model of stability in 2008 when the federal banking and mortgage system collapsed. The 2008 failure of insurance company AIG is often cited as evidence that insurers need federal overseers, but AIG's state-regulated life insurance didn't cause the firm's downfall. AIG's federally regulated financial-products division did. State regulators don't even allow insurance units to make those kinds of risky investments.

State insurance regulation works because it's specific to the industry's unique risks. States are able to tailor a risk-based capital system to their own needs, with different methods for life, health and property and casualty insurance. Those requirements consider all possible sources of risk—from asset risk to underwriting risk to operational risk—when determining minimum holding requirements. The Federal Reserve, on the other hand, will likely subject insurance companies to a one-size-fits-all bank capital framework.

That may encourage, not discourage, risky behavior. Consider a life-insurance company that invests primarily in fixed-income securities to generate the predictable cash flows the firm needs to pay benefits. Under state insurance regulations, the company would sensibly hold less capital...
for top-rated corporate bonds and more capital for riskier, high-yield bonds. But under bank capital rules, all corporate bonds receive the same risk weight, regardless of credit quality. The company would have a perverse incentive to hold the riskier bond for a higher rate of return.

Or take variable annuities, insurance contracts with a guaranteed minimum payment. In the beginning of a variable annuity, known as the accumulation phase, customers invest in a basket of securities managed by the insurance company, much as they would in a mutual fund. But variable annuities often come with a guarantee that the asset value will not fall below a certain level, so the insurance company must set aside capital to ensure it can honor that promise.

Thus the company is at less risk of big payouts when asset values are rising, and at more risk when values are falling. But bank regulation ties the amount of capital a company must hold to the value of the assets on the balance sheet. Companies would be required to hold more capital as asset values increase—while their risk exposure is decreasing. In short, bank rules would require insurers to do the exact opposite of what might actually protect them.

Banking regulations are designed for bankers, not insurers. Applying federal bank standards to insurance companies will be costly and provide no additional protection, and worse, might actually offer less security. Consumers, taxpayers and the economy have benefited from state regulation. Let's not replace a regulatory model we've seen work well with one we've seen fail spectacularly.

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