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Premature, Potentially Dangerous for the U.S. to Embrace Group Capital Regulation for Insurers

Distinctions between banks and insurers important; European-style insurance solvency regulation not appropriate

Before embracing any European-style insurance solvency regulation for U.S. insurance groups and conceivably even systemically important insurers, regulators on this side of the Atlantic should bear in mind that while group capital regulation may be appropriate for banks, it clearly is not generally appropriate for insurance, according to a new paper by Brookings Nonresident Senior Fellow Robert Litan released today. Currently two U.S. life insurers, AIG and Prudential, have been designated systemically important financial institutions (SIFIs) with a third, MetLife, is expected to be designated by the Federal Reserve soon.

In "Source of Weakness: Worrisome Trends in Solvency Regulation of Insurance Groups in a Post-Crisis World," Litan notes that the U.S. insurance regulatory regime has long been customer-centric -- the premiums and capital of any insurer are meant to pay the claims of that insurer's policyholders and not to be drawn on to rescue a failing affiliate within the same group. However, since the financial crisis, international financial bodies have been pressuring the U.S. to adopt the EU's very different approach for globally and systemically important insurers, and potentially for all insurers, borrowing from the banking industry the notion of "group capital" regulation, which makes all parts of a banking group financially responsible for each other.

Litan says that application of a creditor-centric system of solvency regulation to U.S. insurers would a mistake. It not only ignores the legal separateness of the different entities belonging to a single insurance group, but because some states regulate the rates of some insurers, a group capital system would invite state regulators to ignore the capital of the different entities within the group and compel them to charge rates that are not actuarially appropriate which would undermine the legal and economic basis of insurance -- ultimately to the detriment of both insurance policy holders and insurers. EU countries do not regulate the rates of their insurers.

Litan urges U.S. policy makers to "slow the train down" in spite of the pressure from EU and international financial supervisors urging their European group capital approach on U.S. insurance regulation. Although he recognizes that some may be tempted to embrace group capital in the wake of AIG's failure, Litan notes that AIG failed primarily because of its non-insurance activities, and that the Dodd-Frank addressed this problem – the failure to post adequate margin or collateral on the risks of the credit default swaps – through mandatory clearing of standardized CDS and other over-the-counter derivatives, among other regulatory changes.

Litan's study highlights three other key issues:

- **History**: the international bank capital standards established by the Basel Committee were applied to a limited number of institutions and then became a template for a much larger number. If the U.S. were to adopt European-style group capital regulation for what initially may be a limited number of insurance groups, it is likely that over time, those rules would become the default rule for all insurers and insurance groups in this country.

- **Apples and oranges**: there are good reasons for not applying a group capital approach to the overwhelming majority of insurers that cannot reasonably be said to present systemic risk to our financial system, and conceivably to insurance groups that have been so designated: the businesses of banking and insurance, and specifically the nature of their liabilities, are very different.

- **The U.S. is not Europe**: There is a key difference between the way in which other aspects of the insurance are regulated in the U.S. vs EU, as well as in a fundamental difference in regulatory philosophy. While Europe tends to put primary emphasis on preserving insurers and protecting their creditors, the U.S. historically has focused its primary attention on protecting insurance policyholders, while allowing financially troubled insurers to fail – potentially even systemically important ones under the new resolution procedures of the Dodd-Frank Act.

"For all these reasons, it is premature and potentially dangerous for U.S. policy makers to embrace group capital regulation for insurers at this time, even if it is initially proposed only for a limited set of globally systemically important insurance groups. The history of international bank capital standards, plus the apparent objectives of the IAIS, makes clear that any initial limits on global standards tend or are meant to apply to a much larger group of financial institutions over time. Sound public policy requires understanding all of the potential consequences of shifting from a customer-centric regulatory system to a creditor-centric regime before taking that leap," he concludes.