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On "How Should the Federal Government Oversee Insurance?"

Before the
Subcommittee on
Capital Markets, Insurance, and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

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Chairman Kanjorski, Ranking member Garrett, and members of the Subcommittee:

I am pleased to have this opportunity to testify on an issue of fundamental importance to the economic security of individuals and businesses in this country. My main points are as follows:

1. Insurance is not banking and should not be regulated as if it were. The case of AIG notwithstanding, insurance markets are characterized by minimal systemic risk and by strong market discipline. Any new federal regulatory initiatives encompassing insurance should be designed not to undermine the strong market discipline that presently exists.

2. The creation of a systemic risk regulator with authority to regulate "systemically significant" insurance organizations would likely have several adverse consequences. It could easily undermine insurance market discipline and reduce competition without significantly lowering the likelihood of future crises. There is also no compelling reason to expand federal authority for the resolution of financially distressed insurers.

3. Legislative proposals for optional federal chartering of insurance companies should be designed to the extent possible not to undermine market discipline and should specifically seek to avoid expanding the scope of explicit or implicit government guarantees of insurers' obligations.

*Insurance is not banking and should be regulated differently*

Insurance markets are fundamentally different from banking. Sensible regulation, including the design of government guarantees of banks' and insurers' obligations, should recognize the differences. Government guarantees help reduce systemic risk. Virtually everyone knows that they also create moral hazard: they reduce market discipline. Greater systemic risk – the risk that financial problems at one institution involve major spillovers that threaten other institutions and the overall economy – favors stronger government guarantees to prevent runs and contain spillovers, along with more stringent regulation to mitigate the additional moral hazard induced by stronger guarantees.

Systemic risk is much greater in banking than in insurance. Depositor and creditor runs on banks threaten the entire payment system. Banking crises involve immediate and widespread harm to economic activity and employment. This systemic risk provides some rationale for relatively broad government guarantees, both explicit and implicit, of bank obligations. Because such guarantees undermine market discipline, they create a need for tighter regulation, including more stringent capital requirements. The need for relatively stringent capital requirements in turn creates pressure from banks to relax capital requirements and/or to make them more accurate. The first and second Basel accords in part reflect this pressure.

Insurance is inherently different, especially property/casualty and health insurance. There is much less systemic risk and thus need for government guarantees to prevent widespread runs that would destabilize the economy. Insurance guarantees have appropriately been narrower in scope than in banking. Capital requirements have been much less binding. Because insurance capital requirements generally bite less; their accuracy generally has been less important.

Despite these differences, there has been pressure for and movement towards applying bank models of capital regulation to insurance, as illustrated by some proposals for federal insurance regulation and by the Solvency II initiative in the European Union. I regard these developments as misguided. They reflect excessive optimism concerning the ability of seemingly sophisticated regulation to substitute for market discipline, and they pay too little attention to promoting market discipline. Any new regulatory initiatives regarding insurance in the United States should avoid this path.

*A systemic risk regulator would be counterproductive for insurance entities*

The potential benefits of creating a systemic risk regulator that would have authority to regulate nonbank institutions strike me as relatively modest and highly uncertain. Regarding insurance, creation of such a regulator with authority to designate particular insurers as systemically significant and therefore subject to its authority would have several adverse consequences. There is likewise no compelling case at present to create or expand federal authority to intervene with and/or resolve financially distressed insurers.

There are at least three major problems with the proposed creation of a federal entity with authority to regulate any insurer it deemed to be systemically significant:

First, market discipline could easily be undermined with an attendant increase in moral hazard. Any insurer designated as systemically significant would be regarded by many market participants as too big to fail. The implicit if not explicit government backing of its obligations and operations would lower its cost of funding and increase its incentives to take on risk. I am skeptical that tougher capital requirements or tighter regulation of such firms would be adopted and, if so, effective in limiting such risk taking over time. Government / taxpayer bailouts could become more rather than less likely.

Second, level competition between insurers designated as systemically significant and those not so designated would not be possible. Insurers designated as systemically significant would likely have a material competitive advantage. The resulting distortions would tend to increase market concentration and amplify the moral hazard problem.

Third, given the lessons from the current crisis and the earlier savings and loan crisis, it is hardly certain that a systemic risk regulator would be an effective means of limiting risk in a dynamic, global environment. Even without any increase in moral hazard, it could be ineffective in preventing a future crisis, especially once memories of the current crisis fade. This crisis underscores (a) the imperfect nature of federal regulation of banks and related institutions, (b) the necessity of renewed vigilance in bank oversight, and (c) the desirability of encouraging additional market discipline in banking.

Apart from the unique case of AIG, the insurance sector has thus far withstood the events of the past two years tolerably if not remarkably well. That some large life insurers need to replenish capital is hardly surprising, given the sharp fall in equity values, the reductions in values of mortgages and other real estate holdings, and minimum return guarantees provided on many of their products. The AIG intervention, in response to a liquidity crisis resulting from banking and securities-type activities, often with banks as counterparties, was not due to its insurance operations. Those operations appear to have been fundamentally sound at the time of intervention.

The ultimate consequences of having extended "too big to fail" (TBTF) policy to the largest publicly-traded insurance organization, in significant part to protect bank counterparties, are still uncertain. It can be argued plausibly that bankruptcy for AIG, perhaps with additional direct assistance to some of its counterparties, would have been preferable. In any case, however, the lessons to be learned from the AIG anomaly do not include the need for a systemic risk regulator with authority over insurance companies.

*Federal intervention in insurance regulation, if any, should be designed to encourage, or at least not undermine, market discipline*

Before the AIG intervention, insurance markets had been largely outside the scope of TBTF regulatory policy. Consistent with lower systemic risk, state guarantees of insolvent insurers' obligations are limited, which reduces moral hazard and helps preserve market discipline. Customers, especially business insurance buyers, and agents / brokers generally pay close attention to insolvency risk. Ex post funding of state guaranty association obligations by assessments against surviving insurers' obligations is appropriate. Insurers can respond effectively to such assessments without pre-funding. Ex post funding also provides incentives for financially strong insurers to press for effective regulatory oversight. Some people advocate pre-funding of guarantees with risk-based premiums. It is unlikely, however, that meaningful risk-based premium variation would be achieved in practice. Pre-funding would sacrifice the advantages of ex post funding without achieving enough risk-rating to significantly improve incentives.

If the Subcommittee in due course considers possible adoption of optional federal chartering and regulation of insurers, I hope that it will do so in view of possible alternatives, such as those that could encourage regulatory competition among the states or possibly preempt anti-competitive state regulation. In any event, I urge you to recognize the fundamental importance of avoiding expanded government guarantees of insurers' obligations. Under optional federal chartering, this might be achieved in principle by requiring federally chartered insurers to participate in the state guaranty system and/or by designing federal guarantees along the lines of existing state guarantees. The design of any government guarantees also might be tailored in principle to help encourage additional market discipline. It should be recognized from the outset, however, that a monopoly federal guaranty program might ultimately ensue with optional federal regulation.

*Incentives for safety and soundness, too big to fail, and the housing bubble*

Appropriate policy responses to the housing / mortgage finance bubble, whether for banks, insurers, or other financial institutions, require a full understanding of what went wrong and why. Many commercial banks, investment banks, thrifts, hedge funds, mortgage originators, subprime borrowers, and AIG placed heavy bets on continued housing price appreciation and against any fall in prices. They gambled, and the losses have been both huge and widespread.

Why did so many players place these bets? A simple yet significant part of the answer is that the potential gains and losses were asymmetric. If housing prices continued to climb, or at least not fall, the participants could achieve large payoffs. If housing prices failed to appreciate, or even fell, the losses would be largely borne by others. Before they became de jure, de facto guarantees of government sponsored enterprises' debt lowered their financing costs and contributed to mortgage credit expansion and housing price appreciation. Bank deposit insurance and implicit guarantees of banks' obligations encouraged risky lending and investment, especially given political pressure to expand subprime lending. The shift to corporate ownership of investment banks, with limited liability, plausibly encouraged them to take on more risk in relation to capital, especially given expanded competition with investment banking affiliates of bank holding companies. The SEC's adoption in 2004 of consolidated supervision allowed large investment banks to substantially increase leverage, in significant part by taking on more subprime exposure. Many subprime mortgage originators were new entrants with little reputational capital at risk and only modest participation in the risk of underlying mortgages. The Federal Reserve helped finance these risky bets by keeping short-term interest rates at historically low levels, thus fueling demand for credit and housing, and encouraging relaxation in historical mortgage lending standards.

Given what we know, the major objectives of any changes in federal regulatory policy should be to encourage market discipline as a means to incentivize safety and soundness, and to avoid further extension of explicit or implicit TBTF policies beyond banking. Creation of a new systemic risk regulator and/or expanded federal resolution authority for distressed insurers and other nonbank institutions could easily run counter to both objectives. The potential benefits seem modest in relation to the potential adverse results and risks of unintended consequences.