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Marriage, Not Dating, Is The Key To Healthy Regulation

By Eric Dinallo

One clear lesson of the **AIG** meltdown is that a financial services company should not be allowed to choose its own regulator, as AIG did. Despite that obvious warning, Melissa Bean and Ed Royce have introduced legislation in the House of Representatives to institute an “optional federal charter” for insurance companies, meaning insurers could select between state and federal regulation and switch back at will. To be truly effective, the regulatory relationship should be long-term and committed, like a marriage, not ephemeral and casual, like a one-night stand.

How we regulate insurance is not an esoteric issue. Insurance companies collect more than \$1,000bn (£680bn, €750bn) in premiums each year and have more than \$6,000bn in assets. Huge buyers of corporate debt, they are a major source of financing. Without insurance, you cannot buy a house, drive a car or open a business. Because they make long-term promises to pay if something bad happens, effective regulation ensures they deliver by requiring them to hold enough money in reserve.

How was AIG regulated? AIG is an international financial services holding company – with \$1,000bn in assets at its peak – that owns insurance companies and other businesses. AIG secured a tiny savings and loan, which permitted it, in 1999, to choose the federal Office of Thrift Supervision to regulate the holding company and its non-insurance operations, including the now-infamous Financial Products unit. Almost non-existent regulatory capital requirements permitted that unit to take the risky bets that brought down AIG and resulted in its bail-out – all the while regulated by the OTS, whose expertise – savings and loans – represented just one one-thousandth of its balance sheet. Meanwhile, AIG’s insurance companies, regulated by the states and subject to capital requirements, have remained solvent and relatively healthy.

State regulation of insurance is not perfect. But the states’ focus on solvency – requiring insurance companies to maintain strong reserves – have helped them weather the storm better than other areas of financial services.

This is not about turf. Even as a state regulator, I welcome a discussion about federal regulation of some parts of insurance such as reinsurance or bond insurance, but it is a huge mistake to allow an institution to decide it wants one regulator today and another tomorrow. It leads to regulatory arbitrage – playing regulators against each other to get favourable treatment – and a race to the bottom. There is too big a risk that a regulator not in a committed relationship, but just dating an insurer, will not ask tough questions.

Indeed, as Tim Geithner, US Treasury secretary, said recently: “We can’t allow institutions to cherry pick among competing regulators, and shift risk to where it faces the lowest standards and constraints.” He is not warning about a theoretical issue. Commercial banks can now choose their regulator and a recent study found that, since 2000, 240 banks have switched their regulatory charters. Shockingly, at least 30 of them then escaped imminent regulatory or enforcement action, which means the regulator had found some serious problem it wanted corrected.

We can avoid the “optional” part of a federal charter, but still meaningfully involve the federal government in the regulation of insurance. This would mean combining the benefits of state and federal regulation while eliminating the chance to play them off against each another. The federal government could set minimum standards for insurance and let the current state regulators enforce them. The 15,000 employees of the 50 state regulators are close to their markets and consumers with a structure that is hard to replace. The National Association of Insurance Commissioners, of all state insurance regulators, could become a federally recognised self-regulatory organisation, similar to the New York Stock Exchange. If there is federal regulation of some types of insurance make it full, not optional. Such regulation should not separate maintaining solvency from setting rates and reviewing market conduct. To be effective, a regulator must look at a company in its entirety. Since a major lesson of the crisis is the need to hold sufficient capital, federal regulation of insurance should, if anything, tighten capital requirements.

Choice and competition are essential to robust capitalism, but anathema to a healthy regulatory relationship. Whatever the mix of federal and state roles, financial services regulation should be a bastion of arranged marriages – with large capital dowries.

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