Insight

Treasury Report Adopts AAF Proposals for Insurance Regulation

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In response to Executive Order 13772 on Core Principles for Regulating the United States Financial System, Treasury released its report on asset management and insurance. Currently, insurance companies are primarily regulated by their state regulators. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) created the Financial Stability Oversight Council (FSOC) and charged it with designating non-bank financial companies, including insurance companies, as systemically important financial institutions (SIFIs). Once designated, FSOC is tasked with submitting the companies to enhanced oversight and regulation should it decide that material financial distress to a designated company could pose a systemic risk to the stability of the U.S. financial system.

Shortly after FSOC was established, it designated American International Group (AIG), Prudential Financial (Prudential), and MetLife as SIFIs. Since then, FSOC has rescinded AIG's designation. MetLife challenged its designation in court, arguing that FSOC's reasons for designation were "arbitrary and capricious" (the legal standard required to overturn a designation by FSOC), and won its initial case, which is currently waiting on a decision on appeal. Prudential is the last remaining insurance company still deemed a SIFI by FSOC, but, as AAF has suggested, FSOC should de-designate it as well.

If the term "systemic risk" is used broadly to encompass the risk of significant destabilization of the financial system with spillovers on real economic activity, it is misguided for regulators to assume that selecting whole entities for SIFI designation negates that risk. AAF has long argued for an activities-based approach wherein FSOC would identify specific risky activities or products and delegate the task of addressing those risks to the appropriate primary regulator. This is how it currently oversees asset managers, and, as AAF research has shown, if an activities-based approach had been in effect during the mid-2000s, it is possible that the financial crisis would have been substantially mitigated or even prevented.

In Treasury's most recent report, it changes course from its entity-based approach to designation and suggests an activities-based approach, as AAF proposed directly to Treasury. Specifically, it states:

"Treasury's position is that entity-based systemic risk evaluations of insurance companies generally are not the best approach for mitigating risks arising from the insurance industry. Rather than focus on entity-based systemic risk evaluations, insurance regulators should focus on potential risks arising from insurance products and activities, and on implementing regulations that strengthen the insurance industry as a whole. Also, while the FSOC maintains primary responsibility for identifying, evaluating, and addressing systemic risks in the U.S. financial system, the states are the primary regulators of the insurance industry in the United States, and insurance regulation at the federal level should be conducted in coordination with the states."

This is a huge win for American taxpayers and consumers of insurance products across the country. With a move toward an activities-based approach for regulating insurance companies and other non-bank financial companies, FSOC will make our financial system safer and will reduce many of the costliest regulatory burdens facing some of our nation’s biggest engines of economic growth. Although this report carries great weight, it is not yet the official position of FSOC or any other regulator. FSOC and the other applicable regulators should adopt the proposals contained in this Treasury report with haste.