Regulating the Insurers

At a time when so many government agencies have been captured by the industries they oversee, it's hard not to notice when someone like Benjamin Lawsky comes along and stirs things up. Since 2011, the 43-year-old former prosecutor has been superintendent of the New York State Department of Financial Services, which oversees banks and insurers. And this may be his most significant hour yet.

Jonathan Weil of Bloomberg comments on regulation.

This week, after an 11-month investigation, Lawsky released a report that said 17 New York-based life-insurance companies had used $48 billion of "shadow insurance" transactions to shift liabilities for policy-holder claims onto weakly capitalized shell companies that they controlled. This is "likely

to be just the tip of the iceberg nationwide," it said. The maneuvers decreased the parent companies' capital requirements, freeing up money for other purposes, such as paying bigger management bonuses or shareholder dividends.

In short, the insurers set up captive subsidiaries and had them reinsure existing blocks of policy claims. Often the new units were in lightly regulated jurisdictions -- everywhere from Vermont to the Cayman Islands. The problem, as Lawsky explained, is that the parent company is still on the hook if the shell company can't make good on its obligations. Sometimes the shell's assets might only consist of a letter of credit from the parent, as opposed to liquid assets that can be sold to pay claims. If the shell can't pay, the parent probably is in deep trouble, too.

Loose Rules

Some U.S. states seem to compete to write the loosest rules governing the types of assets that captive reinsurers can hold. The industry's jargon is full of cheeky names such as "hollow assets" and "naked parental guarantees." Lawsky called it a "regulatory race to the bottom" that puts policy holders and the broader financial system at risk.

"There's no real danger today or tomorrow," he said in an interview. "It's thinking about our system over the next decade or even two decades." With captives, "you see massive amounts of risk being moved around in a way that is often not transparent and is designed at least in part to juice the numbers of the companies. And when you put those two things together, we've learned that can be a recipe for disaster over the long haul."

Lawsky's bona fides were evident even before the report was released. Citing his probe as "an important factor," MetLife Inc. (MET) last month said it would combine an offshore reinsurer with three U.S. life-insurance units. (A reinsurer is an insurance company for an insurance company.) Lawsky at the time said MetLife's move was a "step in the right direction."

The Department of Financial Services was formed in 2011 when New York state abolished its banking and insurance regulators and combined their functions under one roof. Lawsky, who serves at the pleasure of New York Governor Andrew Cuomo, has shown an ambitious, independent streak from the outset. He made his bones last year when he threatened to strip the

U.K.'s Standard Chartered Plc (STAN) of its state banking license after accusing it of laundering money for Iran.

The feds were moving too slowly for his tastes, so Lawsky's office filed its own claims. Standard Chartered complained bitterly in the press, as did Lawsky's counterparts in Washington. However, the bank quickly agreed to a $340 million deal with the state, which proved to be more than what the feds later got in their own settlement. Lawsky was vindicated. He hadn't gone rogue, as some critics claimed. He had done just what he was supposed to do -- hold a bank that he oversees accountable for its actions.

Guess What

And you know what? The banking and insurance industries take Lawsky and his agency seriously now. Just try to think of the last time that the Federal Reserve publicly threatened to strip a huge bank of its license to do business, or published a white paper exposing some hidden accounting ruse. (I'll bet you can't.) Other initiatives by Lawsky have included a crackdown on force-placed insurers, in which mortgage lenders required homeowners on the brink of financial disaster to buy overpriced policies, while the lenders took kickbacks from the insurance companies.

Lawsky this week made clear he wants to shame other state insurance regulators into bringing about a change in the industry's practices. He called for a nationwide moratorium on approving shadow-insurance transactions and recommended that the National Association of Insurance Commissioners develop uniform disclosure requirements for such deals around the country.

They might be wise to follow his lead. It's good to have an aggressive financial regulator worth paying attention to again.