BIPARTISAN POLICY CENTER

STATEMENT OF AARON KLEIN
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"Finding the Right Capital Regulations for Insurers"

Subcommittee on Financial Institutions and Consumer Protection
Subcommittee on Securities, Insurance and Investment
Committee on Banking, Housing, and Urban Affairs
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Chairmen Brown and Warner, Ranking Members Johanns and Toomey, Members of the Subcommittees, thank you very much for the opportunity to testify at this joint hearing of the Subcommittee on Financial Institutions and Consumer Protection and the Subcommittee on Securities, Insurance, and Investment. I have tremendous respect for the critical role this Committee plays in shaping the financial regulatory and economic policies that have an enormous effect on the lives of all Americans. I am especially honored to appear before you, having served for over eight years on the professional staff of the Committee on Banking, Housing, and Urban Affairs, mostly as Chief Economist for former Chairmen Sarbanes and Dodd.

Bipartisan Policy Center Financial Regulatory Reform Initiative (FRRI)

I serve as the Director of the Financial Regulatory Reform Initiative at the Bipartisan Policy Center. Founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole, and George Mitchell, BPC is a Washington-based think tank that actively seeks bipartisan solutions to some of the most complex policy issues facing our country. In addition to financial regulatory reform, BPC has ongoing projects in housing, immigration, and the federal budget. The Financial Regulatory Reform Initiative's overarching objective is to promote policies that balance financial stability, economic growth, and consumer protection. Finding the right capital regulations for insurance companies under the Dodd-Frank Act is a critically important issue. I commend you for focusing the Committee's attention on the issue. My testimony will focus on the following four key points:

1. The business of insurance is fundamentally different from that of banking and hence must be subject to appropriate yet different capital standards.
2. Regulators need to overcome their "bank-centric" approach when regulating insurance companies.
3. The Dodd-Frank Act envisions regulators overcoming bank-centricity and empowers them to do so.

4. A more optimal regulatory approach should include a federal insurance regulator and optional federal charter. The benefits of such a regulator grow if the Federal Reserve is unable to adjust its bank-centric approach to insurance companies.

Insurance and Banking are Fundamentally Different Businesses, with Different Balance Sheets, Business Models, and Risk Profiles

To understand why it is so important that insurance companies be subject to insurance-based capital regimes, not bank-based capital regimes, one must first appreciate the fundamental differences in their business models, balance sheets, and risk profiles.

The Business of Insurance

At its core the business of insurance is about aggregating risks and matching assets to liabilities. Insurance companies are in the business of taking on risk of different tenures and matching assets and reserves against this risk. The precise approach varies tremendously by the type of insurance product. A company that provides auto insurance, usually on a 6- or 12-month basis, has to have a different asset and liquidity structure than a company that provides life insurance, which is often issued on a multi-decade contract.

Aggregating risk avoids adverse selection by offering highly competitive products that attract broad market share and a large pool of customers to minimize risks. Insurance companies that are able to capture more of a given market are able to more accurately protect themselves against adverse selection and statistically unlikely outcomes. By accumulating and pooling risk, insurance companies allow people to transfer the financial risk of getting into a car accident, losing a loved one, or outliving their assets to a broad risk pool. Aggregating appropriate risk thus paradoxically makes insurance companies safer.

The Business of Banking

Unlike insurance companies, which agglomerate and manage risk, banks are in the business of mitigating risk. Over-concentration in a specific business line is a classic "red flag" for regulators of safety and soundness problems. A key purpose of banks is to transfer timing risk; banks allow depositors to instantly access their funds, while using deposits to make longer-term loans to consumers and businesses. This process is often referred to as maturity transformation. As the Bipartisan Policy Center's Failure Resolution Task Force found, "maturity transformation is the socially beneficial process by which financial institutions fund themselves with

short-term borrowings and use these funds to make longer-term loans or investments in other illiquid assets. Without maturity transformation, our modern economy would grind to a halt."[1]

Can Banking and Insurance Coexist?

Some economists and policy makers have argued that there are economies of scale in mixing the provision of banking and insurance services. This theory was prominent in the 1990s and was one of the driving forces behind the Gramm-Leach-Bliley Act, which repealed the prohibition on the mixing of banking and insurance. The theory was tested more than 15 years ago on a large scale with the merger of Citicorp and Travelers Group. Many commentators at the time expected more mergers and the creation of "financial supermarkets" to provide both services. At the time, Travelers CEO Sanford Weill said that the merger would create "a model of the financial services company of the future," a sentiment shared by others in the industry.[2]

As an empirical economist, I check to see how well reality has matched theory. In the case of the proposed value of combining banking and insurance businesses, the expected benefits have not materialized. With one important exception, which I will discuss in a moment, there are no examples in the United States of mixing banking and insurance on any significant commercial scale, although there are examples of successful acquisitions of smaller banks and thrifts. The Citi-Travelers merger has been unwound and, in the absence of other similar mergers, it seems as if these businesses do not mix, even without regulatory barriers.

A model exception has been the successful provision of banking and insurance services by USAA. What is interesting about USAA is that it operates its business on a field-of-membership basis, more analogous to a credit union than to a bank. Technically, USAA has a thrift regulated by the Office of the Comptroller of the Currency (OCC) and a thrift holding company regulated by the Federal Reserve. The membership requirement involves family military service. The reputation of the company providing both services is also extremely high,[3] although I would not know firsthand, as I am not eligible for its insurance or for its bank lending activity.

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[1] John F. Bovenzi, Randall D. Guynn, and Thomas H. Jackson, "*Too Big to Fail: The Path to a Solution*," Bipartisan Policy Center, May 2013, p. 17. Available at: http://bipartisanpolicy.org/sites/default/files/TooBigToFail.pdf

[2] Yvette D. Kantrow and Liz Moyer, "Citi, Travelers: A Global Leader Takes Shape," *American Banker*, April 7, 1998. Available at: http://www.americanbanker.com/175/citi-travelers-a-global-leader-takes-shape-1041890-1.html

[3] See Tempkin Group, Net Promoter Score Benchmark Study, 2012, October 2012. Available at http://www.temkingroup.com/research-reports/net-promoter-score-benchmark-study-2012/. See also David Rohde, "In the Era of Greed, Meet America's Good Bank: USAA," *The Atlantic*, January 27, 2012. Available at

Can Regulators Overcome Bank-Centricity to Properly Regulate Insurance Companies?

Dodd-Frank Empowers the Federal Reserve to Provide Capital Regulation for Insurers

Dodd-Frank decided to treat thrifts and thrift holding companies nearly the same way it treats banks and bank holding companies, moving their supervision to the OCC for thrifts and the Federal Reserve at the holding company level.[4] Whether the continued bifurcation of regulation between holding company and insured depository is a wise decision is beyond the scope of this hearing, but is something that the Bipartisan Policy Center's Regulatory Architecture Task Force is examining and will discuss in a report to be released this spring.

The Federal Reserve is the regulator for a diverse set of insurance companies under Dodd-Frank. It is unclear how broadly appreciated that was during consideration of all of the aspects of Dodd Frank, including the adoption of the Collins Amendment. What is clear is that Dodd-Frank's decision to move the regulatory responsibility for thrift holding companies and non-bank SIFIs to the Federal Reserve was given along with the ability and responsibility for the Federal Reserve to recognize differences between these entities and develop appropriate capital structures, tailored to each entity or separate class of institutions. The broad authority to tailor was codified in Title I, Subtitle C of the Dodd-Frank Act.[5]

The Importance of Tailoring Capital Standards for Insurance

The economic rationale for capital regulation and for tailoring is clear but bears repeating. Capital regulation is necessary for many purposes, including, to ensure the safety and soundness of financial institutions so that customers can use these products efficiently and effectively. There are two main approaches to quantifying capital regulation for any financial institution. The first is a non-risk-sensitive approach, the leverage ratio, which creates a ceiling on total risk-taking. However, using the leverage ratio alone can have the perverse effect of encouraging institutions to take on more risk by treating all liabilities as equally risky and requiring the same amount of capital. Thus, a risk-based method of capital regulation is required to quantify risk levels for various assets and liabilities and require appropriate capital.

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http://www.theatlantic.com/business/archive/2012/01/in-the-era-of-greed-meet-americas-good-bank-usaa/252161/

[4] 12 U.S.C. §5412 (b)(2)(B) and 12 U.S.C. §5412 (b)(1)(A)

[5] 12 U.S.C. §5365(a)(2)(A)

The financial crisis demonstrated the problems inherent with over-reliance on risk modeling. The mispricing of risk is one of the hallmarks of financial crises. Institutions, regulators, markets, and models are all susceptible to this mistake. I cannot predict in which area we will misprice and incorrectly evaluate risk in the future, but I am certain that it will happen again.

The fundamental question is now how to develop appropriate metrics for both leverage and risk-based capital as it applies to insurance companies. Insurance companies differ fundamentally from banks in how one measures risk and leverage; thus a different capital system, specifically tailored for insurance companies, is necessary. A Bloomberg Government report studying this question concluded that: "the risks that insurers face are different from banks, and that regulating insurers as if they are banks may be inappropriate and unfair to insurance companies."[6]

Did Regulators Draw the Right Lessons from the Crisis for Insurers?

An example of the difference in regulatory mindset necessary for insurance companies can be seen by the treatment of separate accounts. Regulators made a key mistake in the run-up to the financial crisis by allowing banks to keep structured investment vehicles (SIVs) off their balance sheets, exempting SIVs from capital reserve requirements. The SIVs were "canaries in the coal mine" before the last financial crisis. Assets that were supposed to be low risk were in fact risky and required banks to raise significant capital during stressed periods—just at the moment that capital was especially costly. Post financial crisis, regulators have altered their approach, allowing fewer SIVs to be classified as "off balance sheet." For this, regulators should be commended.

Regulators, particularly the Federal Reserve, have also seen their post-crisis power broadly expanded. The Federal Reserve Board now has supervisory authority over many insurance companies as well as all SIFIs. As the Board's authority expands, it is encountering new products that banks don't offer and are accounted for differently, such as separate accounts. As defined by the Office of Financial Research (OFR), separate accounts are those "in which an asset manager selects assets on behalf of large institutional investors or high net-worth individuals under mandates defined in an investment management agreement. Clients retain direct and sole ownership of assets under management."[7]

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[6] Christopher Payne, "Basel Capital Rules May Hinder U.S. Insurers," *Bloomberg Brief: Financial Regulation*, April 26, 2013. Available at: http://www.bloombergbriefs.com/files/Financial_Regulation_042613_p1.pdf

[7] Office of Financial Research, "Asset Management and Financial Stability," September 2013. Available at: http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf

Insurance companies use these separate accounts for products such as variable annuities. The question is whether these accounts are treated as "on" or "off" balance sheet for regulatory purposes. To answer this, regulators must consider the risks separate accounts carry for insurance companies. Historically, insurance has been regulated by the states, which have recognized that funds in separate accounts are more analogous to stock market accounts. Stock brokers are not required to hold capital against their clients' accounts since the assets in those accounts do not belong to the broker. Banks, on the other hand, must retain capital against deposits, since the deposits are liabilities for banks, and are subject to runs.

A question remains as to whether federal regulators such as OFR, the Federal Reserve, and the Financial Stability Oversight Council (FSOC) will draw the appropriate line with respect to separate accounts. If the regulators discover that a non-bank is putting its own solvency at risk and not accounting for separate accounts properly that would merit new regulatory treatment. So far, data from OFR and from the states' historical experience regulating insurance companies does not support that conclusion. Instead, it raises concerns that bank regulators are misapplying bank-centric lessons into a non-bank world without a clear understanding of the different risks, balance sheets, revenue streams, and business models.

The Right Way to Think About Capital Standards

Good regulatory structures involve both minimum capital requirements through leverage limits and more sophisticated risk-based capital structures. Both need to be targeted and tailored to the business that they are regulating. As we have seen, insurance and banking are fundamentally different businesses with different risk profiles. Therefore, they require different capital regulatory and supervisory structures. The Dodd-Frank Act anticipated this and provided the Board with the necessary flexibility to tailor prudential standards accordingly to different businesses.

There is broad agreement that tailoring is the right approach. Federal Reserve Board Chair Janet Yellen said it best: "[T]here are very significant differences between the business models of insurance companies and the banks that we supervise and we are taking the time that is necessary to understand those differences and to attempt to craft a set of capital and liquidity requirements that

will be appropriate to the business models of insurance companies."[8] The question is whether the Board will follow through on Chair Yellen's wise words with carefully considered, differentiated capital standards for insurers that recognize they are not banks.

Dodd-Frank Envisions and Empowers Regulators to Overcome Bank-Centricity

Dodd-Frank made clear in several of its provisions the importance and need for federal regulators to develop and implement non-bank capital regimes for regulated non-bank entities, and the ability for them to do so. These provisions can be found, for example, in sections 112, 120, 165, and 616.[9] These themes were reiterated to regulators by Chairman Johnson (D-SD) and Ranking Member Crapo (R-ID) in their letter to regulators last year: "In setting the new capital rules for the United States institutions, your agencies face a formidable task to carefully tailor the new rules to the unique risks of institutions while neither hampering lending nor undermining the strength of our financial system."[10]

I am not an attorney and will not venture an opinion on how the Federal Reserve should interpret these provisions as they relate to section 171, often referred to as the Collins Amendment. I will point out however, that there is broad support, with which I concur, that capital standards should be tailored for different business models with different risk profiles. This was the clear intention of Dodd-Frank.

Even if individual bank regulators are unable or unwilling to use a tailored approach, the FSOC could solve this problem without additional legislation. Among the duties imposed upon the FSOC in section 112 is the duty to make recommendations to: (1) member agencies on general supervisory priorities and principals that reflect the outcome of discussions among the member agencies; (2) the Board concerning the establishment of heightened prudential standards, including capital standards, for nonbank financial companies supervised by the Board; and (3) primary financial regulators to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks

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[8] *Victoria Craig, "Janet Yellen Talks Disappointing Data, Weather on Capitol Hill," Fox Business*, February 27, 2014. Available at: http://www.foxbusiness.com/economy-policy/2014/02/27/janet-yellen-talks-dissapointing-data-weather-on-captiol-hill/

[9] 12 U.S.C. §112 (a)(2)(I); 12 U.S.C. §120 (b)(2)(B); 12 U.S.C. §165 (b)(1)(A)(i); 12 U.S.C. §165 (b)(1)(B)(i); 12 U.S.C. §165 (c)(1); 12 U.S.C. §616 (d)(b).

[10] U.S. Committee on Banking, Housing, and Urban Affairs, "Johnson and Crapo Urge Regulators to Address Concerns on Basel III," February 13, 2013. Available at: http://www.banking.senate.gov/public/index.cfm?FuseAction=Newsroom.PressReleases&ContentRecord_id=f321c69d-e901-e0ee-14eb-2ae6b730ee91&IsPrint=1

of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and U.S. financial markets.[11]

If these two preferred approaches are not implemented – the following of the intention of Congress by the Federal Reserve, or the use of FSOC's authority to make recommendations that the Fed could then adopt – I would then support a legislative solution to this problem such as the one proposed by Senators Brown and Johanns in S. 1369.

The Case for Federal Insurance Regulation in a Post-Dodd-Frank World

BPC's Regulatory Architecture Task Force has been examining the entire financial regulatory structure, as it exists in a post Dodd-Frank world. The task force's report will be released next month and will contain many recommendations for how we can improve our current regulatory structure. One of those recommendations will be to create a federal insurance regulator and an optional federal charter. This recommendation follows previous bipartisan calls for a federal insurance regulator, including legislation introduced by now Chairman Tim Johnson (D-SD) and then Senator John Sununu (R-NH),[12] as well as the comprehensive regulatory restructuring plan issued by the Treasury Department under Secretary Henry "Hank" Paulson, Jr.[13] It is also consistent with the framework proposed by Secretary Timothy Geithner in the 2009 Treasury White Paper, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation."[14]

Dodd-Frank did not follow those calls, but did create a new Federal Insurance Office (FIO) within the Treasury Department in order to build federal expertise in insurance. The FSOC was given the authority to designate any insurance company as a SIFI and hence transfer regulatory authority to the FRB. An independent voting member was also created for the FSOC with the requirement that s/he have insurance expertise.

How has this worked so far? We have limited data as Dodd-Frank is not yet four years old, but the data we do have indicates disagreement and a lack of consistency. The only public disagreement so far in the designation process among FSOC members was in the designation of Prudential, Inc. Roy Woodall, the independent

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[11] 12 U.S.C. §5322 (a) (2)
[12] The National Insurance Act of 2007, S. 49, 110th Congress, 2007.
[13] The Department of the Treasury, "Blueprint for a Modernized Financial Regulatory Structure." March 2008. Available at: http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf
[14] The Department of the Treasury, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," June 17, 2009. Available at: http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf

commissioner with insurance expertise, dissented on the vote to designate Prudential and was joined by the acting FHFA director. In his dissent, Commissioner Woodall said that the FSOC's analysis underlying the decision to designate Prudential was, "antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance resolution and guaranty fund systems," and that the designation, "will ultimately lead to the imposition of requirements that are by all indications ill-suited for insurance companies."[15]

The upcoming report from BPC's Systemic Risk Task Force will analyze the FSOC process, focusing particularly on questions regarding the FSOC's authority and its desire to regulate entities and institutions as compared to the regulation of activities. As long as designation of entities remains the main tool at the FSOC's disposal, it would be reasonable to expect a continued focus on designation. To a person with a hammer in his hand, problems tend to look like nails.

Has Dodd-Frank Created a Unified Voice for the United States on an International Basis?

One of the major goals in creating the FIO was to establish a unified federal voice on insurance for international regulatory purposes. Dodd-Frank gave the FIO the authority "to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors [IAIS]."[16] The Treasury Department echoes this, stating that a goal of the FIO is "to represent the United States on prudential aspects of international insurance matters, including at the International Association of Insurance Supervisors."[17] However, the Federal Reserve, citing its newly acquired regulatory responsibilities over many insurance companies, recently applied for a seat on the IAIS. The Board's decision to request a seat is understandable given its desire to acquire additional knowledge and expertise on insurance. However, it also sends an unclear signal to the international community as to who speaks for the United States between the chair of the Federal Reserve Board, the director of FIO, or the NAIC, which represents state insurance commissioners, the functional regulators for insurance companies today. The Federal Reserve should publicly affirm that the FIO is the lead representative for the

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[15] S. Roy Woodall, Jr., dissent to the FSOC's designation of Prudential, Inc. delivered to Council members, September 19, 2013, pp. 1, 7-8. Available at: http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf
[16] 12 U.S.C. §313 (c)(1)(E)
[17] U.S. Department of the Treasury, "About: Domestic Finance – Federal Insurance Office." Available at: http://www.treasury.gov/about/organizational-structure/offices/Pages/Federal-Insurance.aspx

United States on the IAIS. This remains an example of the effect of the duplicative and unclear delegation of authority over regulation of insurance companies.

Conclusion

BPC's Financial Regulatory Reform Initiative has found that Dodd-Frank empowered financial regulators with substantial authority and flexibility to use their tools to improve regulation and achieve better regulatory outcomes for both financial services providers and end users of those financial services. We have seen multiple examples of regulators doing just that, ranging from the Federal Deposit Insurance Corporation's Single Point of Entry approach to the Consumer Financial Protection Bureau's use of an open and transparent rulemaking process. We have also found multiple instances where regulators could have taken a better approach, such as the Volcker Rule. And, we have found several instances where additional statutory changes are required, including the need to add a chapter to the Bankruptcy Code to complement Title II of Dodd-Frank, and the desirability of an independent inspector general for the CFPB. However, our work has shown that regulators have significant tools at their disposal to get things right.

It is clear that banks and insurance companies are fundamentally different businesses, which require substantially different capital regimes. In my opinion, Dodd-Frank gave the Federal Reserve Board the necessary authority to the tailor its capital rules for insurance companies. The law clearly supports a tailored approach for insurance companies as well as all non-bank SIFIs. Dodd-Frank envisions a less bank-centric regulatory approach to the non-banks the Board regulates after FSOC designation. It also empowers the FSOC as it relates to authorities as well as institutions. And, it empowers the Federal Reserve and FSOC as it relates to capital rules for non-banks such as insurers.

If the Federal Reserve Board is unwilling, or unable, to implement the tailoring regime required in Dodd-Frank to insurance companies, I would support a legislative solution such as S. 1369 as introduced by Senators Brown and Johanns. This would be a prominent example of the inability of regulators to adhere in practice to the construct created in Dodd-Frank. Whether this signals an isolated instance or a larger problem remains to be seen. It would add credence to the already strong argument in favor of some form of dedicated federal insurance regulation that recognizes and understands the uniqueness of the insurance industry and its importance to our economy.