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Chairman Brown, Ranking Member Crapo, and members of the Subcommittee, thank you very much for this opportunity to discuss the appropriate capital standards to be applied to firms that are predominantly engaged in the business of insurance and subject to Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). I hope to make three primary points in this testimony, which draws substantially on a co-authored draft article, *Regulating Systemic Risk in Insurance*.[1] First, I will emphasize that the business of insurance can create important systemic risks to the larger financial system. The specific contours and magnitudes of these systemic risks are constantly evolving based on shifts in the insurance industry and its regulation. Second, I will suggest

[1] *See* Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance* (March 4, 2014), *available at* http://ssrn.com/abstract=2404492 (arguing that systemic risk in insurance can arise due to correlations among individual insurers with respect to both their interconnections with the larger financial system and their vulnerabilities to failure, and that the Federal Insurance Office should consequently be empowered to supplement or preempt state law when states have failed to satisfactorily address gaps or deficiencies in insurance regulation that could contribute to systemic risk).

that, as contemplated by Dodd-Frank, these risks warrant the application of federally-designed capital standards to nonbank financial companies primarily engaged in the business of insurance that the Financial Stability Oversight Council ("FSOC") designates as systemically risky ("Insurance SIFIs"). Unlike state risk-based capital rules, which focus primarily on consumer protection, these federal capital standards should focus on the distinctive ways in which Insurance SIFIs can pose systemic risk to the larger financial system. This approach is perfectly consistent with Section 171. Third, I will caution against exempting bank/thrift holding companies from Section 171 simply because they or a large number of their subsidiaries are subject to state insurance capital requirements.

(1) Systemic Risk in Insurance

As exemplified by the dramatic failures of American Insurance Group ("AIG") and various financial guarantee insurers, insurance companies and their affiliates played a central role in the 2008 Global Financial Crisis.[2] It is now generally accepted that insurers and their affiliates that effectively provide insurance against the default of financial instruments – whether through formal insurance policies (as in the case of financial guarantee insurers) or through derivatives such as credit default swaps (as in the case of AIG) – can contribute to systemic risk.[3] Other "non-

[2] Additionally, two holding companies principally engaged in the business of insurance received federal funding in the midst of the financial crisis though the U.S. Department of the Treasury's Troubled Asset Relief Program. The Hartford Financial Services Group received $3.4 billion and Lincoln National Corporation received $950 million. GOVERNMENT ACCOUNTABILITY OFFICE, INSURANCE MARKETS: IMPACTS OF AND REGULATORY RESPONSE TO THE 2007-2009 FINANCIAL CRISIS (June, 2013).
[3] THE GENEVA ASSOCIATION, CROSS INDUSTRY ANALYSIS, 28 G-SIBS VS. 28 INSURERS, COMPARISON OF SYSTEMIC RISK INDICATORS (Dec. 11, 2012).

traditional" insurance activities, such as extensive use of securities lending (as in the case of AIG),[4] or mortgage guarantee insurance[5] can also prove systemically risky.[6]

But in the last several years, a narrative has emerged suggesting that these risks are vanishingly small. This argument emphasizes that very few traditional insurers actually failed during the financial crisis.[7] It also stresses that AIG Financial Products – the division of AIG that was principally responsible for writing the credit default swaps that were the primary (though not sole) source of the company's problems – was not regulated as an insurance company, in large part due to federal law.[8] Finally, it argues that insurers, unlike banks, do not have a mismatch in their assets and liabilities.

This narrative, however, ignores important linkages between the insurance industry and the rest of the financial system as well as insurers' potential vulnerabilities to catastrophic events. Although the insurance industry is indeed less systemically risky than the banking and shadow banking sectors, it is also structurally capable of posing a variety of systemic risks to the larger financial system. Perhaps even more importantly, the magnitude and character of these risks

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[4] A substantial contributor to AIG's woes was its securities lending program, which, while coordinated by a non-insurer affiliate of AIG, exploited securities owned by AIG's insurers. *See* William K. Sjostrom, Jr, *The AIG Bailout*, 66 WASH. & LEE L. Rev. 943 (2009).

[5] FEDERAL INSURANCE OFFICE, HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES, (December 2013) (suggesting the need for federal regulation of the mortgage insurance industry).

[6] *See* J. David Cummins & Mary A. Weiss, *Systemic Risk and the U.S. Insurance Sector* (2011), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1725512*.

[7] GOVERNMENT ACCOUNTABILITY OFFICE, INSURANCE MARKETS: IMPACTS OF AND REGULATORY RESPONSE TO THE 2007-2009 FINANCIAL CRISIS (June, 2013).

[8] *See American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation*: 110th Cong. (2009) (Statement of Eric Dinallo, Superintendent New York State Insurance Department).

are themselves constantly evolving and shifting. A decade ago, the notion that a company within an insurance group could threaten the global financial system through its portfolio of credit default swaps would have been viewed – perhaps accurately, at the time – as preposterous. The lesson is that the regulation of systemic risk in insurance must be designed to proactively identify, assess, and manage new potential sources of systemic risk in the industry. With this in mind, consider several specific ways in which insurers could potentially threaten the stability of the broader financial system.

Demand for Assets that Spread Systemic Risk: Insurers are among the largest and most important institutional investors domestically and internationally.[9] They own approximately one-third of all investment-grade bonds and, collectively, own almost twice as much in foreign, corporate, and municipal bonds than do banks. Their holdings of corporate and foreign bonds exceed those of mutual funds and pension funds combined.

Insurers' massive role as investors in financial instruments does not just mean that they can be passive victims of financial instability. Financial markets, as with all markets, are impacted both by supply-side forces and demand-side forces. Thus, when insurers collectively demand certain types of financial assets, the amount supplied and prices of these assets will increase. In fact, recent evidence shows the insurance industry played a major role in stoking demand for mortgage-

[9] This is much more true of the life insurance industry than the property/casualty insurance industry. Accordingly, commentators are likely correct that the former poses more systemic risk than the latter. *See, e.g.*, Steven Weisbart & Robert P. Hartwig, 2011, *Property/Casualty Insurance and Systemic Risk* (2011).

backed securities and related instruments in the years leading up to the financial crisis.[10] By 2007, life insurers held approximately $470 billion in these securities, accounting for about 25% of the total market. Their demand for these securities skyrocketed in the years preceding the crisis, in large part due to unrealized losses in variable annuity products and state capital standards that treated highly-rated structured securities as very low risk.

Insurers were thus substantially responsible for fueling the demand for structured finance securities. And, of course, the explosion in these instruments has been blamed for indirectly helping to fuel the pre-crisis housing bubble.[11] Notably, insurers' contribution to systemic risk in this example occurred even though the terms of their assets and liabilities were well matched and most of them ultimately avoided failure.

Asset Fire Sales: Insurers' massive role as institutional investors also means that they can pose systemic risks by triggering or exacerbating a "fire sale" of specific securities or types of securities.[12] Emerging evidence suggests that insurers did stoke fire sales in mortgage-backed securities and related instruments in 2008,

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[10] Craig Merrill, Taylor D. Nadauld, & Philip Strahan, *Final Demand for Structured Finance Securities*, (Working Paper, January 17, 2014) *available at* http://ssrn.com/abstract=2380859. For evidence that insurers can play a similar role in misallocating credit in corporate bond markets, see Bo Becker, & Victoria Ivashina, *Reaching for Yield in the Bond Market*, JOURNAL OF FINANCE (forthcoming), *available at* http://www.hbs.edu/faculty/Publication%20Files/12-103_c2425c59-1647-42df-8d1b-7b8ed433fb76.pdf.

[11] Facing substantial demand to originate mortgages so that they could be packaged together and securitized, banks and other mortgage originators increasingly loosened credit standards, allowing more and more people to buy houses with loans they ultimately could not afford. *See* KATHLEEN ENGEL & PATRICIA MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS (2011).

[12] Andrew Ellul, Chotibhak Jotikasthira, & Christian T. Lundblad, *Regulatory Pressure and Fire Sales in the Corporate Bond Market*, 101 J. FINANCIAL ECON. 596 (2011).

when many insurers attempted to sell these securities in response to regulatory, rating agency, and market pressures.[13] In offloading these securities in a coordinated fashion, insurers contributed to the sudden illiquidity of these instruments, causing unrelated financial institutions holding these or similar assets to face tremendous liquidity pressures. Indeed, the inability of firms to sell or price such "toxic assets" was the key reason for the failure or near failure of numerous banks and investment banks, including Lehman Brothers.[14]

As above, insurers' seeming role in contributing to fire sales of mortgage-backed securities occurred notwithstanding the matching of their assets and liabilities or their ultimate avoidance of failure. Ironically, insurers' very success in limiting their exposure to "toxic assets" in the early stages of the crisis, and thus safeguarding their own financial strength, may have actually exacerbated the liquidity troubles of unrelated firms. But just like the first people in line during a run on a bank, while insurers may have gotten through the financial crisis relatively unscathed, that does not mean that they were not instrumental in causing the crisis in the first place.

Simultaneous Failure of Several Large Insurers: Although insurers need not fail in order to contribute to systemic risk, the converse is not true: substantial

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[13] Craig B. Merrill, Taylor D. Nadauld, Rene M. Stulz, & Shane Sherlund, *Did Capital Requirements and Fair Value Accounting Spark Fire Sales in Distressed Mortgage-Backed Securities?*, NBER Working Paper No. 18270 (Aug. 2012), *available at* http://www.nber.org/papers/w18270; Andrew Ellul, Pab Jotikasthira, Christian T. Lundblad, Yihui Wang et al., *Is Historical Cost Accounting a Panacea? Market Stress, Incentives Distortions, and Gains Trading* (NYU Working Paper, 2012), *available at* http://ssrn.com/abstract=1972027.

[14] NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, THE FINANCIAL CRISIS INQUIRY REPORT (2011).

failures of several large insurers could well disrupt the financial system as a result of insurers' status as massive investors. In certain cases, an insurance company could be required to quickly liquidate a substantial portion of its portfolio.[15] This might occur if it failed due to a catastrophic event triggering an unmanageable numbers of claims, a failure of a reinsurer, or a "run" on products that permitted policyholders to withdraw funds or take out loans against their policy. If many insurers simultaneously experienced this type of distress, this could trigger, or exacerbate, the types of distortions in capital markets that were witnessed in 2008.

The failure of several large insurers is hardly unimaginable.[16] Insurers are potentially subject to a wide array of catastrophe risks that could trigger a wave of claims across numerous insurers within a short time frame. And while insurers attempt to safeguard against such risks through policy exclusions, reinsurance, and other risk-management techniques, these efforts are hardly fail-safe. For instance, prior to 9/11, commercial property insurance policies did not contain any explicit exclusion for terrorism insurance and insurers did not even include this risk in their calculations of premiums. After 9/11, insurers insisted that terrorism risk was so large and incalculable that they could not provide coverage at all, at least without an

[15] Of course, there are also cases in which an insurance company's failure does not result in an immediate need for the company or its receiver to liquidate much of its portfolio. *See Insurance Oversight and Legislative Proposals: Testimony Before H. Fin. Subcomm. on Ins., Hous. and Cmty. Opportunity*, 112th Cong. 9 (2011) (Statement of Peter Gallanis, National Organization of Life and Health Insurance Guaranty Associations) *available at https://www.nolhga.com/pressroom/articles/HFSCnolhgaTestimonyNov15_2011.pdf.*

[16] For instance, in 1991 six major life insurers, each with over $4 billion in assets, failed as a result of their common exposures to commercial real estate and junk bonds. *See* Scott Harrington, *Policyholder Runs, Life Insurance Company Failures, and Insurance Solvency Regulation*, 15 REGULATION 27 (1992).

explicit federal backstop.[17] Similarly, life insurers face potentially massive exposure to a global pandemic such as the Flu of 1918, which killed between 20 and 40 million people within a single year.

Interconnectedness through Reinsurance: Although insurers attempt to manage catastrophe risk through reinsurance arrangements, the reinsurance industry itself is potentially subject to catastrophe risk. The reinsurance industry is extremely concentrated in a few massive firms, such as Swiss Re, Munich Re, and Berkshire Hathaway. In 2009, for instance, five reinsurance groups provided approximately 60% of the world's reinsurance capacity.[18] This concentration creates deep interconnections among insurers, such that the failure of one or two major reinsurers could simultaneously impact a substantial segment of the insurance industry at once.[19] This risk is exacerbated by the fact that reinsurer financial strength is itself highly opaque, and reinsurers often reinsure risks with one another, creating the possibility that one reinsurer's failure could have a domino effect on other reinsurers.[20]

Exposure to Policyholder Runs: Despite their frequent protestations to the contrary, life insurers are also not immune to the possibility of a run on their products. While this is certainly much less likely for life insurers than banks, a

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[17] Although the massive losses that insurers incurred in connection with 9/11 did not substantially destabilize the industry, insurers' sudden and dramatic shift in their willingness to provide this coverage suggests that they might well have had events transpired differently or had they occurred at the same time as preexisting financial instability.
[18] INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, REINSURANCE AND FINANCIAL STABILITY (July 2012).
[19] *See* J. David Cummins & Mary A. Weiss, *Systemic Risk and the U.S. Insurance Sector* (2011), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1725512 ("Reinsurance is the primary source of interconnectedness within the insurance industry.").
[20] GROUP OF THIRTY, REINSURANCE AND INTERNATIONAL MARKETS (2006).

significant number of many life insurers' policies are subject to early withdrawal and include a significant cash surrender value.[21] Growing competition from life-settlement companies – which offer policyholders the option of selling their policies for cash – will likely increasingly pressure life insurers to allow policyholders to cash out of their policies with smaller penalties. This, in turn, may make life insurers more susceptible to the possibility of a policyholder run. So too might the increasing trend among life insurers to make payouts through "retained asset accounts" that function almost identically to bank accounts.[22] The risk of a policyholder run is exacerbated by the fact that state insurance guarantee funds do not generally fully guarantee the value of most insurance policies, cannot be spread among companies or policies to increase limits (unlike FDIC insurance), and are much less financially credible than FDIC insurance as they are not pre-funded or explicitly backstopped by the federal government.

Systematic Under-Reserving: There is a real risk that insurers may systematically underestimate reserves for certain types of policies or losses. Indeed, a recent proposal by a subcommittee of the Financial Research Advisory Committee noted that the "cyclicality of the insurance industry's profits between hard and soft

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[21] *See* FSOC, BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING PRUDENTIAL FINANCIAL INC. (Sept. 19, 2013). The most substantial policyholder run on a U.S. insurance company involved Executive Life, where policyholder cash surrenders exceeded over $3 billion in the year prior to its failure. Although this run was more a product of Executive Life's tenuous financial position than the cause of its tenuous position, it did indeed have the effect of forcing Executive Life to liquidate a substantial percentage of its portfolio. *See* Scott Harrington, *Policyholder Runs, Life Insurance Company Failures, and Insurance Solvency Regulation*, 15 REGULATION 27 (1992).

[22] *See* TEXAS DEPARTMENT OF INSURANCE, RETAINED ASSET ACCOUNTS SURVEY (2011), *available at* http://www.tdi.texas.gov/reports/life/documents/raareport.pdf (finding in a survey of 160 life insurers open retained asset accounts totaling $2.3 billion with respect to policyholders living in Texas).

markets implies specific periods during which underpricing of risk becomes an industry-wide phenomenon."[23] In the past, such systematic errors in reserving have been limited in the life insurance domain, because life insurers have historically faced rigid and conservative reserving rules for their products.

However, two recent, and related, developments suggest that this longstanding history of conservative reserving in life insurance may not extend into the future. First, in the last decade or so, life insurers have increasingly used captive insurance companies to escape regulatory rules governing reserve setting, a process that some have referred to as "shadow insurance."[24] Recent estimates conclude that "shadow insurance reduces risk-based capital by 53 percentage points (or 3 rating notches) and raises impairment probabilities by a factor of four."[25] Second, state insurance regulation is currently embarking on a fundamental change to its regulatory approach, which would grant insurers broad discretion to use internal models to set reserve levels. The extensively documented inability of federal

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[23] *See* Financial Research Advisory Committee Research Subcommittee, *OFR Study on the Insurance Sector Recommendation*, *available at* http://www.treasury.gov/initiatives/ofr/about/Documents/FRAC%20Research%20OFR%20Study%20on%20the%20Insurance%20Sector%20Recommendation.pdf

[24] *See* NY DEPARTMENT OF FINANCIAL SERVICES, SHINING A LIGHT ON SHADOW INSURANCE (June 2013). Traditionally, captive insurance was simply a way for a traditional non-insurance company, such as Coca Cola or GM, to self-insure its risks rather than purchase conventional insurance. But life insurers realized that they could exploit the rules governing captive insurers to avoid what they deemed to be "excessive" reserve requirements. To do this, the life insurer transfers some of its risk to the captive insurer via a reinsurance transaction. This transaction can reduce reserves because insurers do not need to reserve against risks that are transferred to reinsurers (even if they are affiliated). Meanwhile, captive insurers are subject to a much looser set of solvency rules than ordinary insurers and can generally choose their regulator among any of the states. According to the New York Attorney General, "shadow insurance … puts the stability of the broader financial system at greater risk." *See* Benjamin M. Lawsky, N.Y. Superintendent of Fin. Serv., Remarks at the 22nd Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies in New York City (April 18, 2013) *available at http://www.dfs.ny.gov/about/speeches_testimony/sp130418.htm*

[25] *See* Ralph S.J. Koijen and Motohiro Yogo, *Shadow Insurance* (NBER Working Paper No. 19568, (2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2320921.

regulators to fully understand financial firms' internal risk models suggests that large scale errors in life insurer reserving could be a problem in the future. This is particularly so given that state regulators currently lack sufficient technical expertise or resources to undertake a reasonable evaluation of these models on a firm-by-firm basis.[26]

Ultimately, it is surely true that the insurance industry currently poses less systemic risk than the banking sector or the shadow-banking sector, as many commentators have emphasized.[27] At the same time, however, the insurance industry is a crucial and dynamic component of the American and international financial system, a fact that has been documented by various studies quantifying the connections between insurers and the rest of the financial system based on historical stock prices and similar metrics.[28] As such, the insurance industry can indeed present a meaningful source of systemic risk that cannot be easily limited to a pre-defined set of activities.

(2) Appropriate Capital Requirements for Insurance SIFIs

As contemplated by Dodd-Frank, federal regulators should design, implement, and regularly reassess distinct capital and leverage standards for

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[26] FEDERAL INSURANCE OFFICE, HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES, (December 2013).
[27] *See* Scott Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation*, 76 J. RISK & INS. 785 (2009).
[28] Monica Billioa, Mila Getmanskyb, Andrew W. Loc, & Loriana Pelizzona, *Econometric Measures of Connectedness and Systemic Risk in the Finance and Insurance Sectors* 104 J FIN. ECON. 535 (2012); Faisal Balucha, Stanley Mutengab & Chris Parsons Baluch, *Insurance, Systemic Risk and the Financial Crisis*, 36 THE GENEVA PAPERS 126 (2011); Viral Acharya, Lasse Heje Pedersen, Thomas Philippon, & Matthew P. Richardson, *Measuring Systemic Risk* (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573171.

insurers that are particularly likely to pose systemic risk, including Insurance SIFIs.[29] A central tenet of federalism is that regulatory responsibilities should be assigned, at least in part, to the unit of government that best internalizes the full costs of the underlying regulated activity.[30] The rationale for this principle is that government entities will only have optimal incentives to take into account the full costs and benefits of their regulatory decisions if the impacts of those decisions are felt entirely within their jurisdictions. Given that systemic risk in insurance is a negative externality whose effects are inherently felt nationally and internationally, national and international regulatory bodies should play a role in regulating insurance SIFIs.

Federal involvement in designing capital requirements for Insurance SIFIs is particularly important because state risk-based capital rules are focused predominantly on consumer protection rather than systemic stability.[31] But the

[29] Nonbank financial companies predominantly engaged in the business of insurance and designated as systemically significant by FSOC – which I label as Insurance SIFIs – are not necessarily the only insurers who may pose systemic risks. For instance, mortgage insurers may post systemic risks because of their prominent role in the housing market. *See* FEDERAL INSURANCE OFFICE, HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES, (December 2013). Additionally, as I have argued elsewhere, entire segments of the insurance industry may pose systemic risks because of correlations among individual insurance companies with respect to both their interconnections with the larger financial system and their vulnerabilities to failure. For this reason, I believe that a broader federal role in regulating the insurance industry beyond that established in Dodd-Frank is appropriate. *See* Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance* (March 4, 2014), *available at* http://ssrn.com/abstract=2404492. But because federal regulation in these domains is not authorized by current law and is not the subject of this hearing, I do not discuss these issues further in the body of my testimony.

[30] WALLACE E. OATES, FISCAL FEDERALISM (1972).

[31] Thus, in a Report of the NAIC and the Federal Reserve Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage (2002), a working group of insurance and banking regulators explained the core differences between risk-based capital rules in insurance and banking by noting that "Insurance company regulators place particular emphasis on consumer (policyholder) protection" while "banking regulators focus on depositor protection and the financial stability of regulated entities on a going concern basis."

regulatory objective of a risk-based capital regime has important implications for how that regime should be constructed. In other words, capital regimes focused on systemic risk can, and should, be designed differently than capital regimes focused on consumer protection. Consider several examples of this important point.

First, while a risk-based capital regime designed to address systemic risk should focus on aggregate capital levels of an entire holding company, a capital regime oriented towards consumer protection can rely on entity-level capital regulation with strong ring-fencing rules. Because of its consumer protection orientation, state insurance regulation embraces the latter model: capital requirements are imposed solely on individual legal entities, and regulators attempt to protect these entities from affiliate or holding company risk. By contrast, a capital regime focused on systemic risk demands group-wide capital requirements. This is because risk-management, investment and business strategies are all generally determined at the holding company level.[32] Group capital rules can also limit the prospect of other problems that may have systemic consequences, such as double or multiple gearing.[33]

Second, a capital regime that is focused on systemic risk might well be less dependent on credit-rating agencies in setting capital charges for assets than would a capital regime focused on consumer protection. Currently, state insurance

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[32] *See* Elizabeth F. Brown, *The New Laws and Regulations for Financial Conglomerates: Will They Better Manage the Risks than the Previous Ones?*, 60 AM. U. L. REV. 1339 (2011).

[33] BANK FOR INT'L SETTLEMENTS, PRINCIPLES FOR THE SUPERVISION OF FINANCIAL CONGLOMERATES CONSULTATIVE DOCUMENT (2011). Double or multiple gearing involves scenarios in which the same capital is used as a buffer against risk by two entities at the same time, such that the "net" solvency of the group is less than the sum of the capital of the group's individual entities.

regulation relies substantially on rating agencies in determining capital charges for individual assets.[34] Recent changes in state rules regarding credit for reinsurance also place a renewed regulatory emphasis on rating agencies' assessments of reinsurers' financial strength.[35] But as has now been widely recognized, regulatory reliance on rating agencies can increase systemic risk for a variety of reasons. It can lead to the systematic underpricing of risk, dull the incentives of rating agencies to correctly assess risk, and play a role in triggering fire sales by producing coordinated investment decisions across a wide number of firms. For these reasons, Dodd-Frank substantially limited reliance on credit ratings by all federal (but not state) regulators.[36]

Third, a capital regime focused on systemic risk must be sensitive to the possibility that it might inadvertently contribute to financial instability. As described above, emerging evidence suggests that state regulatory capital rules may have played a role in encouraging insurers to both invest in mortgage backed securities and to offload them when they were downgraded (or when such downgrades were anticipated). Although the literature on how, and when, capital rules and related accounting standards can have inadvertent adverse effects on

[34] Although state insurance regulation has limited its reliance on private rating agencies in assessing structured finance vehicles, it still relies enormously on private rating agencies to assess the quality of insurers' assets. *See* John Patrick Hunt, *Credit Ratings in Insurance Regulation: The Missing Piece of Financial Reform*, 68 WASH. & LEE L. REV. 1667 (2011).
[35] Credit For Reinsurance Model Law, § 2(b)–(c), adopted Nov. 6, 2011, *available at* http://www.naic.org/documents/committees_e_reinsurance_related_docs_preface_adopted_ex_plenary_111106.pdf
[36] Dodd-Frank Act § 939A.

systemic risk is still developing, systemic risk regulators must pay acute attention to this issue.

Group-wide capital rules that limit their dependence on credit-rating agencies and reduce distortions in firm behavior are thus crucial for any capital regime that is principally oriented towards guarding against systemic risk. But various more specific rules might well be appropriate for capital regimes that are designed to guard against systemic risk associated with insurance. For instance, such a regime might well impose higher capital charges on long-term assets with short-term volatility or deep illiquidity relative to an insurance capital regime oriented only towards consumer protection. This is because a central concern from the perspective of systemic risk is that a systemically risky insurer could face sudden liquidity demands for a variety of reasons notwithstanding insurers' usual matching of the duration of their assets and liabilities. Such liquidity pressures could stem from collateral calls associated with derivatives activities or securities lending, mass policyholder withdrawals, a sharp increase in claims due to catastrophe, or the failure of a reinsurer.

Similarly, a capital regime designed to guard against systemic risk related to insurance might well resist some of the recent developments that could weaken life insurer reserve practices. Thus, such a regime could reject principles-based reserving in favor of the traditional approach to setting life insurers' reserves, given the prominent role that reliance on financial firms' own internal models for purposes of setting capital played in triggering the 2008 financial crisis. Or, it might

restrict the credit that insurers can receive by using "shadow insurance" to reduce their liabilities.

To be sure, capital requirements for Insurance SIFIs need not – and, indeed, should not – mechanistically mirror the capital rules that are applied to other types of financial firms. As emphasized in a recent letter of members of Congress, "Strong capital standards need to be consistent with the business models of the industry to which they are applicable."[37] The systemic risks posed by Insurance SIFIs are both different than, and likely less severe than, those posed by large bank holding companies, and an appropriate capital regime for Insurance SIFIs should reflect these facts. At the same time, an appropriate capital regime for Insurance SIFIs should also reflect the fact that the central goal of imposing capital requirements on these entities at the federal level is different than the goal of state capital requirements. As such, the federal capital regime applicable to Insurance SIFIs cannot merely replicate or defer to the consumer protection oriented state capital regime. Capital regimes should be designed not only according to the industry to which they apply, but also to the regulatory goal that they seek to achieve.

My understanding of Section 171 – based on publicly available legal analysis of the provision and several letters from members of Congress – is that it advances these goals. The provision gives the Board of Governors of the Federal Reserve System ("Fed") substantial flexibility in determining how to calculate Insurance

[37] Letter from Members of Congress to Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System (Dec. 11, 2012).

SIFIs' risk-based capital and leverage limits so as to account for the particular risks that these entities present.[38] At the same time, it appropriately seeks to ensure that, however these calculations are performed, they do not fall below minimum levels.

(3) Appropriate Capital Requirements for Bank/Thrift Holding Companies that Substantially Engage in the Business of Insurance

Bank and thrift holding companies have long been subject to federal capital and leverage requirements because of the unique risks associated with owning an FDIC insured institution. Section 171 requires the Fed to ensure that these requirements are no less than those applicable to ordinary small banks. This, in turn, helps to ensure that holding companies of banks and thrifts do indeed serve as a source of strength for their FDIC insured subsidiaries, as has long been intended by the larger federal banking regime. Proposed S. 1369 would exempt bank/thrift holding companies from the Section 171 floor if they directly, or through their subsidiaries, derive a substantial percentage of their consolidated revenues from the business of insurance. This would be a mistake.

As discussed above, state insurance capital rules and bank/thrift capital rules have fundamentally different regulatory objectives. While the former focuses on protecting policyholders, the latter aims principally to limit the exposure of taxpayers to bank failures and minimize the prospect of systemic risk. And, as

[38] Letter from H. Rodgin Cohen to Ricardo Anzaldua, Executive Vice President and General Counsel of MetLife Inc., (May 20, 2013), *available at* http://www.federalreserve.gov/SECRS/2013/May/20130523/R-1438/R-1438_052313_111291_554506713029_1.pdf.; Letter from Members of Congress to Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System (Dec. 11, 2012).

described above, these different orientations have important implications for how the corresponding capital regimes are, and should be, structured.

For these reasons, the fact that a holding company of a depository institution is itself subject to state insurance capital requirements or derives a substantial amount of its revenue from state regulated insurers does not mean that it should be exempted from the minimum floors required by Section 171. Such an entity raises *both* the consumer protection concerns that motivate state insurance regulation and the systemic risk/taxpayer protection concerns that motivate the need for capital/leverage rules for bank/thrift holding companies. It therefore stands to reason that it should be subject to both sets of capital rules, as well as to the Section 171 floor. Establishing a special rule allowing certain bank/thrift holding companies to avoid Section 171 would not only create an uneven playing field, but it could encourage regulatory arbitrage by allowing holding companies of FDIC insured institutions to avoid regulatory requirements by increasing their ownership of insurance entities or their own insurance activities.[39] This, in turn, could have the effect of increasing the size of bank/thrift holding companies.

[39] An additional concern I have with proposed S. 1369 is that it could have the effect of exempting a company from Section 171 on the basis of activities that are not subject to state insurance capital requirements. S. 1369 incorporates the definition of "business of insurance" in Dodd-Frank: "the writing of insurance or the reinsuring of risks by an insurer, including all acts necessary to such writing or reinsuring and the activities relating to the writing of insurance or the reinsuring of risks conducted by persons who act as, or are, officers, directors, agents, or employees of insurers or who are other persons authorized to act on behalf of such persons." Dodd-Frank §1002. This definition is not explicitly tethered to state insurance regulation, as is the proffered rationale for exempting bank/thrift holding companies predominantly engaged in insurance from Section 171. It therefore may be possible under proposed S. 1369 for a bank/thrift holding company to avoid Section 171 on the basis of activities that fall within this broad definition of insurance, but are not subject to state capital requirements.

Exempting from Section 171 bank/thrift holding companies that derive a substantial percentage of their revenue from insurance operations but are not themselves regulated as insurance companies would be particularly bad policy.[40] As described above, the state insurance capital regime does not apply to holding companies of insurance entities. A bank/thrift holding company that derived a substantial percentage of its revenue from the insurance operations of its subsidiaries, but was not itself an operating insurance company, would therefore not face any capital requirements at the holding company level under state insurance law. There is consequently no justification for providing such entities with a special exemption from Section 171.

[40] In the case of a bank/thrift holding company that was itself regulated as an insurance company, state capital rules would apply to the holding company entity. However, such regulation would still not account for the distinctive risks associated with owning an FDIC insured institution.