TESTIMONY OF
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SUBCOMMITTEE ON HOUSING AND INSURANCE

HEARING ENTITLED: "THE IMPACT OF DOMESTIC REGULATORY STANDARDS ON THE U.S. INSURANCE MARKET"

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Thank you, Chairman Luetkemeyer, Ranking Member Cleaver, and Members of the Subcommittee for inviting me to appear before you.

I serve on the Financial Stability Oversight Council (Council) as the "independent member having insurance expertise" and am now the second-longest serving voting member on the Council. Apart from the Treasury Secretary, who chairs the Council, all of the other voting members are federal financial regulators. The position I hold was created essentially as a proxy due to the absence of a Federal insurance regulator.

My experience on the Council over the past four years has made me appreciate the importance of the Council in bringing together different perspectives and experiences, and I have enjoyed working with my colleagues on the Council and their staffs in carrying out the overall mission as envisioned by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank.)[1]

Some have criticized certain majority views of the Council as reflecting a "bank-centric perspective" through which a financial institution is viewed as either a banking organization, or, if not a bank, then it is lumped together in a catch-all category of "nonbank" or "shadow bank." These critics argue that this perspective results in bank-centric rules that then become regulatory templates to be "tailored" for nonbank financial companies and creates an environment in which federal regulatory policy prescriptions are favored over market-focused and state regulation. I personally believe these criticisms have some merit.

[1] Pub. L. 111-203 (July 21, 2010).

Today, I would like to share with you my "minority" observations on three aspects of the Council's work that have most directly affected the U.S. insurance market: (1) the Council's unwillingness to designate systemically important financial institutions, or "SIFIs," based on the systemically risky activities in which the company actually engages; (2) how this approach is also reflected in the Council's annual reevaluations of the four SIFIs designated thus far, which in my view provide no clear path or "off ramp" for companies to address any systemically-risky activities in which they may be engaged; and (3) what I perceive to be continued international encroachment into our domestic regulatory process.

1. The SIFI Designations of GE Capital, AIG, Prudential and MetLife

We have just passed the fifth-year anniversary of the enactment of Dodd-Frank. In those five years, the Council has exercised its Dodd-Frank authorities[2] to identify and designate *four* "nonbank financial companies" as SIFIs: GE Capital Corporation (GE Capital); American International Group, Inc. (AIG); Prudential Financial, Inc. (Prudential); and MetLife, Inc. (MetLife).[3] In the majority view of the Council, these four companies could potentially pose a threat to the stability of the entire U.S. financial system if they were to experience "material financial distress," in other words, imminent failure.

Under Dodd-Frank, there are two statutory standards, or tests, for designating a company as a SIFI. One test, which was used by the Council in all four of its SIFI designations to date, is whether material financial distress at the nonbank financial company could pose a threat to U.S. financial stability. The other test, which has not been used in any of the four SIFI designations, is what I refer to as the "activities test": whether the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, even without its being in material financial distress, could pose a threat to U.S. financial stability.[4]

I concurred in the designations of AIG and GE Capital, but dissented and disagreed with the Council's designations of Prudential and MetLife. During the Council's consideration of GE Capital and AIG, I began suggesting that it would be better for the Council to designate the companies *not* just based on what might follow if the firms were to fail, but also to review them based on their systemically-risky activities, as Dodd-Frank allows. The majority of the Council, however, was

[2] 12 U.S.C. §5323.
[3] MetLife is pursuing judicial review of the Council's designation of the company as a SIFI.
[4] 12 U.S.C. §5323(a)(1).

content to designate the companies solely based on what would happen if they were to experience material financial distress. In the case of AIG and GE Capital, in view of what actually happened to these companies during the crisis, I concurred in the SIFI designations based on the first statutory designation test.

However, in my view, the Council should have taken a different approach with Prudential and MetLife, both of which – unlike GE Capital and AIG – weathered the financial crisis and its aftermath reasonably well. Nevertheless, in designating Prudential and MetLife, the Council again focused only on hypothetical and, in some cases, implausible outcomes of what might happen if either were to fail. The companies were not designated based on the "activities test." In my view, the majority's approach was wrong.

As I explained in my dissents to the SIFI designations of Prudential and MetLife, I believe the Council should focus on the *activities* of financial market participants, the interconnections arising from such activities, and any potential heightened risks posed by those activities. Should the Council find that particular activities of nonbank financial firms present systemic risk, then it should review its options under Dodd-Frank: deliver public proclamations, such as through the Council's Annual Report; make recommendations to Congress; make recommendations to primary regulators, formally or informally, aimed at those activities; designate the activities themselves as systemically important; or designate as SIFIs those companies engaged in such activities (or mix of activities) that could pose a threat to U.S. financial stability.

Likewise, I believe the rationale for a company's SIFI designation (what the Council calls the "basis document"), should specifically identify the systemically risky or disfavored activities, or the combination of such activities, that caused the company to be branded a SIFI, thereby providing actionable guidance as to which activities (or mix of activities) need to be addressed. This is not just so the SIFI can "exit" enhanced supervision (the so-called "exit ramp" or "off ramp") – but, more importantly, so that the financial system can be made safer and less vulnerable to systemic threats, which, of course, in turn is good for long-term, stable economic growth and job creation.

By designating SIFIs based solely on what could happen if they were to fail – and *not* on specific activities or combinations of activities – the SIFIs do not know which activities they need to address (as some of the existing SIFIs have stated publicly). More importantly, other companies providing similar financial services do not know which activities to avoid or guard against, nor do the primary

regulators, including those actively engaged in field-level examination of SIFIs and other large financial firms.

It is often said that the Council is a young institution and is still learning. I am encouraged that the Council has at times – *albeit* belatedly - recognized that focusing on activities is the better approach. For example, with respect to nonbank asset management companies, the Council has put on hold consideration of SIFI designations of individual asset managers in favor of conducting a comprehensive study of potential systemic risks associated with asset management products and activities, industry-wide.

Thus, while any further SIFI designations appear to be on hold for now, we have a situation in which four nonbanks have been judged to be SIFIs under a designation test that has been subsequently – and rightly in my view – temporarily set aside. As explained below, one of the current SIFIs is closer to being "de-designated." If that happens, all of the remaining nonbank SIFIs would be insurance companies that were designated under the now set-aside standard. But I believe it is not too late to reverse course. Indeed, in its annual reevaluations of the three insurance company SIFIs, I have urged the Council to change its approach and to conduct these reevaluations, based not on what might happen if the companies were to fail, but instead on the companies' activities, and to provide each company with actionable guidance on how it could reduce its systemic importance.

2. *Annual Reevaluations Required by Congress*

Dodd-Frank requires the Council to conduct *annual* reviews of each existing SIFI designation to determine whether the company could still pose a threat to U.S. financial stability. Because a majority of the Council decided to designate the four current SIFIs solely under the "material financial distress" test (which, as noted, focuses on what could happen if the institution were to fail), they have continued to apply that test – exclusively - in conducting the annual reconsideration of these SIFI designations. I think we should all be able to agree that the fundamental objective of the systemic regulatory regime embodied in Dodd-Frank is that, over time, the companies own actions, together with the overlay of enhanced prudential supervision conducted by their primary regulator and the Board of Governors of the Federal Reserve System, will reduce the companies' so-called "systemic footprint" in such a way as to allow for them to shed their SIFI designation. But, to achieve that goal, we have to be clear – both to the companies and to the public – about how we plan to get there. In other words, that has to be a plan, and at least from where I sit, it is not clear to me, or the SIFIs, what that plan is.

By designating companies under these failure-based scenarios, it seems to me that the companies may never be able to do enough to have their SIFI designations rescinded. In reality, balance sheets can grow stronger, capital positions can grow, liquidity positions can improve, leverage can drop, yet-to-be regulatory standards and stress tests can be satisfied. Yet, when tested under a scenario of presumed failure where all the cash is gone, all policy and contract holders run, and regulators do not intervene, companies could have as much cash as the very largest financial firm in the world and still not pass the test. Accordingly, I have to wonder whether, under the current approach, there is any viable option for ultimate de-designation.

Unfortunately, I believe the restructuring plans announced by GE Capital present a case study of what happens when a company is confronted with this unpassable test. GE Capital has begun executing, a comprehensive transformation of its businesses. It has publicly disclosed plans to significantly reduce its size, complexity, interconnectedness, and counterparty and debt holder exposures. The orderly sell-off of key financial businesses and assets, as well as the exit from certain markets and activities, will significantly change the nature and extent of the company-specific risks and resolution challenges previously identified by the Council in its designation. Once those plans have been executed, I suspect that the much-smaller GE Capital will pose materially diminished systemic risk.

In light of the singular focus of the Council's SIFI designation based on assumed "material financial distress," it may be difficult for the Council to conclude in a future annual reevaluation that material financial distress at a much smaller and much less interconnected GE Capital could still pose a threat to the U.S. financial system. However, viewed from an activities focused perspective (for which I have been an early and strong proponent), the financial activities and assets to be shed by GE Capital will not be eliminated, but will instead merely migrate to other financial market participants; and those companies, many of which are not subject to comparable regulation, will, in turn, get larger and more interconnected.

In my opinion, a SIFI should <u>not</u> be forced to drastically transform itself, exit markets, divest, downsize, and transfer financial activities to other parts of the financial system as the only path to SIFI de-designation. Instead, I believe the Council should clearly set forth in its annual reviews, other paths and corrective actions that could be taken to reduce and eventually eliminate whatever risk of financial instability the SIFI may pose to the U.S. financial system.

I believe it is vitally important for the Council to provide this type of forward guidance to designated companies, as well as to others operating in financial markets, and to identify specific, concrete, measurable positive developments in its annual reevaluations, including any activities that may have changed or other actions taken that have resulted in a reduction of overall systemic riskiness. Such an approach could encourage further appropriate actions by the companies and their officers and directors.

3. International Developments

International organizations such as the International Association of Insurance Supervisors (IAIS), and the Financial Stability Board (FSB) are working to promulgate capital standards for internationally-active U.S. insurance companies, with a consensual commitment on behalf of the U.S. to the implementation of substantially equivalent domestic standards. I personally worry that the scope of Federal efforts to develop and coordinate Federal policy on international insurance prudential matters has gone too far in displacing authorities that Congress has reserved to the States and State regulators. Beginning with the McCarran-Ferguson Act in 1945, and later reaffirmed in both the Gramm-Leach Bliley Act (1999) and Dodd-Frank (2010), Congress has explicitly entrusted the States and State insurance regulators with the safety and soundness of insurance companies and the protection of insurance consumers.

In my view, the negotiation of these types of international agreements by some Federal agencies has thus far taken place in an atmosphere of opaqueness that I believe to be at odds with our traditional principles of openness, transparency, and oversight in insurance regulation. As the Council's only voting member with insurance expertise, I have a statutory obligation to monitor international insurance developments.[5] And yet, I have been deliberately prevented from playing any non-public role at the international level.[6]

Consequently, like Congress and the public at large, I do not know where this process is headed. I am concerned, however, about the potential negative impacts that may follow from imprudent, hurried and untested capital directives developed not by our own State insurance regulators or Congress – but rather by international

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[5] 12 U.S.C.§5322(a)(2)(D).

[6] *See* United States Government Accountability Office, "International Insurance Capital Standards, Collaboration among U.S. Stakeholders Has Improved but Could Be Enhanced," (GAO Report 15-534, June 2015). This report, requested by the Chair of this Subcommittee, states on p. 46 that "… U.S. IAIS members disagreed on whether the FSOC independent member with insurance expertise would be a relevant participant in U.S. collaborative efforts … ."

organizations and foreign regulators that do not understand the fundamentally different basis on which the U.S. insurance regulatory system operates. As the largest insurance market in the world, the U.S. should be driving the standards that the rest of the world ultimately adopts, not the other way around.

Congress is right to be concerned about these ongoing efforts by foreign organizations that could be used to mandate changes in decisions that Congress has specifically left to our State regulators, or have been reserved for Congress itself to decide. Such concerns should not be limited to insurance regulation. Indeed, foreign regulators also appear to have U.S. financial market regulation in their sights. Several Commissioners at the Securities and Exchange Commission (SEC), for example, have been outspoken about this threat and it now seems that the IAIS's counterpart, the International Organization of Securities Commissions (IOSCO) and the FSB have recently reversed course and will not – at least for the time being – be pursuing designations of individual asset management companies as Global-SIFIs.

Clearly, international *fora* can and do play an important role in regulatory coordination given the increasingly global interconnections of the financial system. However, when these international bodies seek to assume a position of primacy *vis-à-vis* the domestic regulatory authorities and regimes of sovereign countries, I think we should be concerned that the effort has gone awry, even if well-intentioned at the outset.

In my opinion, it is very important that Congress consider a clear statutory framework for: (1) broader U.S. participation at these various foreign organizations, particularly the FSB; (2) establishing appropriate parameters to govern such participation and ensure that it is aligned with the domestic regulatory authorities established by Congress; and (3) increased transparency and accountability to both the Congress and the public.

Conclusion

I appreciate the efforts of the Chairman and Members of this Subcommittee in evaluating the many important issues associated with the supervision and regulation of insurance companies, both from prudential and systemic risk perspectives. I look forward to continuing to work with Congress, my colleagues on the Council, and our state insurance regulators on these critical issues. Thank you. I look forward to answering any questions you may have.