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Chairman Duffy, Ranking Member Cleaver, and members of the Subcommittee, thank you very much for this opportunity to discuss the federal government's role in the insurance industry. In my testimony today, I will first argue that it is essential that the federal government maintain a consistent and robust role in monitoring domestic insurance markets and their regulation by the states. Although state insurance regulation enjoys broad support in today's political climate, this regulatory system was forged largely by states' responses to intense federal scrutiny. Indeed, it would hardly be an over-statement to say that almost every major advance in state insurance regulation over the last half-century can be directly linked to federal criticism, often paired with the real threat of federal preemption.

Until 2010, such federal scrutiny of state insurance regulation was triggered either by high-profile scandals or concerted industry lobbying. The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") helped to systematize and enhance federal monitoring of insurance regulation with the creation of the Federal Insurance Office (FIO). FIO's insurance expertise and consistent assessment of gaps, deficiencies, and inefficiencies in state insurance regulation has helped prompt improvements in state insurance regulation before the underlying problems can trigger front-page news stories or concerted lobbying efforts by aggrieved and coordinated interests. For these reasons, proposals to deprive FIO of the authority, resources, and independence to monitor state insurance regulation and domestic insurance markets are, in my view, deeply misguided.

Second, my testimony will emphasize that the federal government has a special responsibility to monitor, and where necessary supplement, state insurance regulation with respect to the regulation of systemic risk. A core lesson of the 2008 financial crisis is that insurers can create important systemic risks to the larger financial system.[1] Yet as the catastrophic implosion of AIG in 2008 vividly demonstrated, individual states face important structural, legal, and political limitations in their capacity to anticipate and prevent systemic risk. It is for precisely these reasons that Dodd-Frank not only directed FIO to identify "issues or gaps in the regulation of insurers that could contribute to a systemic crisis," but also tasked the Financial Stability Oversight Council ("FSOC") with responsibility for identifying nonbank financial firms whose "material financial distress . . . could pose a threat to the financial stability of the United States." Firms that are designated as systemically risky through this process are subject to supervision by the Board of Governors of the Federal Reserve System (the Fed) as well as enhanced prudential standards.

It is imperative that Congress and the Trump Administration maintain the integrity and objectivity of this FSOC designation scheme, notwithstanding its admitted imperfections and limitations. Contrary to the assumptions of many of its critics, the

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[1] See Daniel Schwarcz & Steven Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. Chi. L. Rev. 1569 (2014).

FSOC designation scheme was not designed to consistently adjudicate between safe and risky firms as a court might, or to create a mathematical formula that firms can apply to their balance sheets to see if they are systemically risky. Such precision is impossible given the constantly evolving nature of systemic risk. Instead, FSOC designation was established to deter nonbank financial firms from taking on systemically significant risks, and encourage those that come too close to this line to de-risk. Judged from this vantage point, the FSOC designation scheme has largely achieved its objectives to date.[2] Eliminating that scheme now – either through legislation or administrative action – would likely induce some non-bank financial firms to affirmatively seek out systemic risk in hopes of being bailed out in the future.

Third, my testimony will suggest that, as envisioned in Dodd-Frank, FIO can and should work with state insurance regulators to coordinate the United States' position in international negotiations and standard setting organizations. Federal involvement in the international insurance context is vital both because of the prominence of systemic risk issues in this setting and because of federal actors' unique capacity to craft a unified U.S. position on insurance matters.

However, proposals requiring FIO to reach a consensus with state insurance regulators on international matters, limiting its capacity to support international standards that would move U.S. insurance regulation forward, or mandating that it consult with Congress throughout international negotiations, are deeply problematic. These reforms would effectively give a single state veto power with respect to international insurance matters. More generally, they would undermine federal actors' realistic capacity to

[2] See Daniel Schwarcz & David Zaring, *Regulation by Threat: Dodd-Frank and the Non-Bank Problem*, 84 U. Chi. L. Rev. (forthcoming, 2017).

meaningfully engage with the international community in the insurance domain. The predictable result of these unprecedented rules would be that the international community would move forward in the development of international standards without the U.S. playing a meaningful role in that process.

(1) FIO plays an important role in monitoring the state regulatory system and efforts to weaken its already limited authority, resources, and independence are therefore misguided.

(a) <u>As a historical matter, federal scrutiny has dramatically influenced and improved state insurance regulation.</u>

Ever since the Supreme Court held that Congress has the power to regulate insurance markets, the federal government has played a vital role in monitoring and indirectly shaping state insurance regulation.[3] Indeed, only one year after the Supreme Court's holding, Congress exempted the insurance industry from most federal antitrust laws on the condition that the states adopt – as President Roosevelt explained in his signing statement of the law – "actual regulation of rates by affirmative action of the states."[4] This federal condition was itself driven by a Department of Justice report concluding that many state insurance regulators tolerated explicit price fixing schemes among insurers.

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[3] Numerous experts on the history of state insurance regulation have made similar observations. See, e.g., Kenneth Meier, Political Economy of Regulation: The Case Of Insurance 51-54 (1988); Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 UCLA L. Rev. 394, 457-58 (2014); Bipartisan Policy Center, Improving US Insurance Regulation (2017).

[4] Meier, supra, at 51-54. The McCarran Ferguson Act itself only requires states to "regulate the business of insurance." But as President Roosevelt's signing statement confirms, this phrase was understood at the time to focus on rate regulation, a sentiment that helps explain why states uniformly adopted the ubiquitous prohibition on "excessive, inadequate, or unfairly discriminatory" rates in insurance.

States responded to these federal pressures by implementing a robust system of insurance rate regulation and ultimately limiting competing insurers' capacity to fix rates.[5]

In the decades since the McCarran Ferguson Act's passage, federal scrutiny of state insurance regulation has continued to prompt many of the most important advances in state insurance regulation. Consider, for instance, the state-based system of solvency regulation, which is often described as the most effective component of the state insurance regulatory system. Until the early 1990s, state solvency regulation was both inconsistent across different states and remarkably ineffective. States maintained widely divergent capital and reserve rules, and they largely ignored fundamental techniques of prudential regulation, such as risk-based capital requirements. It was not until the early 1990s, after a series of high-profile insurer failures prompted a scathing congressional report entitled "Failed Promises"[6] along with a bevy of Congressional proposals to federalize insurance regulation, that state insurance regulators developed the core pillars of modern solvency regulation. Acting in direct response to these federal pressures, states coordinated through the National Association of Insurance Commissioners (NAIC) to develop risk-based capital requirements and an accreditation scheme that promotes uniform and coordinated solvency monitoring and enforcement.

Another key element of state solvency regulation – guarantee funds, which protect policyholders from the risk that their carrier will be financially unable to pay claims – also was implemented by states in direct response to federal scrutiny. Prompted by a series of insurer insolvencies that had left policyholders without their promised insurance

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[5] Daniel Schwarcz, *Ending Public Utility Style Rate Regulation in Insurance*, 35 Yale J. Reg. (forthcoming, 2018).
[6] Subcomm. on Oversight & Investigations of Comm. on Energy & Commerce, 101st Cong., Failed Promises: Insurance Company Insolvencies (Comm. Print 1990)

benefits, legislation was introduced in Congress in 1969 to create a federal property/casualty insurance guaranty fund. The legislation was never passed, in large part because it triggered concerted efforts among state regulators and lawmakers to remedy the underlying problem. The NAIC promptly developed a model law establishing property/casualty guaranty funds and, within the span of only a few years, nearly every state adopted the model act.[7] The resulting system of state guarantee funds continues to this day to do a reasonably good job of protecting policyholders from the risk that their insurer will become insolvent.

State reforms in the face of specific and overt federal pressure have not only improved the effectiveness of insurance regulation, but have also increased its efficiency. For instance, certain large property/casualty and life insurers had long complained about the inefficiencies of state policy form regulation. But it was only when these carriers began to back federal legislation to create an Optional Federal Charter in the early 2000s that states began to take meaningful steps to improve the efficiency of state review of policy forms.[8] These efforts included initiatives such as the Interstate Insurance Product Regulatory Commission and the State Electronic Rate and Form Filing system. Similarly, states only started to take concrete steps to coordinate producer licensing standards in response to a direct preemption threat contained within the Gramm-Leach Bliley Act, which required the creation of a national scheme for producer licensing if states did not act.

Many more examples could be given of state reforms that were prompted by direct federal scrutiny and criticism of state insurance regulation. But the point should now be

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[7] Robert Klein, Issues Concerning State Guarantee Funds (1992).

[8] See Terri Vaughan, *The NAIC's 2002 Agenda: Toward a More Efficient System of Insurance Regulation*, 20 J. Ins. Reg. 251 (2002).

clear: state insurance regulation as it exists today is fundamentally a product of periodic federal scrutiny, which has consistently proven to be the key catalyst in prompting states to remedy gaps, deficiencies or inefficiencies in their insurance regulatory regime.

(b) Through the creation of the Federal Insurance Office, the Dodd-Frank Act helped systematize and enhance federal scrutiny of state insurance regulation.

Although federal scrutiny has historically played a foundational role in prompting positive changes in state insurance regulation, such scrutiny was itself generally driven either by high-profile scandals or concerted industry-driven lobbying efforts. This system for triggering state insurance reforms is hardly ideal. Regulatory systems should, to the extent possible, anticipate and correct market problems or regulatory deficiencies before they result in scandal. And while insurers and other insurance-industry groups have the resources and clout to generate federal scrutiny of inefficient state regulatory practices, policyholders and public interest groups have no similar realistic capacity to place their insurance-regulatory concerns on the federal agenda.

The Dodd-Frank Act helped to systematize and enhance federal monitoring of state insurance regulation with the establishment of the Federal Insurance Office ("FIO") within the U.S. Treasury Department. FIO does not have any regulatory powers. Instead, Dodd-Frank directed FIO to monitor "all aspects of the insurance industry, including identifying issues or gaps in the regulation of insurers." It also instructed the office to assess "the extent to which traditionally underserved communities and consumers, minorities… and low- and moderate-income persons have access to affordable insurance products." 31 U.S.C.A. § 313. To help FIO achieve these objectives, Dodd-Frank granted the office certain information-gathering authorities, including the authority to collect data directly from insurers. Dodd-Frank also required FIO to make annual reports to Congress and to conduct a study on how to modernize and improve state insurance regulation.

Over the last several years, FIO has proven effective in identifying shortcomings in state insurance regulation and prompting potential state regulatory reforms. Consider just one example: FIO has consistently recommended that state regulators reform their treatment of captive reinsurance transactions.[9] In these transactions, an insurer purchases reinsurance from an affiliated company that is subject to more limited regulatory scrutiny because it is organized as a "captive insurer" rather than an ordinary insurer. States long permitted this regulatory arbitrage, even though it made insurers' risk profiles deeply opaque due to the limited transparency of reinsurance captives' balance sheets.[10] In the face of targeted criticism by FIO – as well as the New York Insurance Department and the Financial Stability Oversight Council – states have adopted some important reforms of these transactions, while continuing to consider additional necessary improvements.

Of course, the causal link between FIO scrutiny and any specific state insurance reform effort, such as captive reinsurance, is impossible to prove. But any fair observer of state insurance regulation over the last handful of years would grant that FIO's reports and criticisms have undoubtedly influenced state reforms on a broad array of issues, ranging from group supervision, to insurance affordability, to coordination of market conduct supervision.

(c) <u>Recent reform proposals would dramatically undermine the Federal Insurance Office's capacity to monitor state insurance regulation.</u>

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[9] See Federal Insurance Office, How to Modernize and Improve the System of Insurance Regulation in the United States (2013).
[10] See Daniel Schwarcz, *The Risks of Shadow Insurance*, 50 Ga. L. Rev. 163 (2015).

The proposed Federal Insurance Office Reform Act of 2017, H.R. 3861, would dramatically reduce FIO's capacity to effectively monitor state insurance regulation, thereby undermining healthy federal scrutiny and criticism of that system. First, the Act would constrain FIO's authorities and resources, even though the office already enjoys extremely limited powers under Dodd-Frank and includes a small staff that consumes few resources. The Bill would limit the office to not more than 5 specific personnel; it would eliminate FIO's capacity to collect, analyze, or disseminate data in any manner other than through an information-sharing agreement; it would limit its capacity to produce reports; and it would jettison the FIO Director's authority to advise the secretary on major domestic insurance issues.

The proposal to eliminate FIO's data collection powers is particularly noteworthy in light of the office's mandate to study insurance affordability issues. In a recent report, FIO found that minimum required levels of auto insurance were unaffordable in approximately 9% of zip codes with substantial minority or low- or moderate- income populations, areas that together include over 18 million people.[11] However, data limitations prevented FIO from assessing the causes of these affordability problems in individual zip codes, the extent to which they differentially impacted sub-populations, or whether individual insurers were disproportionately contributing to these issues. State insurance regulators nonetheless recently abandoned a proposal to collect data on individual insurers that would facilitate analysis of these issues.[12] It is precisely when

[11] See Federal insurance Office, Auto Affordability Study (2017).

[12] The backstory of this development helps illustrate why robust federal scrutiny of state insurance regulation is necessary. In 2012, shortly after Dodd-Frank's passage, the NAIC created an Auto Study Working Group to study the issue of insurance affordability. After years of inaction, members of the Working Group finally concluded that understanding the scope and causes of insurance affordability problems required them to collect granular data with respect to individual insurers' auto insurance premiums and claims rates. The committee eventually developed a detailed data call, which it exposed for

state insurance regulators are unwilling to collect the data necessary to assess matters of national importance that FIO can and should use its data collection authority.

In addition to undermining FIO's authorities and resources, the Bill would limit FIO's independence from state regulators. For instance, it would require FIO to "achieve consensus among the states" in coordinating federal international insurance policy and other matters of international importance. Although this provision is oriented towards international affairs, it would limit FIO's realistic capacity to challenge state insurance regulators in any domain, lest FIO find itself unable to move ahead on its international responsibilities.

By diminishing FIO's authorities, capabilities, and independence, H.R. 3861 would shield state insurance regulation and the NAIC from the systematic and consistent federal scrutiny that they have faced since the passage of Dodd-Frank. Although individual state insurance regulators may enjoy this reprieve from informed and expert scrutiny, the system of state insurance regulation would ultimately suffer as a result. Reduced federal scrutiny would ultimately mean reduced pressure on state insurance regulators to proactively identify and respond to regulatory gaps and inefficiencies. Defenders of the state insurance regulatory system should welcome such scrutiny and acknowledge the foundational role it has played in the evolution of state insurance

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comments and refined with the benefit of input from numerous stakeholders. During the most recent NAIC national meeting, however, the Working Group suddenly, and without meaningful prior notice, abandoned its proposed data call in favor of an industry-crafted proposal. That proposal requires insurers, through statistical agents, to report only aggregate industry data, which is designed to facilitate ratemaking review rather than to facilitate the investigation of affordability questions. Aggregated industry data, of course, eliminates regulators' capacity to determine whether a subset of individual insurers' practices disproportionately contribute to affordability problems. It also undermines regulators' capacity to verify the data for completeness or accuracy or assess what percentage of individual markets are served by non-standard carriers. And these problems with the industry data collection proposal are just the tip of the iceberg. For a more complete description of these problems with the NAIC Auto Study Working Group process, see Letter from Consumers Union, Consumer Federation of America, and Center for Economic Justice to Ted Nickel, President of the National Association of Insurance Commissioners (9/5/17), available at http://consumerfed.org/wp-content/uploads/2017/09/cu_cfa_cej_naicletter_autoaffordability_170905.pdf regulation. Unfortunately, the proposed Federal Insurance Office Reform Act of 2017, H.R. 3861, would do exactly the opposite.

(2) The federal government has a special responsibility to monitor, and where necessary supplement, state insurance regulation with respect to the regulation of systemic risk.

(a) <u>Non-bank financial companies such as insurers can pose systemic risks to the broader financial system.</u>

As exemplified by the dramatic failures of American International Group ("AIG") and various financial guarantee insurers, as well as the temporary but severe capital shortfalls of large life insurance companies that had issued long-term guarantees to policyholders, insurance companies and their affiliates played a central role in the 2008 financial crisis. Despite these facts, a narrative has emerged in certain policy circles over the last several years that insurers are not, in fact, systemically risky. This argument emphasizes that very few traditional insurers actually failed during the financial crisis. It also stresses that AIG Financial Products – the division of AIG that was principally responsible for writing the Credit Default Swaps (CDSs) that were an important source of the company's problems – was not actually an insurance company. Finally, and perhaps most prominently, it emphasizes that insurers, unlike banks, do not have a mismatch in their assets and liabilities that can make them susceptible to run-like dynamics.

But commentators who dismiss systemic risk in the insurance industry misunderstand the nature of AIG's collapse in 2008 and ignore broader linkages between the insurance industry and the rest of the financial system. First, AIG's failure in 2008 was just as much a failure of the firm's insurance operations as its derivatives business.

It is true that one of the primary causes of the firm's failure was its CDS operations. But an equally important cause of AIG's collapse was the company's ill-fated securities lending program, under which it lent out the assets of its insurers to large financial institutions in exchange for cash collateral, which it then invested in mortgage backed securities.[13] These securities lending contracts were very short-term, thus allowing spooked counterparties to quickly demand a return of their cash collateral. Unlike CDSs, securities lending operations are common among life insurers, and deeply intertwined with the broader nature of life insurance operations, which generally require insurers to own long-term securities that can profitably be lent out to other actors within the financial system.

More generally, while it is certainly true that experts continue to disagree about how systemically risky insurance companies are at present, an emerging consensus exists that insurance-focused firms are indeed structurally capable of posing a variety of systemic risks to the larger financial system.[14] There are several basic explanations for these conclusions. First, insurers are among the largest and most important institutional investors domestically and internationally. They own approximately one-third of all investment-grade bonds and, collectively, own almost twice as much in foreign,

[13] See Anna Paulson & Robert McDonald, *AIG in Hindsight*, 29 J. Econ. Persp. 81 (2015).
[14] See, e.g., Ralph S. Koijen & Motohiro Yogo, Risk of Life Insurers: Recent Trends and Transmission Mechanisms, in The Economics, Regulation, and Systemic Risk of Insurance Markets (2016); Viral Acharya, Thomas Philippon, and Matthew Richardson, Measuring Systemic Risk for Insurance Companies (2016), in Systemic Risk of Insurance Markets, supra; Anna Paulson and Richard Rosen, Measuring Interest Rate Risk in the Life Insurance Sector: The US and the UK (2016), in Systemic Risk of Insurance Markets, supra; Daniel Schwarcz & Steven Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. Chi. L. Rev. 1569 (2014); J. David Cummins & Mary A. Weiss, *Systemic Risk and the U.S. Insurance Sector*, 81 J. Risk & Ins. 489 (2014); Scott Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation*, 76 J. Risk & Ins. 785 (2009); Monica Billio, Mila Getmansky, 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 Baluch, Stanley Mutenga & 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.

corporate, and municipal bonds than do banks. Insurers' massive role as investors means that they can pose systemic risks by triggering or exacerbating "fire sales" of specific securities or types of securities. Second, such fire sales could themselves be triggered by a variety of mechanisms. As AIG demonstrated, certain life insurer activities, like securities lending and derivatives trading, can create sudden liquidity needs. Moreover, many life insurance products, such as Guaranteed Investment Contracts, funding agreements, and certain annuity products entitle policyholders to withdraw funds on demand, creating the prospect of runs that are analogous to bank runs.[15] Abrupt changes in regulatory or accounting rules could also conceivably trigger a fire sale among insurers, as could a wide-spread catastrophe, particularly if any of these occurred in the midst of broader financial instability.

There can thus be little doubt that the collapse of an insurance giant could in the future threaten the stability of the broader financial system and economy, just as the collapse of AIG did in 2008. Perhaps even more troublingly, the risk of this outcome is in some ways larger now than it was before the crisis. Although necessary to save the financial system, the bailouts of AIG and other nonbank financial firms only cemented the understanding of market actors that the federal government will ultimately have no choice but to bailout systemically significant nonbank financial firms in a panic. This understanding, in turn, may affirmatively incentivize insurers and other non-bank financial firms to become systemically risky so as to benefit from this implicit government backstop.

(b) <u>State insurance regulators face legal, political, and structural barriers to regulating systemic risk in insurance.</u>

[15] See Chicago Fed Letter, How liquid are U.S. life insurance liabilities? (2012).

State insurance regulators do a commendable job of regulating insurance companies for solvency concerns. But this regulatory objective is importantly different from the goal of preventing systemic risk. Solvency regulation is ultimately driven by the goal of protecting policyholders, whereas systemic risk regulation is driven by the objective of limiting the possibility that insurance activities or failures could contribute to financial instability. Only the federal government has the appropriate political accountability and line of sight into the entire financial regulatory system to effectively police this broader, macro-prudential risk.

In the insurance setting, the most important practical difference between solvency regulation and systemic risk regulation is the object of regulatory oversight. Solvency regulation can be effectively directed at individual legal entities within a larger financial conglomerate, so long as regulators carefully scrutinize transactions among legal entities and their affiliates or holding companies. This is the fundamental premise of state insurance regulation, which focuses almost exclusively on individual legal entities. Indeed, every core element of state insurance regulation – including risk-based capital rules, reserve requirements, licensing requirements, investment restrictions, and financial monitoring – is applied solely to individual operating insurers.[16]

By contrast, broad consensus exists across the international community that effective systemic risk regulation requires both supervision and prudential rules that are directed

[16] To illustrate, at the end of 2014, MetLife included 359 subsidiaries in 50 different countries. Many of these subsidiaries operated within the United States, and only a subset of these subsidiaries were licensed insurance companies that were subject to state insurance regulation. These individual insurance entities, moreover, were regulated by numerous different states, including New York, Connecticut, Delaware, Rhode Island, and Missouri. All of the traditional tools of state solvency regulation were independently directed at each of these insurance entities, rather than the consolidated MetLife enterprise. See Fin. Stability Oversight Council, Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc. (Dec. 18, 2014).

across an entire financial conglomerate.[17] In other words, to the extent that an insurance-focused firm is systemically risky, then effective regulation requires evaluating it holistically and applying the core tools of prudential regulation, such as risk-based capital requirements, to the financial conglomerate as a whole. It is for precisely these reasons that banking regulation—where systemic risk has long been a core regulatory concern—explicitly extends to both individual banks and their holding companies.

State insurance regulation is simply not capable of providing the group-level regulatory scrutiny of financial conglomerates that systemic risk regulation demands. First, state insurance regulation imposes no quantitative restrictions, such as group capital requirements, on consolidated financial conglomerates. Instead, group supervision by state insurance regulators relies exclusively on supervisory colleges and working groups, which depend on regulators effectively using their discretion to identify problems.[18] Second, state insurance regulators generally lack meaningful legal authority over insurance holding companies or their non-insurance subsidiaries.[19] Third, state insurance

[17] See Basel Committee, Principles for the Supervision of Financial Conglomerates 3 (2011) (discussing the importance of group-level supervision in addition to entity supervision for the regulation of large financial conglomerates); International Association of Insurance Supervisors (IAIS) Core Principles 23 (describing as a core principle of insurance regulation that "[t]he supervisor supervises insurers on a legal entity and group-wide basis."); FSOC Final Rule, 77 Fed. Reg. 21660 (Apr. 11, 2012) (codified at 12 C.F.R. Pt. 1310) (providing that FSOC will evaluate the "[e]xistence and effectiveness of consolidated supervision" in determining whether a nonbank financial firm could pose a systemic risk to the broader financial system).

[18] See Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States*, 5 U Cal. Irvine L. Rev. 537 (2015); Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance*, 5 U. Cal. Irvine L. Rev. 1389 (2015).

[19] In general, state commissioners can only compel insurance subsidiaries to submit reports, not parent companies or non-insurance affiliates. The one exception is that, under the Model Holding Company Act, states can indeed demand that parent companies file an enterprise risk report. See NAIC, Model #440, Insurance Holding Company System Regulatory Act § 4L. But even in the case of this limited exception, state insurance regulators have no enforcement authority over the parent itself. Instead, their sole enforcement authority for a parent's noncompliance with this single requirement comes under § 11F, which permits regulators to disapprove dividends or distributions or to place an order of supervision on the insurance subsidiary. For these reasons, insurance subsidiaries must rely on the kindness of their parent companies and affiliates to obtain information about transactions and exposures through the group. Since much of this data collection is voluntary, it comes as no surprise that insurance regulators do not systemically collect consolidated group-wide data on insurance firms. See Patricia A. McCoy, *Systemic*

regulators cannot monitor the exposures of non-insurance firms (like investment banks, commercial banks, and hedge funds) to insurance groups, because they lack access to information about other firms' exposures to insurance groups, as well as the expertise, budget, and staff to monitor those interconnections successfully.

State actors' local political accountability also limits the extent to which they can be relied on to regulate systemic risk in insurance. The core problem is that state insurance regulators are either directly or indirectly politically accountable only to the constituents in their jurisdictions. But the benefits of reducing systemic risk are felt almost entirely outside of the boundaries of any individual state. For this reason, systemic risk regulation should generally be conducted at the national and international levels.

In light of these considerations, it is hardly surprising that international bodies have repeatedly expressed concern about the capacity of states to regulate large financial conglomerates that may pose systemic risks. For instance, a peer review of the U.S. state-based system of insurance regulation by the Financial Stability Board concluded "that while the state-based regulatory system was effective in assuring policyholder protection and the soundness of individual insurance companies, it lacked a systemic focus and the capacity to exercise group-wide oversight."[20] Similarly, a report of the International Monetary Fund noted that international regulatory regimes have increasingly "been supplementing their strong solo company focus with financial and other requirements and

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Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance, 5 U. Cal. Irvine L. Rev. 1389 (2015). More generally, state insurance commissioners lack authority to sanction insurance group parent companies or non-insurer affiliates for any activities that jeopardize their insurance affiliates or threaten systemic harm to outside financial firms. Instead, state regulators can only hope to achieve such enforcement indirectly by imposing sanctions on the insurance subsidiaries that they do regulate. Needless to say, these jurisdictional impediments are magnified when an insurance subsidiary is domiciled in one state and its holding company is incorporated in another state. See id.; Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States, 5* U Cal. Irvine L. Rev. 537 (2015).

[20] Financial Stability Board, Peer Review of the United States 32 (2013).

more supervisory focus applied at the group level and U.S. supervisors should do the same."[21]

These concerns are not simply theoretical: state insurance regulators' lack of adequate group regulation was partially responsible for AIG's collapse in 2008.[22] As described above, AIG's failure was attributable to both the firm's CDS business and its securities lending operations. Although state regulators did not have jurisdiction over AIG's CDS operations, the firm's securities lending operations directly implicated its insurers, whose assets were used to sustain the program. Yet "prior to mid-2007, state regulators had not identified losses in the securities lending program and the lead life insurance regulator had reviewed the program without major concerns."[23] State insurance regulators failed to diagnose these problems with AIG's securities lending program because it was operated by non-insurer affiliates of the company. As a result, no individual insurance regulator took primary responsibility for carefully scrutinizing that program.[24] Just as importantly,

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[21] International Monetary Fund, United States: Publication of Financial Sector Assessment Program Documentation—Detailed Assessment of Observance of IAIS Insurance Core Principles (2010) (noting that

[22] To be sure, federal regulators also had jurisdiction over AIG and failed to prevent its collapse. The explanation for this failure was that federal financial regulation before the crisis was structured so as to allow firms like AIG to "shop" for their preferred regulator. AIG exploited this system to select the U.S. Office of Thrift Supervision (OTS) as its consolidated regulator. The OTS had a reputation for being a lax regulator, particularly with respect to non-banking products and services, for which the agency lacked expertise. See Gov't Accountability Office, Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration (2007) (describing the OTS's relative lack of expertise in supervising financial activities that did not involve activities traditionally engaged in by thrifts, such as credit default swaps); Causes of the Recent Financial and Economic Crisis, Before the Fin. Crisis Inquiry Comm'n, (Sept. 2, 2010) (statement of Chairman Ben S. Bernanke) (noting that OTS's supervision of AIG's derivatives activities in its financial-products unit was extremely limited in practice). Dodd-Frank responded to these problems both by eliminating OTS as well as the federal regulatory architecture that allowed firms to select their consolidated regulator. See Kathleen C. Engel & Patricia A. McCoy, The Subprime Virus (2011).

[23] U.S. Gov't Accountability Office, GAO-11-616, Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc. 13 (Sept. 2011).

[24] The Role of Derivatives in the Financial Crisis: Hearing Before the Fin. Crisis Inquiry Commission, 111th Cong. 206 (2010) (testimony of Eric R. Dinallo, Former Superintendent, N.Y. State Ins. Dep't) (admitting that AIG's securities-lending operations "le[d] to . . . regulatory assignment questions"); *See* Federal Insurance Office, How to Modernize and Improve the System of Insurance Regulation in the

state insurance regulators' focus on individual insurance entities also caused them to miss the key fact that the risks associated with AIG's securities lending program were the exact same risks being taken by the company's financial products subsidiary.[25]

In sum, state insurance regulation faces substantial structural limitations in its capacity to regulate systemic risk in the business of insurance. These limitations help explain why state insurance regulators failed to prevent the collapse of AIG in the 2008 crisis. And they also help to explain why the international community has consistently expressed concern about the effectiveness of the state-based system of insurance regulation in the United States with respect to group supervision.

(c) <u>Through both FIO and the FSOC designation scheme, federal actors help supplement state insurance regulation so as to help limit the prospect that systemic risk could build up in this sector of the financial system.</u>

Given the limitations of state insurance regulation in policing against systemic risk, the federal government has a particularly vital role to play in monitoring for the buildup of such risk and proactively seeking to prevent it. As described above, this is one of the core missions that Dodd-Frank gives to FIO. Indeed, the very first responsibility that FIO is entrusted with under the statute is to identify "issues or gaps in the regulation of insurers that could contribute to a systemic crisis."

But Dodd-Frank's primary approach to preventing systemic risk in the insurance industry is to task the Financial Stability Oversight Council ("FSOC") with responsibility for identifying systemically risky nonbank financial firms. This power of the council,

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United States 40 (2013) (noting that the "inability of [state regulators' solo entity focus] to account for consolidated supervision was evident during the financial crisis, particularly in the case of AIG").

[25] See Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States, 5* U Cal. Irvine L. Rev. 537 (2015).

although it has only been utilized four times, has occasioned considerable controversy in court, in Congress, and among commentators. These critics typically assume that the core purpose of FSOC designation is to accurately and consistently identify non-bank financial firms whose collapse would threaten the financial system. And they often imply that FSOC can only accomplish this by developing a detailed and analytically complete account of what factors render a non-bank financial firm systemically suspect, complete with a quantified and comprehensive cost-benefit analysis conducted in the course of any particular designation. The council's designation decisions look less like these critics' preferred sort of precise determination, and more like an inference, based on a range of factors and evidence, that material financial distress at targeted firms "could" contribute to broader financial instability.[26]

These criticisms miss the mark because they ignore the reality that the distinction between non-bank firms that are systemically significant and those that are not is, at this point, inherently murky and indeterminate. Although broad consensus exists on many of the relevant factors for assessing whether an individual non-bank firm is systemically significant, it is impossible to predict with any modicum of certainty how any single firm's financial distress or range of activities might reverberate throughout the broader financial system in some hypothetical, future, financially-stressed world.

The FSOC designation scheme nonetheless helps prevent insurance firms from becoming systemically risky by deterring them from seeking out systemic risk in the first place.[27] FSOC's refusal to reduce designation (or de-designation) to a simple formula

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[26] See, e.g., Report of The Republican Staff of The House Financial Services Committee, The Arbitrary and Inconsistent FSOC Designation Process (2017).
[27] See Daniel Schwarcz & David Zaring, *Regulation by Threat: Dodd-Frank and the Non-Bank Problem,* 84 U. Chi. L. Rev. (forthcoming, 2017).

means that firms that come too close to being plausibly systemically risky face the prospect of designation, and the "enhanced supervision and prudential standards" that come along with it. This, in turn, deters most insurers and other non-bank firms from treading too closely to the systemic risk line, as evidenced by the actions of firms that have been designated as systemically significant to date. Although the amorphous nature of FSOC's designation regime creates uncertainty for some firms on the borderline of systemic risk designation, this is a necessary downside of an FSOC regime whose primary goal is not to correctly identify every systemically significant non-bank firm, but is instead to reliably prevent most non-bank firms from taking on the pre-crisis systemic risk profiles of firms like AIG, Lehman Brothers, or Bear Stearns.[28]

To be sure, systemic risk in insurance can also arise outside of individual institutions due to activities that take place across segments of the industry, but are not localized at any particular firm.[29] As such, FSOC can and should employ an activities-based approach in identifying and responding to systemic risk in insurance. But an activities-based approach is not mutually exclusive with the FSOC regime for designating individual firms.

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[28] FSOC's recent de-designation of AIG is notable in this respect. As found by the requisite two-thirds of FSOC's voting members, AIG is a significantly less risky company now than it was in past years. See Financial Stability Oversight Council, Views of Financial Stability Oversight Council Members Regarding Rescission of Determination Regarding American International Group, Inc. (AIG) (2017). Notably, though, several of the voting members of FSOC that supported de-designating AIG also acknowledged the importance of continued federal monitoring of the company for systemic risk concerns. See Opinion of Independent Member Roy Woodall ("I do believe [that AIG] should continue to be monitored from a macro-prudential perspective."); Statement of Janet Yellen on the Financial Stability Oversight Council's decision to rescind the designation of American International Group (AIG) as a systemic nonbank financial company ("It is important to continue to monitor large nonbank financial firms to ensure that, should they encounter distress, the functioning of the broader economy is not threatened.").

[29] See Daniel Schwarcz & Steven Schwarcz, *Regulating Systemic Risk in Insurance,* 81 U. Chi. L. Rev. 1569 (2014) (arguing that "Dodd-Frank largely overlooked a second, and equally important, potential source of systemic risk in insurance: the prospect that correlations among individual insurance companies could contribute to or cause widespread financial instability.").

To the contrary, an activities-based approach to systemic risk in insurance is complementary to FSOC's designation of individual firms, for two reasons. First, the two approaches deal with different risks: even if no individual activity in which insurers engage can appropriately be deemed systemically significant on its own, it is possible for an individual insurance firm to be systemically significant. This is because a firm's risk profile is a product of the inter-relationships of the firm's various activities. To illustrate, AIG did not fail solely because of its CDS business or its securities lending operations. Instead, it failed because these two activities posed the exact same risk to AIG: that mortgage-backed securities would drop precipitously in value and become deeply illiquid. An activities-based approach to systemic risk regulation is not attuned to this type of concern, which is fundamentally about how the various activities within an individual institution can interact with one another, rather than the inherent riskiness of any individual activity when considered in isolation.

Second, FSOC's capacity to promote regulatory reform with respect to insurance activities depends, as a practical matter, on its power to designate individual firms as systemically significant. Under Dodd-Frank, FSOC cannot set supervisory priorities for member agencies or develop new or revised regulations regarding activities or practices that are under their jurisdiction. Instead, FSOC simply has persuasive authority with respect to these key elements of the financial regulatory universe. For instance, FSOC can "recommend" that member agencies apply "new or heightened standards and safeguards for financial activities or practices that could" generate systemic risk. But member agencies need not accept these recommendations, so long as they provide an explanation for their decision.

For these reasons, FSOC's practical capacity to induce primary financial regulators, such as state insurance regulators, to address activities-based systemic risk concerns depends on it being able to designate as systemically significant the firms that are within those regulators' jurisdiction. Even though FSOC designation does not strip a primary regulator of its authority over a designated firm, it no doubt diminishes the authority and power of that primary regulator, thereby intruding on its regulatory turf.[30] Moreover, FSOC would have good reason to respond to a primary financial regulator's refusal to adopt its recommendations by designating some of the firms that the regulator oversees. This is because "existing regulatory scrutiny" is one key factor in considering whether an individual firm is systemically risky. Thus, it would stand to reason that a primary financial regulator's refusal to accept an FSOC recommendation would increase the potential for the firms overseen by that regulator to be deemed systemically significant.

This capacity of FSOC's designation power to incentivize regulators to better account for systemic risk is perfectly illustrated by FSOC's successful campaign to induce the SEC to reform its regulation of money market funds. Several years ago, the SEC opposed new regulations of money market funds that a significant majority of FSOC deemed vital to preventing systemic risk. Eventually, the SEC relented and adopted these important reforms to money-market mutual funds. They did so, however, only after the Council had explicitly threatened the SEC with the prospect of designating large money market funds and their advisors as systemically significant.[31] In other words,

[30] See Daniel Schwarcz & David Zaring, *Regulation by Threat: Dodd-Frank and the Non-Bank Problem,* 84 U. Chi. L. Rev. (forthcoming, 2017).
[31] As the minutes to a 2012 FSOC meeting on money market funds indicated, the Treasury Secretary "urged the Council to take parallel steps to consider authorities under Title I … of the Dodd-Frank Act in

FSOC was only able to implement an important activities-based reform as a result of its capacity to designate individual firms should these reforms not be adopted. Eliminating FSOC's ability to designate individual systemically significant firms would thus also undermine the Council's ability to promote activities-based reforms.

(3) Proposals requiring FIO to reach a consensus with state insurance regulators on international matters, limiting its capacity to support international standards that would move U.S. insurance regulation forward, or mandating that it consult with Congress throughout international negotiations are deeply problematic.

(a) <u>The federal government, through FIO, should – in coordination with state insurance regulators – play a primary role in representing the U.S. in the international arena.</u>

One of FIO's most important roles under Dodd-Frank is 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." 31 U.S.C. § 313. Dodd-Frank also directs FIO to assist in the negotiation of "covered agreements," which are agreements with other countries "regarding prudential measures with respect to the business of insurance or reinsurance."

FIO's central role in coordinating federal policy in the international domain is appropriate for two reasons. First, as explained more fully earlier in my testimony, the federal government has a uniquely important role to play in the insurance regulatory domain with respect to systemic risk issues, which transcend state and national

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the event that the SEC is unwilling to act in a timely and effective manner." See Minutes of The Financial Stability Oversight Council (9/28/12).

boundaries and require broad financial market expertise. Systemic risk is one of the most important issues in the international insurance arena precisely because this risk cannot be reliably contained in any particular country, especially given the international reach of many of the biggest insurance-focused firms. It follows naturally that federal actors should play a major role in representing the United States' interests in the international domain.

Second, the federal government is well situated to help coordinate and develop a single U.S. position with respect to insurance matters in international settings. Although states do a commendable job of coordinating their activities and efforts at the NAIC, the NAIC itself is not a governmental entity and state insurance regulators frequently disagree among themselves on policy and regulatory matters. Federal actors like FIO can and should work with individual state regulators, the NAIC, and the Fed (which regulates insurance-focused firms that FSOC deems systemically significant) to craft a single, unified U.S. position with respect to key insurance issues that are being negotiated or discussed in the international domain. Moreover, because federal actors are typically the sole representatives of U.S. interests in the international regulatory arena, they enjoy unique credibility and negotiating leverage that cannot be matched by state regulators.

(b) <u>Although proposals to formalize FIO consultation with state insurance regulators are sensible, requirements that FIO reach a "consensus" with state insurance regulators or that it reject any international standards that would advance U.S. insurance regulation are deeply troubling.</u>

Proposals to formalize the role of state insurance regulators in international processes, such as the negotiation of covered agreements, make good sense. At present, FIO's obligation to consult with state regulators in developing international positions is not explicitly defined in federal law. Such coordination and consultation is essential, given that FIO is not itself an insurance regulator. FIO's lack of regulatory authority means not only that it can gain valuable perspective from state insurance regulators, but also that it will have a difficult time committing in the international arena to positions that state insurance regulators predominantly oppose.

But certain legislative proposals would go well beyond merely formalizing the role of state insurance regulators in the international process, and would instead completely undermine the capacity of federal actors – and the United States more generally – to meaningfully engage in the international insurance arena.

First, some proposed reforms would have the effect of making federal actors completely subservient to the states in the development of international insurance positions. For instance, the Federal Insurance Office Reform Act of 2017, H.R. 3861, would require that FIO develop a "consensus" among state insurance regulators with respect to all international positions. This proposal would effectively give a single state veto power on international insurance matters. In fact, states themselves rarely reach consensus with respect to policy and regulatory matters. As such, the provision could effectively limit the U.S. from taking any position on key issues in the international insurance arena. This, of course, would undermine U.S. influence and the capacity of state or federal actors to advance the U.S. insurance agenda internationally.

Second, several reform proposals would affirmatively forbid federal actors from embracing any international position that is not completely consistent with existing state and federal insurance laws. For instance, the International Insurance Standards Act of

2017, H.R. 3762, would prohibit federal actors from agreeing to any position that would be "inconsistent with … Federal and State laws, regulations, and policies on regulation of insurance, including the primacy of policyholder protection in solvency regulation." It would also bar federal actors from acceding to any position "that would not recognize existing Federal and State laws, regulations, and policies on the regulation of insurance as satisfying such proposals."

These proposals are deeply troubling. As discussed above, there are indeed good reasons to believe that systemic risk issues in insurance are not sufficiently addressed by the current state-based system of insurance regulation. Handcuffing federal actors in their international dealings to absolute adherence to the current U.S. system of insurance regulation eliminates the possibility of making any progress in the future on this or related issues. It also effectively announces to the international community that the U.S. is completely unwilling to compromise with respect to any international insurance issue. This approach will predictably lead the international community to simply cut out U.S. actors from the development of international insurance norms and standards.

A third set of proposals – also contained within the International Insurance Standards Act of 2017, H.R. 3762 – undermine federal actors' capacity to engage in the development of international insurance standards by requiring them to report back to Congressional committees before and during the process of developing these standards. These provisions unnecessarily undermine federal actors' capacity to meaningfully negotiate in the international arena. Such negotiation requires parties to be willing and able to adapt over the course of discussions and consideration of differing viewpoints and information. The procedures laid out in H.R. 3762 do exactly the opposite, eliminating the capacity of negotiators to amend their positions or consider compromises without first going through an extensive and unprecedented Congressional approval process. There is a reason why no other federal actor negotiating in the international community is subject to a comparable process of reporting and approval on the development of international standards.

Not only would the unprecedented procedures included in H.R. 3762 undermine the capacity of federal actors to meaningfully engage in the international arena, but they are completely unnecessary to ensure effective legislative oversight in this domain. The IAIS does not make law; it is merely an international standard setting organization. Its principles only have the force of law in the U.S. to the extent that they are affirmatively adopted through ordinary legislative or regulatory processes. To the extent that regulators or lawmakers deem international standards developed at the IAIS to undermine U.S. interests, then they can simply refuse to import them into domestic law.