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Patricia A. McCoy†

I. Introduction

In the United States, the federal government dominates financial services regulation with the singular exception of insurance regulation, which traditionally has been reserved to the states. This state-based system has long been criticized by some as too costly for insurers and consumers due to the lack of a uniform national standard. Nevertheless, so far the touted inefficiencies in state-based insurance have never been enough for any of the repeated attempts to shift insurance regulation wholesale to the federal government to succeed.¹

In part, the continued dominance of state insurance regulation rests on state regulators’ relative success in managing two risks: market conduct and solvency.² After the 2008 financial crisis, however, systemic risk emerged as a new topic of concern in insurance. This development altered the calculus of the allocation of authority for insurance regulation between the states and

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¹ Liberty Mutual Insurance Professor, Boston College Law School. This article was made possible through generous research support from the University of Connecticut School of Law and Boston College Law School and benefited from comments by Shauhin Talesh and the other participants in the September 19, 2014 insurance law symposium at the University of California at Irvine School of Law. Karen Breda provided invaluable reference librarian assistance. The author also thanks Brian Atchinson, John Cogan, Kathleen Engel, Andromachi Georgosouli, Bill Goddard, Miriam Goldby, Peter Kochenburger, Rosa Lastra, Tom Leonardi, Brendan Maher, Philip Rawlings, Jim Rebitzer, Dan Schwarcz, Steve Schwarcz, Tom Sullivan and Terri Vaughan for their insights into the extent and nature of systemic risk in insurance and the ensuing debate over federal regulation. None of those individuals is to blame for the views expressed in this chapter, which are mine alone.

² For an account of that history, see Federal Insurance Office, U.S. Department of the Treasury, How to Modernize and Improve the System of Insurance Regulation in the United States 1 (Dec. 2013) [hereinafter cited as the “FIO Modernization Report”].

See FIO Modernization Report, supra note 1, at 13.
the federal government. Since 2008, concerns about cost savings to industry and a single set of national rules for efficiency’s sake have moved to the back burner in the ongoing debate over the proper role of the federal government in the oversight of insurance. Instead, systemic risk and global cooperation have become the new *leitmotifs* of that debate.

Suffice it to say, insurers and state insurance regulators have been ill-prepared for this change. In landmark reform legislation in 2010, Congress bestowed jurisdiction on the federal government to regulate systemic risk in insurance, to the consternation of the insurance industry and state insurance commissioners. Both groups oppose systemic risk oversight of insurers by the federal government based on three principal arguments. One is that insurance companies do not pose systemic risk because they do not have mismatches between short-term liabilities and long-term assets that could make them vulnerable to runs. The second is that the meltdown of the global insurer American International Group (AIG) was not caused by insurance, but rather by derivatives trading in an overseas non-insurance affiliate. Finally, these constituencies argue that insurance companies survived 2008 relatively intact thanks to the effectiveness of state insurance regulation.

These arguments, however, have not kept pace with the evolution in theories of systemic risk since 2008. The experience with runs in the shadow banking sector in 2008 highlighted the potential for runs in certain insurance products, particularly in the life insurance industry. The role of insurers as financiers of short-term liabilities has implications for the creation of systemic risk elsewhere in the financial system. In the wake of AIG, the hazards posed by weak group oversight of insurance groups to financial stability have also received attention.
As this suggests, the federal government’s evolving approach to systemic risk in insurance is a microcosm of the larger debate over sources of systemic risk. In this article, I examine two theories of systemic risk that have surfaced in decisions by the Financial Stability Oversight Council (FSOC or the Council) designating systemically important insurers and consider the broader implications of those decisions for the future federal regulation of insurance.

One of FSOC’s theories derives from a classic theory of bank runs, in which a mismatch between short-term liabilities and long-term assets exposes financial institutions to a spike in demand for immediate withdrawals in cash. In the insurance context, FSOC has invoked that theory three times to date based on the cash surrender features in certain life insurance and annuity products. The Council has also pointed to systemic risk created by runs on other products offered by non-insurance affiliates in insurance groups. Finally, FSOC has cited concerns about runs in other parts of the financial system to justify its focus on the role of large insurance companies as suppliers of short-term credit to other vulnerable counterparties.

In addition, FSOC has announced a second, more aggressive theory of systemic risk that focuses on the potential adverse macroeconomic repercussions from loss of coverage by a dominant insurer, whether that withdrawal of coverage is voluntary or due to the insurer’s insolvency (and regardless of the cause of any insolvency). Despite the novel nature of this theory, it has not been well-explained in FSOC’s formulations to date. Nevertheless, this fuzzy

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3 The Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010 created FSOC and charged that body, among other things, with designating nonbank financial services providers that “could pose a threat to the financial stability of the United States” as systemically important financial institutions (SIFIs) that are subject to enhanced prudential regulation by the Federal Reserve Board. Pub. L. No. 111-203, § 113(a)(1), 124 Stat. 1376 (2010).
rationale has had real-world consequences because FSOC has relied on it so far in designating at least one insurance company as systemically risky.

Taken together, these theories point to a growing federal role in insurance regulation. To the extent that life insurance and certain annuity policies grant early redemption rights at policyholders’ initiative, the life insurance industry faces a real but uncertain risk of runs that will continue to attract FSOC’s scrutiny. In addition, insurance companies engage in other discrete activities that have been found to be systemically risky, including securities lending, derivatives trading, and sponsorship of money market mutual funds. These activities are certain to be subject to heightened federal oversight and may subject insurance companies regardless of their size to federal regulation of those activities in years to come.

As a corollary, the fact that these same systemically risky activities can be conducted in non-insurance subsidiaries of insurance groups – as AIG made clear – has propelled effective consolidated group supervision to the forefront of policy discussions. The global reach of internationally active insurance groups and pronouncements on group oversight by international regulatory bodies highlight the fact that only the federal government has the potential jurisdiction and treaty-making authority to conduct that supervision effectively. Finally, the solvency concerns that underpin both of FSOC’s theories of systemic risk are likely to pave the way for much more intrusive federal involvement in risk-based capital standards and other types of solvency regulation, first for internationally active insurance groups and eventually for the entire insurance industry.

In short, systemic risk regulation by the federal government, both singly and in tandem with international bodies, is a game-changer. It is likely to transform the locus of insurance
regulation both in ways that are predictable and others that are not. Yet the larger implications of this change for continued state dominance in insurance regulation are not well recognized. To that extent, federal oversight of systemic risk in insurance has the stealth potential to affect the insurance industry by imposing certain federal regulatory standards industrywide.

II. A Brief Historical Overview

Historically, the states have held the predominant role in insurance regulation. This arrangement stands in stark distinction to regulation of banking and securities, which both gravitated inexorably toward federal regulatory domination in the twentieth century. In this brief historical overview, I discuss the states’ central role in insurance regulation and the limited federal intervention in that realm through 2009.

A. Through 1945

In the early decades of the republic, the states made the first forays into U.S. insurance regulation. New Hampshire appointed the first insurance commissioner in 1851 and other states quickly followed suit. Less than twenty years later, the Supreme Court issued a seminal ruling which barred federal intervention in insurance via the Commerce Clause. In that 1868 decision in Paul v. Virginia, the Supreme Court ruled that the business of insurance did not constitute interstate commerce for purposes of the Commerce Clause. In that 1868 decision in Paul v. Virginia, the Supreme Court ruled that the business of insurance did not constitute interstate commerce for purposes of the Commerce Clause. One of the consequences of that decision was that Congress lacked the power to regulate insurance at the federal level, at least under the Commerce Clause, thereby clothing the states with primacy in insurance regulation. A few short years after Paul was handed down, the New York superintendent of insurance, George

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4 FIO Modernization Report, supra note 1, at 11.
5 75 U.S. 168 (1868).
W. Miller, convened the inaugural meeting of what is known today as the National Association of Insurance Commissioners (NAIC), a voluntary organization consisting of the insurance commissioners of all fifty states, the District of Columbia, and the American territories.  

In 1944, the Supreme Court reversed its decision in Paul and ruled that insurance could in fact constitute interstate commerce, giving Congress the constitutional power to regulate insurance transactions crossing state lines. Quickly, the states rallied in opposition to that decision. In response, in 1945, Congress enacted the reverse preemption provision in the McCarran-Ferguson Act, which provides that no federal law may invalidate, impair, or supersede state laws governing the business of insurance unless the federal law specifically relates to the business of insurance. With the passage of McCarran-Ferguson, the states’ commanding role in the regulation of insurance was further entrenched and federal attempts to oversee insurance faced even higher barriers to success.

B. Post McCarran-Ferguson Through 2009

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Federal oversight of traditional insurance activities and products is limited today and it was even more limited before the 2008 financial crisis and the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act\(^\text{10}\) (the Dodd-Frank Act or Dodd-Frank) in 2010.

Before Dodd-Frank, federal oversight of insurance fell into three discrete categories. First, federal regulators and courts deemed some traditional insurance products to also constitute “banking” or “securities,” thus triggering the application of federal banking or securities laws on top of (or sometimes to the exclusion of) state insurance laws.\(^\text{11}\) Second, a major federal statute enacted in 1974 titled the Employee Retirement Income Security Act (ERISA)\(^\text{12}\) subjected employee benefits – including pension, health insurance, and disability benefits offered to employees through the workplace – to strict fiduciary standards under federal law. As a result, insurance companies that serve as underwriters or plan administrators of health insurance, disability insurance, or pension benefits offered by covered employers must comply with ERISA. Finally, the federal government instituted a number of social insurance programs,\(^\text{13}\) the most important being Social Security retirement and disability benefits,\(^\text{14}\) Medicare health benefits for the elderly,\(^\text{15}\) Medicaid health benefits for the poor,\(^\text{16}\) unemployment insurance,\(^\text{17}\) and some


\(^{11}\) For instance, in 1959, the Supreme Court held that variable annuities, which had long been regulated as insurance by the states, also constitute securities for purposes of the federal securities laws. Securities and Exchange Comm’n v. Variable Annuity Life Insurance Co., 359 U.S. 65 (1959). Variable life insurance is similarly federally regulated as a security. Later, in 1995, the Supreme Court held that national banks could sell fixed and variable annuities as agents. Nationsbank of North Carolina, N.A. v. Variable Annuity Life Insurance Co., 513 U.S. 251, 254-55 (1995). Meanwhile, the federal regulator for national banks, the Comptroller of the Currency, permits national banks and their subsidiaries to underwrite credit insurance, municipal bond insurance, and single-interest insurance (which insures banks against loss or damage to personal property that serves as bank collateral) based on the determination that such insurance is a banking product that is incidental to the business of banking. 12 C.F.R. pt. 37; OCC Interpretive Letter No. 338, 1985 OCC Ltr. LEXIS 23 (May 2, 1985); OCC Letter No. 283, 1984 OCC Ltr. LEXIS 37 (March 16, 1984); Gramm-Leach-Bliley Act, Pub. L. No. 106-102, § 302(b), 113 Stat. 1338, 1407 (1999).


\(^{13}\) Another major social insurance program – workers compensation for private-sector employees who are injured on the job – is administered by individual states. See Legal Information Institute, Workers Compensation, available at http://www.law.cornell.edu/wex/workers_compensation (last viewed Dec. 10, 2014).


\(^{15}\) See Medicare.gov (describing benefits) (last viewed Dec. 10, 2014).
catastrophe insurance (most notably, flood insurance,\textsuperscript{18} nuclear liability insurance under the Price-Anderson Act,\textsuperscript{19} and terrorism risk insurance\textsuperscript{20}).

Outside the realm of traditional insurance products, private insurance companies may intersect with federal regulation in other ways, depending on their activities. Insurance companies that act as securities broker-dealers have to comply with the broker-dealer registration and oversight provisions of the Securities Exchange Act of 1934.\textsuperscript{21} Insurers that serve as investment advisers have to observe the Investment Advisers Act of 1940,\textsuperscript{22} while those that sponsor mutual funds or private funds must obey the Investment Company Act of 1940.\textsuperscript{23} After the Gramm-Leach-Bliley Act of 1999\textsuperscript{24} allowed insurance underwriters to become affiliates of depository institutions under the common control of a financial holding company, affected insurance companies became subject to consolidated holding company oversight by the Federal

\textsuperscript{16} See Medicaid.gov (describing benefits) (last viewed Dec. 10, 2014).
\textsuperscript{17} Unemployment insurance is offered jointly by the federal government and the states. See U.S. Department of Labor, Unemployment Insurance (UI), available at http://www.dol.gov/dol/topic/unemployment-insurance/ (last viewed Dec. 10, 2014).
Reserve. Insurance company affiliates of financial holding companies must also observe the limits on interaffiliate transactions under Sections 23A and 23B of the Federal Reserve Act.\textsuperscript{25}

\section*{III. The Changing Dimensions of the Debate}

As the last section discussed, federal forays into insurance regulation have been limited to certain sectors, with health insurance, variable annuities, and pensions being the most important examples. The landmark passage of the Affordable Care Act\textsuperscript{26} and its health insurance mandate in 2010 further expanded the federal presence in health insurance. The federal role in social insurance has grown as well. All of these sectors are ones in which private insurers’ exit from parts or all of those markets or other market failures compelled the federal government to step in.

Apart from these limited federal incursions, the states succeeded brilliantly in fending off federal encroachment in insurance regulation through 2010. For over a century, there have been campaigns from time to time to insert the federal government into the general regulation of insurance. These campaigns have argued for federal oversight based on traditional arguments involving efficiency, uniformity, and consumer protection. Otherwise, none of these traditional rationales ever gained sufficient political traction to trump the states’ predominant role in insurance regulation.

But with the financial crisis of 2008 and the ensuing federal response, the terms of the debate changed in a radical and powerful way. For the first time following the crisis, calls for greater federal oversight of insurance were framed in terms of the potential systemic risk that insurance company activities posed to the financial stability of the United States and the world.

\textsuperscript{25} 12 U.S.C. §§ 371c, 371c-1.

The public furor over the federal government’s massive bailout of AIG in 2008 and the revelations about bonuses to AIG executives in March 2009 added urgency to those calls. Following the bailout, many considered it self-evident that the federal government had to oversee the entire financial system, including insurance companies, in order to contain systemic risk.

A. The Traditional Dimensions of the Debate Over State vs. Federal Regulation

Historically, two of the rationales for a greater federal role in insurance were lax corporate governance by insurers and inadequate solvency regulation by state insurance commissioners. For example, in the early twentieth century, some of the proposals for general federal regulation of insurance were a response to corrupt insurance company practices and insolvencies. In 1904, a series of insurance company scandals involving stock market manipulation, covert campaign contributions, and officer misappropriation of policyholder funds caused President Theodore Roosevelt to advocate federal regulation of insurance in his annual address to Congress. Sixty years later, in the 1960s, a spate of auto insurer insolvencies, combined with a lack of state guaranty funds to assist injured policyholders, led to renewed calls for an optional federal insurance company charter and a federal guaranty fund. Another string

\[\text{Footnotes:}\]
\[\text{27} \quad \text{Federal Reserve Board, Press Release: Federal Reserve Board, with full support of the Treasury Department, authorizes the Federal Reserve Bank of New York to lend up to $85 billion to the American International Group (AIG) (Sept. 16, 2008), available at www.federalreserve.gov.}\]
\[\text{28} \quad \text{See, e.g., Edmund L. Andrews & Peter Baker, A.I.G. Planning Huge Bonuses After $170 Billion Bailout, N.Y. TIMES, March 14, 2009.}\]
\[\text{29} \quad \text{KENNETH J. MEIER, THE POLITICAL ECONOMY OF REGULATION: THE CASE OF INSURANCE 57-58 (1988); Theodore Roosevelt’s Annual Message to Congress for 1904.}\]
\[\text{30} \quad \text{See FIO Modernization Report, supra note 1, at 15.}\]
of insurance company insolvencies in the 1980s and 1990s prompted Congress to explore the need for federal solvency regulation of insurers.\textsuperscript{31}

Although scandals and insolvencies frequently served as the impetus for efforts to federalize insurance regulation, commonly those proposals invoked the need for efficiency and national uniformity as well. In his 1904 address to Congress, for instance, President Theodore Roosevelt advocated federal intervention on grounds that insurance was “national and not local in its application.”\textsuperscript{32} The following year, Senator John Dryden of New Jersey sought to implement Roosevelt’s proposal by introducing a bill to create a new federal Bureau of Insurance in the Department of Commerce and Labor, based in part on the need to reduce “a vast amount of needless clerical labor to meet the requirements of some fifty different States and Territories and consequent decrease in expense rate.”\textsuperscript{33}

In these early instances, efficiency and uniformity provided supplemental rationales for legislation that was primarily meant to redress scandals. However, by the end of the twentieth century, national uniformity became the main justification in its own right for proposals for federal oversight. For example, a single national standard was the rationale for a provision in the Gramm-Leach-Bliley Act in 1999 mandating a new federal agency for national insurance agent licensing requirements unless a majority of the states and U.S. territories met a 2002 statutory deadline for agreeing to reciprocal licensing of insurance brokers and agents.\textsuperscript{34} Similarly,

\textsuperscript{31} See FIO Modernization Report, \textit{supra} note 1, at 15-16.
\textsuperscript{32} Theodore Roosevelt’s Annual Message to Congress for 1904.
\textsuperscript{33} \textit{Bill for Government Control of Insurance; to be introduced in the Senate by John F. Dryden}, N.Y. TIMES, Feb. 27, 1905, p. 5.
\textsuperscript{34} Pub. L. No. 106-102, § 321, 113 Stat. 1338 (1999). This agency was referred to as the National Association of Registered Agents and Brokers or NARAB.
efficiency concerns, including the cost of state insurance regulation, slow delivery of new insurance products to market, state price regulation, and duplicative and inconsistent state rules, animated repeated proposals in the early 2000s to create national insurance standards and an optional federal charter for insurance companies.  

While concerns over consumer protection received lip service during recent debates, the real justification for the proposed federal reforms was reducing regulatory red tape for national and international insurers. Advocates for a greater federal role argued, for instance, that national uniformity would give consumers access to innovative new insurance products regardless of where they lived; would reduce opportunities for industry capture of regulators; would help eliminate arbitrage and a possible race to the bottom in insurance standards; and would improve consumer protection for policyholders and beneficiaries more generally. Nevertheless, deregulation was the predominant theme of the debate, with a stress on the cost savings to insurers from streamlining regulation nationally and internationally. Despite the expressions of solicitude for consumers, there was little actual discussion of how to avoid opportunities for industry capture or arbitrage at the federal level or how to set a single federal standard to better protect insurance industry consumers.

Notwithstanding these repeated efforts to inject the federal government into the general regulation of insurance for the sake of better corporate governance, efficiency, and uniformity, the states were able to beat back those efforts and preserve their preeminent role in insurance

35 The Federal Insurance Office has asserted, for instance, that per dollar of premium, the costs of state-based regulation are 6.8 times greater for an insurer doing business in the United States than for one operating in the United Kingdom. FIO Modernization Report, supra note 1, at 5.
36 See, e.g., FIO Modernization Report, supra note 1, at 16-17.
37 See, e.g., FIO Modernization Report, supra note 1, at 1, 5.
oversight. They succeeded in defeating a greater federal role through two main strategies: accommodation and recharacterization.

In the first strategy, accommodation, the states often adopted piecemeal reforms that were designed to harmonize regulation and reduce duplication – with the prospect of more to come – sufficient to convince undecided members of Congress to preserve the status quo. For instance, in response to proposals to create a federal guaranty fund following the auto insurer failures of the 1960s, the NAIC preempted those proposals by adopting two model state guaranty fund acts – one for property and casualty insurance and the other for life and health insurance – in 1969 and 1970 respectively.\(^{39}\) Numerous states enacted these model laws\(^{40}\) and all 50 states offer state guaranty funds today.\(^{41}\)

Later, after federal scrutiny of more insurance company insolvencies in the 1980s and 1990s, the states, acting through the NAIC, adopted new risk-based capital requirements for personal lines insurers and later developed uniform statutory accounting principles for the industry. In addition, the states formulated a new peer review process called the Financial Standards and Accreditation Program that was designed to make insurance rules more consistent across the states.\(^{42}\) Meanwhile, in 2002, the states defused Gramm-Leach-Bliley’s threat to impose national insurance agent licensing requirements by certifying that 35 states and territories had agreed to reciprocity in producer licensing, thereby meeting the law’s requirements to avoid

\(^{39}\)See, e.g., FIO Modernization Report, supra note 1, at 15.

\(^{40}\)See, e.g., FIO Modernization Report, supra note 1, at 15.

\(^{41}\)See, e.g., National Conference of Insurance Guaranty Funds, State Guaranty Fund Web Sites (“All 50 states and the District of Columbia are served by property and casualty guaranty funds”), available at www.ncigf.org (last viewed Aug. 8, 2014); National Organization of Life and Health Insurance Guaranty Associations, What is NOLHGA? (“The National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) is a voluntary association made up of the life and health insurance guaranty associations of all 50 states and the District of Columbia”), available at www.nolhga.com (last viewed Aug. 8, 2014).

\(^{42}\)See, e.g., FIO Modernization Report, supra note 1, at 16.
federal action by the statutory deadline. More recently, the NAIC has coordinated multistate market conduct examinations of insurers and boosted the analytical power of these examinations by introducing a new uniform data collection system in 2011 to centralize market conduct data for use by insurance regulators in all fifty states.

The other strategy used by states to fight attempts at federal intervention was to \textit{recharacterize} opponents’ arguments on efficiency and uniformity to emphasize the advantages of decentralized government. States argued, for instance, that divergent state insurance regulations produced more efficient outcomes by providing laboratories of experimentation that could determine the optimal level of regulation. In another efficiency argument, states asserted that they were more responsive to local conditions and consumer complaints than federal regulators. States also pointed to tough, pro-consumer insurance commissioners as evidence that industry capture of the states was not as easy it seemed.

These recharacterization arguments took on new life during the aftermath of the financial crisis of 2008. Insurance companies did not suffer the same broad threat to solvency as commercial and investment banks during the crisis and state insurance regulators succeeded in keeping AIG’s insurance subsidiaries afloat that fall. Similarly, the financial crisis brought new appreciation for the role of states as laboratories of experimentation. In contrast to insurance, banking regulation had achieved increasing national uniformity through federal preemption of state anti-predatory lending laws during the years leading up to the crisis, only to blow up when federal regulators refused to replace tougher, preempted state standards for subprime mortgage

\footnote{See, e.g., FIO Modernization Report, \textit{supra} note 1, at 16.}

loans with meaningful regulatory controls of their own. Later, it became apparent that many states had been tougher protectors of residential mortgage borrowers than the federal government. Along with that realization came new acknowledgment of the value of multiple gatekeepers, and calls to reduce duplicative state regulation lost some of their firepower.

Other traditional arguments for federal involvement in insurance also took a beating. The financial crisis cast doubt on the wisdom of financial innovations solely for innovation’s sake. Similarly, the corruption at the U.S. Office of Thrift Supervision (OTS), its capitulation to industry interests during the housing bubble, and its demise belied claims that state insurance regulators would be easier to capture than a single federal regulator. Finally, the ruinous race to the bottom in mortgage lending standards that was fueled by the optional federal charters for commercial banks and thrifts and the opportunities for arbitrage they provided knocked the wind out of the sail for proposals for an optional federal charter in insurance.

In sum, until 2008, the debate over state versus federal regulation of insurance was framed in terms of corporate governance, uniformity, and efficiency (with lip service to consumer protection). Those justifications were never enough to cause the states to lose their primacy in insurance regulation and those arguments lost even more of their punch after the financial crisis. Ironically, however, with the onslaught of that crisis, the prevailing terms of the

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46 For the history of OTS during this period, see KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 158-60, 174-84, 221-23 (Oxford University Press, 2011).

debate dramatically shifted from uniformity and efficiency to systemic risk, to the detriment of state insurance regulation.

**B. The New Terms of the Debate**

In the aftermath of 2008, policymakers first trained their focus on the banking, securities, and derivatives sectors. But eventually they raised questions about the insurance industry’s role – or lack thereof -- as well. The main impetus for that scrutiny was the federal government’s bailout of AIG. The distress of financial guaranty insurers and private mortgage insurers and their importance to the housing sector also sparked attention. With these events, the terms of the debate over state versus federal regulation of insurance changed dramatically to encompass new concerns about systemic risk.

During their post-crisis examination of insurance, the Obama Administration and individual members of Congress flagged certain activities of insurance companies and groups as systemically risky. Eventually those concerns led to the creation of the Federal Insurance Office and the provisions on systemically important insurers in the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010.

1. **The Insurance-Related Events of 2008**

   Apart from one narrow segment of the insurance industry – financial guaranty insurers and private mortgage insurers – traditional insurance underwriters mostly sat on the sidelines during the 2008 financial crisis. Unlike many commercial banks and investment banks,
insurance companies remained solvent throughout that period with relatively few exceptions.\textsuperscript{48} None of the core products at issue during the crisis – subprime mortgages, residential mortgage-backed securities, or collateralized debt obligations – had been issued by traditional insurers. Similarly, no accounts of runs like the ones that capsized the investment banks Bear Stearns and Lehman Brothers, depository institutions such as Washington Mutual and Wachovia, or even money market funds like the Reserve Primary Fund\textsuperscript{49} appeared in the trade press’ coverage of insurance underwriters during that period. With one exception, insurance seemed to remain the sleepy and unglamorous outpost of financial services that it had always been in recent years.

But regrettably for the insurance industry, that exception was the precedent-shattering case of AIG. The tale of AIG assumed a life of its own, with far-reaching consequences for insurance and its regulation. While AIG was in some ways an anomaly, its near-failure was so terrifying and its federal bailout so costly that the federal government could not relinquish continued regulation of that group. In turn, the spotlight on AIG and a few other cases of insurance company bailouts by federal authorities prompted closer analysis of other possible sources of systemic risk from insurance.

\begin{itemize}
\item[a.] \textbf{AIG}
\end{itemize}

\begin{footnotesize}

\textsuperscript{49} For a description of those runs, see KATHLEEN C. ENGEL \& PATRICIA A. MCCOY, \textit{THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS} 87-90, 94, 102-121 (Oxford University Press, 2011).
\end{footnotesize}
Every industry hit by a financial crisis has its poster child. In the insurance industry in 2008, that poster child was the world’s largest international insurance group,\(^50\) American International Group or AIG.

\(\text{(a) AIG’s Credit Default Swap Activities}\)

During the early 2000s, AIG embarked on a path to ruin by selling hundreds of billions of dollars in over-the-counter credit default swaps (CDS) on subprime mortgage collateralized debt obligations (CDOs) through its non-insurance subsidiary in London known as AIG Financial Products (AIG-FP). Those swaps had a functional resemblance to insurance because they promised payments to the buyers of that protection based upon the occurrence of specified events of default. Nevertheless, those swaps were exempt from insurance regulation (and regulation of virtually any other type) and did not require an insurable interest.\(^51\)

While AIG-FP stopped selling new CDS in 2005, it remained liable for over half a trillion dollars in swap protection at the end of 2007.\(^52\) Given the enormity of that liability, AIG’s over-the-counter swaps presented systemic risk because a default by a protection seller of that size could trigger a chain reaction of other counterparty insolvencies and defaults.\(^53\)

Unfortunately for AIG, it had managed its CDS obligations too cockily, setting itself up

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\(^{50}\) See FIO Modernization Report, supra note 1, at 18.

\(^{52}\) American International Group, Inc., Form 10-Q (2d Quarter 2008).

\(^{53}\) For a full description of this dynamic, see KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 105-07, 221-23 (Oxford University Press, 2011).
for a fall. AIG-FP had seriously underestimated the chance that the CDOs it had guaranteed would default and consequently had underpriced the swap protection that it had sold. AIG also grossly misjudged two other risks: market risk, which was the risk that AIG’s swaps might drop in value, forcing the firm to take major write-downs and losses to capital, and counterparty risk, the risk that AIG’s swap buyers would demand more cash security than expected from AIG to back its guarantees. The latter miscalculation proved ruinously costly because the company had invested its proceeds from CDS in highly illiquid assets that later proved tough to sell when the company needed to raise cash collateral for the swaps.

Initially, when AIG sold its swaps, it was able to do so with no reserves or collateral because the company had a stellar AAA credit rating. Confident that there would be no serious collateral calls, AIG’s CDS managers also failed to pay attention to capital adequacy. As a result, AIG-FP only had about $2.1 billion in capital in December 2007 and most of that capital was of dubious quality.

(b) AIG’s Securities Lending Business

AIG’s CDS business was located outside of its insurance company subsidiaries. However, that was not true for its securities lending service, which was another systemically risky activity conducted by AIG. In that line of business, AIG’s insurance subsidiaries lent their

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securities to short sellers in return for cash collateral through a non-insurance affiliate named AIG Securities Lending Corporation.\textsuperscript{58}

Originally, state insurance regulators had set conservative parameters on the reinvestment of the cash collateral when they approved the practice because the borrowers of AIG’s securities were entitled to return those securities and demand back their cash at any time. However, in order to grow its securities lending business, AIG started overstepping those limits by asking for less than full collateral and reinvesting the cash collateral it received in illiquid residential mortgage-backed securities (RMBS).\textsuperscript{59} Those decisions came back to haunt AIG after the credit rating agencies successively slashed the ratings on those RMBS as the subprime crisis deepened in 2007 and 2008. When AIG’s securities lending counterparties appeared to return their securities and demand their cash back, AIG had increasing difficulty repaying them, given its inability to sell off the RMBS it had invested their cash in for anywhere near full price.\textsuperscript{60} Compounding this problem, the average term of the RMBS AIG had invested in was substantially longer than the average length of AIG’s securities loans, which ranged from overnight to 60 days.\textsuperscript{61} Because AIG’s insurance subsidiaries were heavily involved in the group’s securities lending activities,\textsuperscript{62} they were directly exposed to runs on cash due to those activities.


\textsuperscript{60} See, e.g., \textit{CONGRESSIONAL OVERSIGHT PANEL JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT’S EXIT STRATEGY} 44-46 (June 10, 2010); \textit{Spring break: A practice which underpins swathes of the financial system faced turmoil}, \textit{The Economist} (May 22, 2013).

\textsuperscript{61} See \textit{FIO Modernization Report, supra} note 1, at 19.

\textsuperscript{62} See, e.g., \textit{CONGRESSIONAL OVERSIGHT PANEL JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT’S EXIT STRATEGY} 46 (June 10, 2010); \textit{Spring break: A practice which underpins swathes of the financial system faced turmoil}, \textit{The Economist} (May 22, 2013); \textit{FIO Modernization Report, supra} note 1, at 18-19.
(c) **AIG’s Collapse and Federal Bailout**

Things began to deteriorate in late 2007, when the credit rating agencies issued a series of downgrades on AIG’s credit obligations, thereby depressing AIG’s stock value and forcing AIG to post more collateral. As more downgrades ensued, AIG had to write down its CDS portfolio and the company struggled to meet mounting cash collateral calls to cover its CDS and securities lending obligations.\(^63\)

The day of reckoning came on Monday, September 15, 2008 – the day that Lehman Brothers filed for bankruptcy – when Standard & Poor’s and Moody’s cut AIG’s long-term rating three more notches. The downgrades meant that AIG suddenly had to raise as much as $75 billion in cash to cover its credit default swap obligations. Although the New York insurance commissioner had just given AIG permission to pull $20 billion in cash out of its insurance subsidiaries in exchange for illiquid assets worth the same amount, that was just a drop in the bucket compared to the total $75 billion that was coming due. Without sufficient time to raise the rest of the cash by dumping tens of billions of dollars in assets into a falling market, AIG rapidly careened toward bankruptcy.\(^64\)

Meanwhile, the Lehman Brothers bankruptcy had sent global markets into a panic and federal officials could not stomach a repeat of that fiasco. Consequently, on Tuesday September 16, Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke grimly capitulated and agreed to an $85 billion federal bailout of AIG. To finance the rescue, the Federal Reserve opened its discount window for the first time ever to an insurance company,

\(^63\) CONGRESSIONAL OVERSIGHT PANEL JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT’S EXIT STRATEGY 37-40 (June 10, 2010).
\(^64\) CONGRESSIONAL OVERSIGHT PANEL JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT’S EXIT STRATEGY 59-68 (June 10, 2010).
citing the “unusual and exigent circumstances” clause of former Section 13(3) of the Federal Reserve Act. 65

In exchange for that financial lifeline, the federal government took a majority 79.9 percent equity stake in AIG. 66 Once Uncle Sam became AIG’s controlling shareholder, it pumped even more money into AIG in the form of more loans and commercial paper support to salvage its investment. By the end of 2009, total federal aid to AIG had ballooned to $182 billion. 67 It was the biggest federal financial bailout of all time. 68

When Bernanke and Paulson forged the rescue package for AIG, their main aim was to avert contagion. They were concerned about AIG’s commanding role as the one of largest sellers of credit default swap protection on corporate bonds, mortgage-backed securities, and CDOs worldwide. AIG owed a total of $441 billion in swap obligations, including $20 billion to Goldman Sachs alone. If AIG gone bankrupt and defaulted on its swaps, investment banks and depository institutions that had bought that swap protection immediately would have to take write-downs, eating into their already thin capital and forcing them to sell more stock just when investors were fleeing equities. 69

Bernanke and Paulson were also concerned about runs on other financial institutions if AIG filed for bankruptcy. In a briefing to members of Congress on the night of the bailout, both

66 CONGRESSIONAL OVERSIGHT PANEL JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT’S EXIT STRATEGY 71 (June 10, 2010).
68 AIG eventually paid back the loans in full and the federal government sold its equity stake. See Javier E. David, AIG Makes Final Repayment to Government for Bailout, CNBC.COM, March 1, 2013.
men warned that an AIG bankruptcy filing could lead to a massive run on mutual funds because AIG was one of the ten biggest stock holdings in 401(k) plans. Similarly, AIG’s debt would immediately go into default if AIG went bankrupt, thereby exposing the numerous banks and mutual funds who owned that debt to the risk of runs.  

On the surface, the AIG debacle did not appear to involve traditional insurance. All of AIG-FP’s activities took place outside of AIG’s insurance subsidiaries. Furthermore, all of AIG’s insurance operations remained solvent, thanks to the vigilance of state insurance regulators.

Nevertheless, the risky securities lending activities of AIG’s insurers cast doubt on that account. On closer examination, furthermore, the AIG episode raised troubling questions about insurance regulation and its ability to oversee complex, internationally active insurance groups. In at least one respect, insurance regulators had manufactured that problem themselves. In a classic case of arbitrage, AIG’s decision to push its disastrous credit default swap activities into an unregulated subsidiary was made possible, in part, by the decision by the New York Superintendent of Insurance declining to define CDS as insurance in 2000. This regulatory gap was not confined to the states: the federal government was complicit as well, having made the rash decision in 2000 to exempt credit default swaps from federal regulation. The point is, however, that the state insurance authorities passed up the opportunity to regulate a systemically risky product that easily could have been defined as insurance. Had the states done so, all CDS

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72 See supra note 51 and accompanying text.
would have had to have an insurable interest, which would have eliminated trillions of dollars in speculative bets on other entities’ investments in debt known as naked credit default swaps.

Equally importantly, the AIG chapter shone light on the fact that no state insurance regulator had the authority to oversee AIG’s holding company, AIG-FP, or AIG Securities Lending Corporation to determine whether undue risk in those operations threatened the insurance subsidiaries over which they did have purview. Insurance regulation was siloed: state insurance regulators had preeminent oversight of AIG’s insurance subsidiaries, but no real authority over its non-insurance affiliates. Accordingly, they did not detect the illegal expansion of AIG’s securities lending business and were clueless about AIG’s CDS activities.

Complicating the states’ lack of jurisdiction, AIG-FP was located in London, which state commissioners were powerless to reach. As it happened, AIG did have a consolidated federal supervisor by virtue of AIG’s ownership of an insured savings and loan institution: the hapless former U.S. Office of Thrift Supervision. As events proved, OTS was not up to the job and Congress eventually abolished the agency in the Dodd-Frank Act.

Despite OTS’ miserable performance in supervising AIG, state insurance regulators were no more capable of that task for different reasons. No state law gave them jurisdiction to directly regulate the parent holding companies of insurance groups. Similarly, insurance commissioners lacked authority to oversee the non-insurance subsidiaries of insurance conglomerates, something that was doubly a problem in the case of foreign subsidiaries.

For a full account of the myriad failings in OTS’ oversight of AIG and how it came to acquire jurisdiction over AIG-FP despite AIG-FP’s location in the European Union, see KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS 221-23 (Oxford University Press, 2011).

This lack of state statutory authority had two important consequences. First, to the extent that parent companies and non-insurance affiliates of insurance companies posed systemic risk to the financial stability of the nation, only the federal government could regulate that risk, not the states. And, second, the states’ lack of effective parent company oversight revealed the limits on the states’ own ability to prevent excessive risk-taking in other parts of complex insurance groups. Without mandatory capital requirements for holding companies, state insurance regulators could not ensure that those holding companies served as a source of strength for their insurance subsidiaries. In the case of AIG, the CDS activities of AIG-FP put crushing demands on AIG’s parent company for capital support, thereby siphoning off capital that otherwise would have been available to backstop the insurance operations. The availability of that parental support was crucial because AIG’s insurance companies had suffered losses from their own risky securities lending activities. To make matters worse, AIG’s holding company then begged state insurance commissioners in September 2008 for permission to upstream cash from the insurance subsidiaries to help AIG-FP to meet its collateral calls. The New York insurance commissioner acceded to that pressure and agreed to a $20 billion upstream commitment in exchange for illiquid assets of uncertain value. In this way, AIG’s non-insurance activities directly put policyholder reserves at risk.

The bailout of AIG also unleashed the most potent rationale for federal intervention of all. For AIG was the first time that the federal government bore the negative externalities from

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75 This problem persists. The Financial Stability Board reported that “no action has been taken” in the United States (outside of depository institution holding companies and insurance company SIFIs) “to apply insurance capital requirements to the consolidated insurance group. This means that no adjustments are made by states to address any intra-group creation of capital caused by multiple gearing.” Financial Stability Board, Peer Review of the United States – Review Report 37 (Aug. 27, 2013), available at http://www.financialstabilityboard.org/2013/08/r_130827/ (last viewed Dec. 18, 2014).

76 Events overtook this decision, however, and ultimately the $20 billion payment was never made. CONGRESSIONAL OVERSIGHT PANEL, JUNE OVERSIGHT REPORT: THE AIG RESCUE, ITS IMPACT ON MARKETS, AND THE GOVERNMENT’S EXIT STRATEGY 49-50 (June 10, 2010).
an insurance group’s failure. Moreover, the AIG debacle was no small event. To the contrary, AIG’s rescue was the largest federal bailout of a private enterprise in U.S. history.\(^{77}\) The political outrage that ensued matched the enormity of the rescue\(^ {78}\) and reflected serious substantive concerns. Moral hazard by industry was certain to result from the impression – which the Federal Reserve’s actions confirmed -- that AIG was too big to fail. Similarly, the Federal Reserve suffered a serious blow to its legitimacy after making its unprecedented decision to give AIG access to the discount window.

b. **TARP Payments To Other Insurance Companies**

During the fall of 2008, AIG was not the only insurance company recipient of the federal government’s largesse. Over $4 billion of Washington’s $700 billion Troubled Asset Relief Program (TARP) went to bail out two other troubled insurers, The Hartford Financial Services Group, Inc., and Lincoln National Corporation. The Allstate Corporation, Ameriprise Financial, Inc., Principal Financial Group, and Prudential Financial applied for and received preliminary approval for TARP funds, but eventually turned them down.\(^ {79}\) Several other insurance companies also applied for TARP funds (including MetLife), but later withdrew their

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\(^{78}\) Public rage boiled over when the press reported in March 2009 that AIG had recently awarded $165 million in bonuses to executives at AIG-FP, notwithstanding the bailout. KATHLEEN C. ENGEL & PATRICIA A. MCCOY, *THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS* 141 (Oxford University Press, 2011).

applications or were denied.\textsuperscript{80}

The TARP rescues of The Hartford and Lincoln National shed light on other insurance company activities that could spell systemic risk necessitating bailouts. Both companies were life insurers that suffered sharp capital declines after the market nosedive in the fall of 2008 saddled them with hefty investment losses and multiplied their liabilities on guaranteed benefits under their variable life insurance and annuity products.\textsuperscript{81} In turn, the TARP applications filed by these and other insurance companies sensitized the Treasury Department to the counterparty exposure and fragility of some life insurers to market volatility.

c. Financial Guaranty Insurers

Another segment of the insurance industry – financial guaranty insurers -- was hard hit but did not receive federal bailouts during the financial crisis. Those insurers, also known as “bond insurers,” provide a layer of insurance against default on bonds. Traditionally this insurance was limited to municipal bonds. However, with the explosion of private-label mortgage securitization in the late 1990s, financial guaranty insurers began to sell insurance to


investors against defaults on RMBS and CDOs as well.\textsuperscript{82} In 2008, there were nine main U.S. bond insurers and they guaranteed over $2 trillion in mortgage-related securities in the years leading up to the crisis. During the housing bubble, the bond insurers also issued credit default swaps on RMBS and invested in RMBS and CDOs, including securities they had guaranteed themselves.

In recognition of the potentially ruinous exposure posed by financial guaranties, state insurance regulators traditionally limited financial guaranty insurers to a monoline structure which prohibited those companies from offering other types of insurance.\textsuperscript{83} In other ways during the run-up to 2008, however, state regulators were overly sanguine about the risks these companies were taking. In particular, state regulators allowed the financial guaranty insurers to operate with relatively little capital (in some cases zero) because of the historically low default rates on municipal bonds and residential mortgages.\textsuperscript{84}

This thin capital buffer left financial guaranty insurers ill-prepared for what was to come. Starting in early 2007, financial guaranty insurers were hit with a mounting number of claims as defaults spiked on home mortgages and RMBS and CDOs.\textsuperscript{85} By 2008, bond insurers were reeling from losses. This is apparent from the sharp increase in the industry’s combined ratios from 2006 to 2008. The combined ratio is the percentage of premiums that an insurer pays out in claims and expenses. A ratio under 100\% means profitability; a ratio over 100\% raises

\begin{itemize}
\item \textsuperscript{82} See, e.g., FIO Modernization Report, supra note 1, at 19-20, 30.
\item \textsuperscript{83} See, e.g., FIO Modernization Report, supra note 1, at 30.
\item \textsuperscript{84} See, e.g., FIO Modernization Report, supra note 1, at 29-30.
\item \textsuperscript{85} For the same reason, the private mortgage insurance industry was buffeted with losses. Private mortgage insurers guarantee repayment of individual home mortgages if the borrowers default. Typically, these insurers focus on higher-risk mortgages (typically where the loan-to-value ratio exceeds 80\%). See Basel Committee on Banking Supervision, Joint Forum, Mortgage Insurance: market structure, underwriting cycle and policy implications, Consultative document 2-3 (Feb. 2013), available at www.bis.org (last viewed Dec. 14, 2014); Federal Insurance Office, U.S. Department of the Treasury, Annual Report on the Insurance Industry 34 (June 2013), available at www.treasury.gov (last viewed Dec. 14, 2014).
\end{itemize}
profitability concerns. In 2006, the financial guaranty insurance industry’s average combined ratio was 10%. By 2008, the same ratio was 484%. Only one bond insurer – Warren Buffett’s company, Berkshire Hathaway – had a combined ratio of less than 100% at the end of 2008.

Soon the rating agencies responded with downgrades. By the end of 2008, all of the U.S. bond insurers except Berkshire Hathaway had lost their AAA ratings and Berkshire lost its later on. By May of 2012, eight of the nine bond insurers were no longer writing new business and more than half had been seized or were in runoff. (Table 1).

Table 1: Bond Insurer Health as of May 2012

<table>
<thead>
<tr>
<th>Bond Insurer</th>
<th>S&amp;P Rating as of May 2012</th>
<th>Writing New Business?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Berkshire Hathaway</td>
<td>AA+</td>
<td>No</td>
</tr>
<tr>
<td>Assured Guaranty</td>
<td>AA-</td>
<td>Yes</td>
</tr>
<tr>
<td>MBIA/National</td>
<td>BBB</td>
<td>No</td>
</tr>
<tr>
<td>Radian</td>
<td>B+</td>
<td>In runoff</td>
</tr>
<tr>
<td>Ambac</td>
<td>Not rated</td>
<td>Seized by the State of Wisconsin in 2010</td>
</tr>
<tr>
<td>Syncora</td>
<td>Not rated</td>
<td>In runoff</td>
</tr>
<tr>
<td>ACA</td>
<td>Not rated</td>
<td>In runoff</td>
</tr>
<tr>
<td>FGIC</td>
<td>Not rated</td>
<td>Seized by New York State in 2011</td>
</tr>
<tr>
<td>CFG</td>
<td>Not rated</td>
<td>In runoff</td>
</tr>
</tbody>
</table>

These credit rating downgrades were disastrous to the financial guaranty industry’s viability. In the structured finance business, the bond insurers were essentially lending out their AAA credit ratings to issuers for a fee. Consequently, their financial survival hinged on their AAA ratings. If the insurers’ credit ratings dropped below AAA, that would harm their ability to write new business and bring in new premiums.

That’s exactly what happened. By 2011, the market for insured municipal bonds shrank from 50% of new issues pre-crisis to only 5%. The contraction of this market made it
temporarily difficult for some municipalities to raise money by selling bonds.\(^{86}\) Meanwhile, the private-label market for structured mortgage finance collapsed and has not come back in any significant way. As of 2013, only two U.S. bond insurers – Assured Guaranty and a new entrant, Build America – were actively providing financial guarantees.\(^{87}\) While some observers express optimism about the industry,\(^{88}\) its near-term future prospects remain uncertain.

The events of 2008 showed how financial guaranty insurance could spawn systemic risk in multiple ways. First, the downgrades of the bond insurers led to downgrades on the securities that they guaranteed. This affected both mortgage-related securities and municipal bonds. Institutional investors such as commercial banks and insurance companies that were limited by law to owning investment-grade holdings often had to sell bonds that had been downgraded to junk, which put downward pressure on prices. Similarly, financial institutions that bought swap protection from the bond insurers had to mark those swaps to market, sustaining losses and eroding their capital. Making matters worse, some bond insurers and private mortgage insurers refused to pay claims, sometimes because regulators ordered them to do so.

Financial guaranty insurance was just one of the sources of systemic risk in the insurance sector. AIG’s credit default swap activities and securities lending by its insurance company subsidiaries both proved vulnerable to runs. In the life insurance sector, costly guaranteed minimum benefits on variable life and annuity products caused some of the nation’s largest life insurers to ask for federal lifelines. Meanwhile, the bond insurance industry was virtually wiped

\(^{86}\) See, e.g., FIO Modernization Report, supra note 1, at 19.


out in 2008 and remains on life support. Together these events fueled calls to regulate insurance for systemic risk.

2. **The Federal and International Policy Response**

In the aftermath of 2008, the U.S. government, in tandem with global regulators, moved aggressively to erect a new, overarching system for the regulation of systemic risk. The U.S. system was federal in nature, which meant that any financial institution posing systemic risk faced the prospect of federal oversight. The urgent need for systemic risk regulation and the surprising new concerns about systemic risk in insurance that 2008 unearthed opened the door to a new, major federal presence in insurance regulation. Meanwhile, international bodies leaned on the United States to strengthen its systemic risk oversight, which further strengthened the federal government’s hand in intervening in insurance regulation.

a. **The Dodd-Frank Act**

Although the federal government had tinkered with systemic risk on a hit-or-miss basis before 2008, the manifest deficiencies in that oversight compelled Congress to mandate a formal and elaborate federal system for systemic risk regulation in the Dodd-Frank Act in 2010. This system contemplated both the supervision of individual, systemically risky financial institutions and of systemically risky activities more generally. In addition, Dodd-Frank established the new Federal Insurance Office as a beachhead for the new federal role in insurance.

1. **Federal Regulation of Systemically Important Insurers**

AIG’s near demise and its unprecedented federal bailout impelled Congress to enact several provisions in the Dodd-Frank Act to address systemic risk emanating from the insurance
sector. Front and center, Congress was distressed that no one regulator – state or federal – had exercised any effective consolidated oversight of AIG for systemic risk. Similarly, Congress was concerned about the lack of any special resolution facility for failing systemically risky nonbank firms akin to the FDIC resolution procedures long used for failing banks.\textsuperscript{89}

In response to these and similar concerns, Congress created a new framework for federal oversight of systemic risk in Dodd-Frank. The linchpin of that framework was the creation of the Federal Stability Oversight Council in Title I.\textsuperscript{90} Among other things, Congress charged FSOC with deciding whether to designate particular nonbank financial services providers, including insurers, as systemically important financial institutions (SIFIs) for the purpose of added federal regulation.\textsuperscript{91} To carry out that oversight, Congress authorized the Federal Reserve Board to supervise and regulate all SIFIs, including bank and nonbank SIFIs alike, using enhanced prudential standards.\textsuperscript{92} In addition, in Title II of the 2010 legislation, Congress authorized the federal government to place failing financial institutions, including insurers, into federal receivership in the unusual circumstance where their failure and resolution under

\textsuperscript{89} In contrast to depository institutions, federal regulators had no good process for putting AIG into an orderly federal receivership. At the time, the federal government could not locate a buyer for the company and so its only options were to put AIG into bankruptcy or to grant a government bailout. Fresh off the Lehman Brothers bankruptcy, the Federal Reserve was understandably anxious about an AIG bankruptcy and chose the safer route. As a result, the federal government came to control the world’s largest insurance company overnight.


\textsuperscript{91} Dodd-Frank Act, Pub. L. No. 111-203, § 113(a), 124 Stat. 1547 (2010). Nine of FSOC’s ten voting members are federal regulators outside of the insurance area. The tenth is an independent member with insurance expertise who is appointed by the President and confirmed by the Senate for a six-year term. In addition, two of FSOC’s five non-voting members are from the insurance sector: the Director of the Federal Insurance Office and a state insurance commissioner, picked by his or her peers. \emph{Id.} at § 111(b)-(c).

\textsuperscript{92} Dodd-Frank Act, Pub. L. No. 111-203, §§ 114, 115(a)(1), (c), 117(a)-(b), 161(a)-(c), 162(a)-(b), 165, 124 Stat. 1547 (2010). Under Dodd-Frank, TARP recipients that were bank holding companies with total consolidated assets of $50 billion or more on January 2, 2010, but that later ceased to be bank holding companies, are also subject to enhanced standards and supervision. \emph{Id.} § 117.
otherwise applicable state or federal laws would have serious adverse effects on the financial stability of the United States.\textsuperscript{93}

To date, FSOC has designated three large insurance enterprises – AIG, Prudential Financial, Inc., and MetLife – as nonbank SIFIs.\textsuperscript{94} As a result, these insurance company SIFIs will be subject to examination by the Federal Reserve Board. In addition, they will face enhanced federal prudential standards including group-wide minimum leverage and risk-based capital requirements,\textsuperscript{95} liquidity requirements, risk management requirements, resolution plan and credit exposure report requirements, concentration limits, a contingent capital requirement, enhanced public disclosures, short-term debt limits, and other prudential standards instituted by the Federal Reserve Board.\textsuperscript{96}

2. \textit{The Creation of the Federal Insurance Office}


\textsuperscript{95} In December 2014, Congress passed an amendment to Dodd-Frank clarifying that the Federal Reserve Board shall not be required to include insurance subsidiaries when establishing the minimum leverage and risk-based capital requirements on a consolidated basis for depository institution holding companies and nonbank SIFIs. Nothing in the amendment, however, prohibits the Board from establishing capital requirements at the group level. Insurance Capital Standards Clarification Act of 2014, S. 2270, 113\textsuperscript{th} Cong., 2d Sess., § 2(2) (2014), codified at 12 U.S.C. § 5371(c)(1)-(c)(2).
For the most part, however, the FIO’s authority is truncated and the Office does not displace the traditional supervisory and regulatory role of the states over insurance.

In lieu of having regulatory responsibilities, FIO’s jurisdiction is mostly restricted to monitoring the insurance industry (including for access to insurance and for regulatory gaps that could contribute to systemic risk), recommending nonbank SIFI designations for individual insurers, assisting the Secretary of the Treasury in administering the Terrorism Insurance Program under the Terrorism Risk Insurance Act of 2002, and consulting with the states on insurance matters of national and international importance. Where FIO has teeth is in its power to develop federal policy on the prudential aspects of international insurance issues and to assist the Secretary in negotiating international treaties and other agreements regarding the prudential regulation of the business of insurance or reinsurance. As part of that authority, FIO represents the United States in the International Association of Insurance Supervisors (IAIS) and can issue determinations that provisions of federal treaties preempt state insurance law.

FIO also plays a formal role in the designation and federal oversight of nonbank SIFIs under Titles I and II. The Director of the FIO is a nonvoting member of FSOC for purposes of FSOC decisions on designations and oversight. Furthermore, the Director must give approval, along with two-thirds of the Governors of the Federal Reserve Board, before the Secretary of the Treasury may seek to appoint the Federal Deposit Insurance Corporation as the federal receiver of an insurance company on grounds of systemic risk.

The creation of FIO and FSOC and the Federal Reserve’s new role in insurance have significance beyond these entities’ formal duties. Before these events, the federal government had virtually no expertise in insurance. Now, however, the federal government has a growing number of professionals spread across the Treasury Department and the Board who have serious expertise in insurance. Already many of them are deeply immersed in regulating some insurers. Their presence provides a small but meaningful pad from which federal insurance regulation could be launched. Furthermore, they have a growing stake in expanding federal insurance regulation because doing so will enhance their responsibilities and reputations.102

3. **Across-the-board supervision of systemically risky activities**

Often the preoccupation with SIFI designations gives the false impression that systemic risk regulation outside of commercial banking is limited to the oversight of systemically important financial institutions. The federal government, however, also has broad authority to issue industry-wide regulations for financial activities posing systemic risk. This type of regulation allows regulators to address systemic risk emanating from the activities of numerous interconnected market actors, large and small.

There are growing instances of across-the-board systemic risk regulation. The Dodd-Frank Act mandated extensive new regulation of derivatives trading. Standardized derivatives must now be cleared and executed through central clearinghouses to improve transparency and limit counterparty risk.103 Dodd-Frank also imposed margin requirements on swaps to reduce the risk to counterparties and to tamp down leverage.104 Swap dealers and major swap

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102 I am grateful to Dan Schwarcz for these points.
103 Dodd-Frank Act, Pub. L. No. 111-203, §§ 723, 763(a), (c), 124 Stat. 1547 (2010).
participants are subject to new minimum capital requirements to safeguard against insolvency.\textsuperscript{105}

Finally, Dodd-Frank authorized the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission to institute new data reporting and recordkeeping requirements for derivatives.\textsuperscript{106}

Naturally, the asset-backed securitization industry was another target of reform in Dodd-Frank. Dodd-Frank imposed new requirements on that industry regarding conflicts of interest, mandatory disclosures, representations and warranties by issuers, asset review and evaluation obligations, and the retention of risk by securitizers to ensure that they have “skin in the game.”\textsuperscript{107}

Other reforms address capital markets trading and investment fund activities. Under the Volcker Rule, Dodd-Frank restricted proprietary trading by bank holding companies.\textsuperscript{108} Meanwhile, for the first time ever, investment advisors to hedge funds and private equity funds must register with SEC.\textsuperscript{109} In addition, private fund advisors must make periodic filings with the Commission on topics such as assets under management, use of leverage, counterparty credit risk exposure, and trading practices.\textsuperscript{110} In 2014, the Commission adopted further reforms to reduce the risk of runs on money market funds in response to pressure from FSOC.\textsuperscript{111}

More such regulations can be expected down the road. In fall 2014, the SEC announced plans to expand mandatory reporting by investment funds to include data on separate accounts,

their holdings of derivatives, the liquidity and valuation of their assets, and their securities lending activities.\textsuperscript{112} The SEC also said that it planned to review options for improving fund liquidity and for limiting the use of derivatives by retail mutual funds to boost returns through leverage.\textsuperscript{113} The Commission also trained attention on a living will requirement for investment advisors and funds and on stress tests to evaluate the ability of funds to meet spikes in redemptions following economic shocks.\textsuperscript{114} The Commission announced those plans after FSOC changed its focus in July of that year from designating large asset managers as nonbank SIFIs to regulating potentially risky activities in the investment fund and asset management industries.\textsuperscript{115}

All of these systemic risk initiatives occurred against a backdrop of parallel initiatives by international financial regulatory bodies. In the process, the U.S. reforms underwent global scrutiny, increasing the pressure for a stronger federal presence in insurance regulation.

b. \textbf{International Response}

In the aftermath of the financial crisis, the G20 leaders asked the Financial Stability Board (the FSB) to address the systemic risk presented by global SIFIs (G-SIFIs). The FSB


responded by publishing a systemic risk policy framework and designating a number of large banking groups as global systemically important banks in November 2011. Meanwhile, the FSB delegated the tasks of developing systemic risk policies for insurers and identifying global systemically important insurers (G-SIIs) to the International Association of Insurance Supervisors (IAIS).

The IAIS identified nine initial G-SIIs in July 2013. The three U.S. insurers on that list were AIG, MetLife, Inc., and Prudential Financial, Inc. That same month, the IAIS unveiled its policy framework for G-SIIs. Among the framework’s prescriptions were heightened supervision, orderly resolution facilities, backstop capital requirements, and higher loss absorption capacity for non-traditional insurance and non-insurance activities.

The IAIS’ recommendations for enhanced supervision were not just limited to G-SIIs. In addition, the IAIS promulgated its Common Framework for the Supervision of Internationally Active Insurance Groups (nicknamed ComFrame) to foster global convergence in the oversight of internationally active insurance conglomerates, regardless of whether they are designated as G-SIIs.

Meanwhile, in 2013, the FSB completed a peer review of insurance regulation in the U.S. that criticized state-based regulation and recommended scrapping it in favor of federal

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116 Financial Stability Board, Global systemically important insurers (G-SIIs) and the policy measures that will apply to them (July 18, 2013), available at www.financialstabilityboard.org (last viewed Aug. 30, 2014).
117 Financial Stability Board, Global systemically important insurers (G-SIIs) and the policy measures that will apply to them (July 18, 2013), available at www.financialstabilityboard.org (last viewed Aug. 30, 2014).
118 Financial Stability Board, Global systemically important insurers (G-SIIs) and the policy measures that will apply to them 1 & 4, Annex 1 (July 18, 2013), available at www.financialstabilityboard.org (last viewed Aug. 30, 2014). These G-SIIs were identified using the methodology announced in International Ass’n of Insurance Supervisors, Global Systemically Important Insurers, Initial Assessment Methodology (July 18, 2013), available at www.iaisweb.org (last viewed Aug. 31, 2014).
regulation.\textsuperscript{122} According to the FSB, “[g]iven the drawbacks of the current regulatory set-up, the US authorities should carefully consider and provide recommendations to Congress as to whether migration towards a more federal and streamlined structure may be a more effective means of achieving greater regulatory uniformity.”\textsuperscript{123} In addition, the FSB was sharply critical of the states’ inadequacies in consolidated oversight of insurance groups and in capital adequacy regulation of insurance groups.\textsuperscript{124}

These steps by the FSB and the IAIS have exerted pressure to deepen federal involvement in insurance regulation in a number of ways. The IAIS’ decision to designate AIG, MetLife and Prudential as G-SIIs undoubtedly played a part in the companies’ U.S. SIFI designations. Global regulators’ emphasis on effective group supervision further underscored the holes in the U.S. approach to that issue. Meanwhile, the FSB’s push for international harmonization of capital adequacy standards for internationally active insurers could well set a standard that could ripple throughout the insurance industry.

\textbf{IV. Why Federal Intervention in Insurance is Likely to Grow in Future Years}

Before 2008, the insurance industry and state insurance regulators succeeded in staving off unwanted federal regulation of private insurance (apart from health insurance, employee benefits, and certain types of catastrophe insurance) partly because the federal government had not been tapped to bail out the insurance sector. That all changed in 2008. That fall, in a stark departure from the past, the federal government had to bear part of the negative externalities

\textsuperscript{123} \textit{Id.} at 10.
\textsuperscript{124} \textit{Id.}
resulting from systemic risk associated with the insurance sector, most notably in the bailout of AIG and the TARP payments to The Hartford and Lincoln National.

History sheds light on the watershed significance of crossing that line. In a related context before 1989, state bank and thrift regulators had significantly broader authority and discretion in regulating federally insured depository institutions than they do today. But during the savings and loan crisis in the 1980s, some state regulators relaxed their prudential safeguards against lax lending and equity investments to such an extreme that over two thousand thrifts and banks failed.\textsuperscript{125} Despite the large number of depository institution failures during that period, only a “relatively small number of failures” were needed to “cause serious strains on the [federal] deposit insurance fund.”\textsuperscript{126} The losses were so enormous that the federal savings and loan deposit insurance fund failed and the federal deposit insurance fund for banks went into the red, forcing Congress to recapitalize both funds at taxpayer expense.\textsuperscript{127} In response to this abdication by the states, Congress stripped the states of power to set minimum prudential standards for banks and thrifts in 1989 and 1991 and consolidated that authority in the federal government.\textsuperscript{128}

Similar to the events in banking, the federal bailouts to the insurance industry in 2008 inexorably changed the terms of the debate over federal intervention in insurance. The question is not whether the federal government will intervene in insurance; rather, it is to what extent and

how. Meanwhile, the recent financial crisis, the enactment of Dodd-Frank, the creation of FSOC and FIO, and the insurance initiatives of their international regulatory counterparts ignited a new and more expansive discussion about the meaning of the term “systemic risk” and the regulatory consequences flowing from that meaning. As I will discuss in the pages to come, the debate over federal regulation of insurance is playing out against the background of the larger debate over the definition of “systemic risk.”

A. Term Mismatch and Runs

In its broadest sense, “systemic risk” is the risk that an entire system will experience a series of correlated breakdowns. Historically, systemic risk most often has been conceptualized as the problem of directly linked failures. Under that theory, one financial actor’s inability to meet its obligations can directly inflict severe losses on its creditors, which can cause them to default on their own obligations and set off a chain reaction that topples other creditors down the line. This could be set in motion by one large shock to a financial sector or the economy or, less often, by a more limited shock to one institution that destabilizes its counterparties. The lower a financial firm’s capital or the higher its indebtedness or leverage, the more it will be vulnerable to systemic risk. Alternatively, systemic risk may also arise where the failure of one financial firm causes creditors or investors to question the solvency of similar firms and withdraw their funds.129

These scenarios share one thing in common, which is a balance sheet featuring a maturity mismatch between short-term liabilities and long-term assets that makes a financial firm susceptible to runs. The classic example involves a bank run, in which a bank, faced with a stampede by depositors to withdraw their demand deposits, becomes insolvent because it cannot liquidate its long-term assets at fair market value fast enough to pay off its depositors in full. If the bank’s distress spreads to other banks – because depositors elsewhere start to worry that their own banks are insolvent, because those banks are creditors of the original bank that failed, or for some other reason – then the bank run may ripen into systemic risk.130

Conventionally, the insurance industry has not been considered vulnerable to runs because of differences in its balance sheet makeup and especially the maturity of its liabilities.131 The classic model of insurance is premised on the law of large numbers, in which a large number of uncorrelated risks are distributed along a normal curve. In addition, policyholders usually cannot demand a payout unless and until there is an occurrence of an insured event. For both reasons, insurance claims should be spaced out over a relatively long period of time, which lengthens the average maturity of an insurance company’s liabilities to policyholders. Ideally, that allows an insurer to match its liabilities to the longer-term maturities of its assets. Consequently, insurers are less likely than commercial banks to experience a surge in cash redemptions that would threaten their liquidity and require them to liquidate their assets for less than fair market value.132 Similarly, traditionally insurers were not highly leveraged because

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130 See, e.g., Douglas W. Diamond & Philip H. Dybvig, Bank runs, deposit insurance, and liquidity, 91 J. Pol. Econ. 401 (1983); Gary Gorton & Andrew Winton, Financial Intermediation 63 (NBER Working Paper 8928 May 2002) (“[t]hese definitions have in common the feature that a panic is a systemic event in which consumers want to hold currency in exchange for their demand deposits”); see generally id. at 63-68.
131 For an examination of this argument, see Daniel Schwarcz & Steven L. Schwarcz, Regulating Systemic Risk in Insurance, 81 U. Chi. L. Rev. __, ___ (2014).
they did not rely heavily on financing through debt or substitutes for debt such as derivatives, repurchase (repo) agreements or securities lending.

While this traditional model of insurance often holds true, recent experience showed that the insurance industry is not completely immune from runs. As the financial crisis revealed, there are pockets of activities in some insurance companies and groups that increase their leverage and expose those firms (or their counterparties) to runs. FSOC relied heavily on these areas of concern in designating insurance companies as SIFIs to date.

1. **Term Mismatch in Shadow Banking**

The events of 2008 showed that bank deposits were not the only type of short-term liabilities that were subject to runs. As the post-mortem demonstrated, modern finance had spawned a “shadow banking system” of other forms of short-term debt financing that were also vulnerable to runs. For example, all of the top U.S. investment banks in 2008 depended on short-term (often overnight) lines of credit in the form of repo lending for funding.\(^{133}\) Bear Stearns and Lehman Brothers cratered when their repo lenders refused to renew their overnight loans. Similarly, in the over-the-counter derivatives market, panic about AIG’s ability to meet its credit swap protection obligations led to cash margin calls of crushing proportions. Money market funds also experienced runs, one of which capsized the Reserve Primary Fund in September 2008.\(^{134}\)

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\(^{133}\) A repurchase or repo agreement is a functional substitute for a loan in which the financial institution seeking to borrow sells securities for cash pursuant to an agreement to buy back the securities at a set price at a later date. See Tobias Adrian et al., Repo and Securities Lending 2-3 (Fed. Res. Bank of N.Y. Staff Report No. 529, Feb. 2013), available at http://www.newyorkfed.org/research/staff_reports/sr529.pdf (last viewed Dec. 30, 2014).

These types of runs can spread systemic risk through one and sometimes two pathways. The first pathway involves counterparty exposures. If a mega-firm reneges on its short-term liabilities, that can bring down the creditors who are owed that money, which in turn could topple their creditors. Generally, this concern about a cascading effect is limited to situations where a company’s counterparties are other systemically important financial institutions and not retail customers. In contrast, the second pathway – where mass liquidation of assets in order to meet redemptions sends market prices into a tailspin – can harm large financial institutions and retail customers alike.

a) **Term-Mismatch Problems in the Insurance Industry**

As the events of 2008 showed, runs were not limited to investment banks, money market funds, or derivatives issuers. Closer analysis revealed a number of term-mismatch problems in pockets of the insurance industry creating the potential for runs. FSOC cited several such problems in its decisions to designate AIG, Prudential Financial, Inc., and MetLife as SIFIs.

Specifically, FSOC expressed concern about various funding streams that increased the leverage of all three insurance SIFIs and their vulnerability to runs due to term mismatches. For example, the Council pointed to AIG’s, Prudential’s, and MetLife’s securities lending businesses as one worrisome area of counterparty exposures and asset liquidation. Repo financing at all

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135 According to Acemoglu, Ozdaglar & Tahbaz-Salehi, highly interconnected financial systems are safer so long as the size and number of damaging shocks remain small. As shocks increase in quantity and in size, however, financial systems featuring a high degree of interconnectedness among large counterparties become increasingly fragile. Daron Acemoglu, Asuman Ozdaglar & Alireza Tahbaz-Salehi, *Systemic Risk and Stability in Financial Networks*, ___ AM. ECON. REV. ___ (forthcoming 2015).


137 FSOC, Basis for the Financial Stability Oversight Council’s Final Determination Regarding Prudential Financial Inc. 2 (Sept. 19, 2013), available at www.treasury.gov (last viewed Aug. 11, 2014); FSOC, Basis of the Financial Stability Oversight Council’s Final Determination Regarding American International Group, Inc. 3, 14
three insurers posed similar concerns. In addition, the Council singled out the three companies’ derivatives holdings, which could “require [them] to either post additional collateral or to raise cash to close out certain funding transactions.” These activities presented term-mismatch problems to the extent that AIG, Prudential, or MetLife could be forced to dump substantial amounts of long-term or illiquid investments in order to raise cash to meet collateral class or repayment demands on short-term repo loans, securities loans, or derivatives obligations.

In its *MetLife* decision, FSOC also flagged a new area of concern, involving term-mismatch problems with MetLife’s funding agreement-backed notes (FABNs) and related products. FABNs are financing instruments in which investors buy notes from a special purpose vehicle (SPV) organized by a sponsor such as MetLife. In MetLife’s case, those notes are backed by an underlying agreement by MetLife to pay interest and principal on amounts that it borrows from the SPV. Some of these FABNs were short-term, which could create liquidity

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problems for MetLife if the holders of those notes decided not to renew their investments.\textsuperscript{141} In its designation opinion, FSOC pointed out that MetLife had one of the highest leverage ratios among its peers, due in part to its reliance on FABNs.\textsuperscript{142} FSOC was also worried that up to 65 money market mutual funds could “break the buck” if MetLife defaulted on its funding agreement-backed securities owned by those funds, thereby triggering a run on other money market funds.

FSOC also discerned the potential for runs in the redemption rights issued by all three companies on some of their traditional life insurance products. These insurers issued large amounts of life insurance products (including variable annuities) that guaranteed cash redemptions to policyholders who surrendered those policies or took out loans.\textsuperscript{143} Similarly, MetLife’s guaranteed investment contracts (GICs) gave customers a unilateral right of withdrawal for purposes of loans, benefits, or transfers to other funds within a plan.\textsuperscript{144} Three types of contagion might ensue in case of a surge in redemptions, according to FSOC. First, if large financial intermediaries and other companies had significant exposure to institutional products of that nature, they could face counterparty risk or need to write down those assets from

\textsuperscript{142} The Council also pointed to MetLife’s outstanding long-term debt, junior subordinated debt, unsecured credit and committed facilities, and Federal Home Loan Bank financing as sources of its leverage. FSOC, Basis of the Financial Stability Oversight Council’s Final Determination Regarding MetLife, Inc. 9, 16, 18-19, 24 (Dec. 18, 2014), available at www.treasury.gov (last viewed Dec. 19, 2014).
book value to market value if the insurer encountered material financial distress. Second, a decision by such large insurers to sell illiquid assets at fire-sale prices in order to meet redemptions could disrupt the broader financial markets. Lastly, if policyholders at other companies lost confidence in the solvency of their life insurers, that could lead to an uptick in early withdrawals at those companies as well.  

FSOC expressed further concerns about the widespread effect of any losses on MetLife’s retail policyholders and customers if it defaulted on the guaranteed features, given MetLife’s position as the largest publicly traded U.S. insurance organization and the largest provider of life insurance in the U.S. and the size of its customer base, which was 100 million strong worldwide.  

In voicing that concern, however, the Council did not explain how those losses could activate a recession or systemic risk. Similarly, while FSOC expressed concern about features of AIG’s annuity products that “could make them vulnerable to rapid and early withdrawals by policyholders,” it did not describe those features in any detail or quantify the magnitude of those contracts.

b) Implications for Future Federal Oversight of Insurance

FSOC’s focus on term-mismatch problems in insurance groups has several possible implications for the future direction of federal insurance regulation. These repercussions include heightened federal scrutiny of leverage and potential runs in insurance, greater federal oversight

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of insurance groups more generally, and across-the-board regulation of insurers, no matter their size, who engage in systemically risky activities.

(1) Federal Focus on Leverage and Potential for Runs

First, the SIFI deliberations showed that some large insurers are more reliant on short-term debt than was commonly understood. To the extent that insurance companies – especially large insurance companies – rely on short-term debt for part of their financing, that will catch FSOC’s eye. Since most insurance companies’ liabilities are financed by premiums and thus are heavily weighted toward long-term obligations to policyholders, this is relatively rare but not unknown.

There is one instance in which insurance policies can have demand-like features and that is with certain life insurance and annuity policies that are subject to early withdrawal at the initiative of the policyholder. As a general rule, life insurers reserve the right to suspend these sorts of redemptions. Nevertheless, they are likely to hesitate to invoke that right lest it suggest the appearance of insolvency. Given FSOC’s concern about the propensity of these types of life insurance and annuity policies to runs in the form of spikes in redemptions, it comes as no surprise that the first three U.S. insurance SIFI designees were giants in the life insurance industry.

These cash-redemption features are unique to the life insurance industry, but other term-mismatch problems flagged by FSOC involve financial activities engaged in by insurance companies more generally. Securities lending and derivatives trading are the most obvious examples; sponsorship of investment funds (including money market funds and mutual funds) is

another. To the extent an insurer’s securities lending, derivatives trading or fund activities present systemic risk, FSOC may be watching, whether the company specializes in life insurance or in property/casualty coverage.

(2) **Consolidated Insurance Group Oversight**

Another far-reaching corollary of the term-mismatch discussion involves the regulatory implications of holding company structure. The vast majority of U.S. insurance companies are owned by holding companies – numbering about 320 groups -- many of which combine insurance underwriters with non-insurance affiliates under one roof. The holding company organization of modern insurance groups has federal implications that state regulators cannot fully deflect.

First, to the extent an insurance group owns one or more federally insured depository institutions, that group is a holding company that is subject to consolidated supervision by the Federal Reserve Board. The Federal Reserve has oversight of two types of depository institution holding companies: financial holding companies (which own commercial banks) under the Bank Holding Company Act and savings and loan holding companies (which own savings banks) under the Savings and Loan Holding Company Act. Over the past few decades, a number of large insurance underwriters acquired commercial bank or savings institution affiliates. That trend continued during the financial crisis, when several freestanding insurance companies

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150 Pub. L. No. 84-511, 70 Stat. 133, as amended (1956), codified at 12 U.S.C. §§ 1841 *et seq.* The Federal Reserve also supervises ordinary bank holding companies under the same Act, but those holding companies cannot own insurance underwriters. *Id.*

acquired insured depository institutions in order to qualify for TARP funds or access to discount window loans by the Federal Reserve. \(^{152}\) Together, about 21 U.S. depository institution holding companies were primarily engaged in insurance underwriting in mid-2013. \(^{153}\) Meanwhile, at least 8 of the top 104 U.S. depository institution holding companies (with over $10 billion in assets) on June 30, 2014 were primarily engaged in insurance underwriting. \(^{154}\)

Before the enactment of the Dodd-Frank Act, the Federal Reserve Board had extremely limited authority over insurance subsidiaries of depository institution holding companies. However, after the 2008 debacle, the Federal Reserve Board’s reach over ordinary insurers who are part of financial holding companies grew significantly. Specifically, in Dodd-Frank, Congress expanded the Federal Reserve’s powers to examine consolidated depository institution holding companies, including those owning insurers. \(^{155}\) The Board gained new powers to examine all of a holding company’s subsidiaries, whether they are depository institutions,

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functionally regulated subsidiaries such as insurers,\textsuperscript{156} or some other type of affiliate. Importantly, the Board no longer has to make a threshold showing that an insurance subsidiary poses a risk to a bank or thrift affiliate or is suspected of violating the law before commencing an examination. For the first time, the Board acquired the power to examine functionally regulated subsidiaries engaged in commodities and/or swaps activities. The Board further gained new authority to examine holding companies and all of their subsidiaries for potential systemic risk.\textsuperscript{157}

These new federal oversight powers are significant because any insurer controlled by a depository institution holding company will be subject to federal monitoring and examination under Dodd-Frank, regardless of size. Partly due to this heightened federal presence, after 2010, some insurance groups divested or changed the charters of their insured depository institutions to escape holding company oversight by the Federal Reserve.\textsuperscript{158} That strategy backfired in MetLife’s case, prompting FSOC to cite the company’s divestiture as a justification to re-subject

\textsuperscript{156} Functionally regulated subsidiaries of depository institution holding companies include insurance underwriters and securities underwriters.

\textsuperscript{157} Today, safety and soundness examinations of holding companies may be conducted for a broad variety of statutory purposes. One of those purposes is to inform the Board of the nature of the operations and financial condition of the holding company and the subsidiary. Another is to gauge financial, operational, and other risks within the holding company system that may pose a threat to the stability of the financial system of the United States or the safety and soundness of the holding company or of any of its depository institution subsidiaries. Finally, safety and soundness examinations are allowed to scrutinize the systems of the holding company for monitoring and controlling the holding company’s risks. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 604(b), (h)(2), 124 Stat. 1547 (2010), codified at 12 U.S.C. §§ 1467a(b)(4)(A)(i), 1844(c)(2)(A)(i).

Under Dodd-Frank, the Federal Reserve Board is also authorized to conduct compliance examinations to monitor the compliance of the holding company and any of its subsidiaries with the Bank Holding Company Act and federal laws that the Board has specific jurisdiction to enforce against the parent or the subsidiary. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 604(b), (h)(2), 124 Stat. 1547 (2010), codified at 12 U.S.C. §§ 1467a(b)(4)(A)(ii), 1844(c)(2)(A)(ii).

MetLife to consolidated oversight as a SIFI. Insurance groups that have other reasons to retain depository institution subsidiaries – for instance, because those banks or thrifts are integral to their business models or because those groups want access to the Federal Reserve’s discount window – will have to live with the Fed’s expanded oversight. To the extent a shadow banking activity is located directly within a financial holding company’s insurance subsidiary, that activity is apt to garner closer scrutiny by the Fed.

Even when a large insurance group does not own a federally insured bank or thrift and thus is not a depository institution holding company, it may still face the risk of a SIFI designation where term-mismatch problems threaten the stability of the U.S. financial system. In such instances, umbrella supervision of the entire group is warranted for several reasons. One is to monitor any uptick in systemic risk in the group’s individual units and to curtail that risk. Another is to police interaffiliate transactions – such as loans or upstreamed dividends – that might be used to finance systemically risky activities while jeopardizing the financial health of the affected affiliates and their customers, including policyholders or depositors. Safeguarding the parent company’s ability to serve as a financial source of strength to subsidiaries that are insurance companies or banks is another justification for consolidated oversight. The umbrella supervisor also needs to be able to monitor and gauge counterparty exposures to the systemically risky activities in question. Finally, the consolidated supervisor must be able to coordinate (as best it can absent a global super-regulator) oversight of the cross-border activities and resolution of large, internationally active insurance groups.

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159 FSOC, Basis of the Financial Stability Oversight Council’s Final Determination Regarding MetLife, Inc. 28 (Dec. 18, 2014), available at www.treasury.gov (last viewed Dec. 19, 2014) (observing that “MetLife, Inc. has deregistered as a banking holding company and MetLife is not currently subject to consolidated supervision”).
Despite its many past missteps and lapses, the federal government is the only U.S. regulator with the jurisdiction and capacity to carry out umbrella oversight of insurance groups for systemic risk.\textsuperscript{160} No state regulator has full regulatory jurisdiction over insurance holding companies or their non-insurance subsidiaries.\textsuperscript{161} Instead, under state insurance holding company system regulatory acts, state regulators only directly supervise licensed insurance subsidiaries within insurance groups. Under the system called “windows and walls,” state insurance departments use their oversight of regulated insurers to indirectly monitor certain types of activities within the group. State departments have created “windows” into group activities by obtaining or mandating information on the business dealings of parent companies and non-insurer affiliates. This is accomplished through a variety of methods, including reporting by insurers of financial statements for the parent and all affiliates, the institution of an enterprise risk report, assessments of group capital, examination authority over insurers and their affiliates, memoranda of understanding (MOUs) with primary regulators of those other entities, information gleaned from federal securities filings, and participation in supervisory colleges for internationally active groups.\textsuperscript{162}

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Daniel Schwarcz and Steven L. Schwarcz make a forceful argument to this respect in \textit{Regulating Systemic Risk in Insurance}, 81 U. Chi. L. Rev. \textbf{___}, \textbf{___} (2014). The European Union has struggled with similar questions concerning whether to follow a decentralized network regulatory approach or a centralized lead-agency model in crisis management. For an analysis of the merits of that debate outside of the systemic risk context, see Arjen Boin, Madalina Busuioc & Martijn Groenleer, \textit{Building European Union capacity to manage transboundary crises: Network or lead-agency model}, 8 \textit{Regulation \\& Governance} 418 (2014).

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FSOC baldly questioned the effectiveness of supervisory colleges in its \textit{MetLife} opinion:

While supervisory colleges may allow state insurance regulators to monitor other parts of an insurance organization, and may enhance communications of confidential supervisory concerns across an enterprise, they are not equivalent to the supervisory and regulatory authorities to which a nonbank financial company that the Council determines shall be subject to supervision by the Board of Governors and enhanced prudential standards is subject \textit{[sic]}, nor do they have direct supervisory authority over the holding company or its non-insurance subsidiaries.

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Similarly, state regulators have set up “walls” by requiring review of specific transactions between insurers and their affiliates to prevent holding companies from inappropriately siphoning cash out of their insurance subsidiaries and to protect the ability of those subsidiaries to pay their policyholders’ claims. Transactions requiring advance approval include investment purchases, reinsurance agreements, management and cost sharing agreement, tax allocation agreements, some guarantees, intercompany investments, requests for extraordinary dividends, and any other material transactions that could adversely affect policyholder interests. Companies must also meet state requirements in order to acquire insurance companies.\footnote{FSOC, Basis of the Financial Stability Oversight Council’s Final Determination Regarding MetLife, Inc. 27-28 (Dec. 18, 2014), available at www.treasury.gov (last viewed Dec. 19, 2014)}

AIG-FP’s credit default swap dealings was the imminent threat of a global financial meltdown; AIG-FP’s threat to the solvency of AIG’s insurance companies, while of very real consequence, paled in comparison to that global threat.

This inward-looking focus of the “windows and walls” approach results from limitations on the direct jurisdiction of state insurance commissioners over the non-insurance affiliates of insurance company subsidiaries. Those restrictions limit the effectiveness of the “windows and walls” system in several ways. First, only 24 states had fully or substantially adopted the 2010 revisions to the NAIC Model Insurance Holding Company System Regulatory Act as of November 2013 that strengthened the group oversight authority of state insurance commissioners. Worse, only 7 states had promulgated the 2010 revisions to the implementing regulation by that date. As a result, many states are operating under older versions of the law and regulation that further cramp the ability of state insurance departments to keep apprised of group activities outside of regulated insurance subsidiaries.

Second, even in states that have adopted the 2010 revisions, their information-gathering powers are limited. State insurance departments only can require periodic reports by insurance subsidiaries but not by parent companies or non-insurance affiliates (other than enterprise risk reports, which parent companies must file). Furthermore, insurance regulators do not collect comprehensive data for a number of several reasons. The Financial Stability Board reported, for instance, that “[g]roup-wide consolidated data and the financial statements of affiliates within an

165 These jurisdictional challenges are even more difficult when an insurance subsidiary is domiciled in one state and the holding company is incorporated in another state. See Duane Morris, Insurance Regulatory Update – Holding Company Supervision, Designation of Prudential Financial as Being “too Big to Fail,” Principle-Based Reserving and Captives, Sept. 23, 2013, available at www.duanemorris.com (last viewed Dec. 17, 2014).

insurance group are not systematically collected and data is usually only requested by regulators in those instances where it has been produced for other mandated purposes. According to the FSB, “[t]his constrains the ability of state authorities to effectively supervise all insurance groups and to analyse events that might impact the group as a whole, absent a framework for consolidated regulation and supervision.”

Meanwhile, although the 2010 revisions to the model insurance holding company law require insurance subsidiaries to gather information about activities and exposures throughout the group, those subsidiaries must rely on the kindness of their fellow affiliates to obtain that information. Even the model act recognizes that this dependence presents problems. Thus, the model act acknowledges that insurance subsidiaries may not always be able to obtain “information not in possession of the insurer” that is requested by a state commissioner. In that event, the model act states, “the insurer shall provide the [insurance] commissioner a detailed explanation of the reason that the insurer cannot obtain the information and the identity of the holder of the information.” If the department concludes that the explanation is “without merit,” it may fine the insurer or suspend or revoke its license. The department may also examine the affiliates to obtain the information or subpoena and depose “any person” for purposes of

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169 See NAIC, Insurance Holding Company System Regulatory Act § 4(A)-(B); NAIC, Insurance Holding Company System Model Regulation With Reporting Forms and Instructions §§ 14, 20, Form B. Section 4(F) of the Model Act does require “[a]ny person within an insurance holding company system subject to registration . . . to provide complete and accurate information to any insurer, where the information is reasonably necessary to enable the insurer to comply with the provisions of this Act.” As I discuss below, however, the enforcement mechanisms for this duty are weak.
170 NAIC, Insurance Holding Company System Regulatory Act § 6(B)(2).
171 NAIC, Insurance Holding Company System Regulatory Act § 6(B)(2). Elsewhere in the model act, Section 11(F) states that “[w]henever it appears to the commissioner that any person has committed a violation of Section 3 of this Act [on registration and disclosure] and which prevents the full understanding of the enterprise risk to the insurer by affiliates or by the insurance holding company system, the violation may serve as an independent basis for disapproving dividends or distributions and for placing the insurer under an order of supervision . . . “ Once again, however, these repercussions only apply to the insurer, not to its non-insurance affiliates.
determining compliance. However, the model act provides no agency sanctions against any of the insurer’s affiliates for withholding requested information.\textsuperscript{172} Alarmingly, these restrictions resemble the similar limitations that the Federal Reserve Board labored under unsuccessfully when supervising bank holding companies before 2010 and indicate that the model act is not up to the task of properly monitoring enterprise risk in insurance groups.

Third and in a related vein, “windows and walls” also depend on the existence of and cooperation of other primary regulators to share information. Some affiliates, however, are largely unregulated and do not have a primary regulator. Meanwhile, turf wars, red tape, and lack of standardized data may make cooperation harder and slower than expected.

Fourth, under the model act, state insurance regulators only have limited authority to take enforcement action against group personnel outside of an insurance subsidiary. Most of the sanctions in the model act are directed at registered insurance affiliates or their officers, directors, employees, or agents.\textsuperscript{173} Directors and officers “of an insurance holding company system” do face sanctions in two situations. First, any holding company system officer or director who “knowing violates, participates in, or assents to, or who knowingly shall permit any of the officers or agents of the insurer to engage in” illegal transactions or investments shall face monetary civil forfeitures.\textsuperscript{174} Second, any officer, director or employee of an insurance holding company system who “willfully and knowingly subscribes to or makes or causes to be made any false statements or false reports or false filings with the intent to deceive the commissioner” will be subject to criminal prosecution, imprisonment and criminal fines.\textsuperscript{175} The \textit{mens rea}

\textsuperscript{172} NAIC, Insurance Holding Company System Regulatory Act § 6(B)(2), (E). See the discussion below for possible criminal sanctions against individual holding company directors and officers.
\textsuperscript{173} NAIC, Insurance Holding Company System Regulatory Act §11.
\textsuperscript{174} NAIC, Insurance Holding Company System Regulatory Act §11(B).
\textsuperscript{175} NAIC, Insurance Holding Company System Regulatory Act §11(E).
requirement of knowing or willful misconduct, however, makes it difficult to muster the proof needed to impose any of these sanctions. Meanwhile, state insurance commissioners have no authority under the model act to sanction insurance group parent companies or non-insurer affiliates, either for activities jeopardizing their insurance affiliates or for activities that threaten systemic harm to financial firms other than affiliated insurers. Instead, “state regulators rely on achieving outcomes indirectly via the regulated [insurers] of a holding company.”

Finally, nothing in the “windows and walls” system allows state regulators to see the connections and monitor the exposures of counterparties outside of an insurance group. Federal regulators were hamstrung during the Bear Stearns, Lehman Brothers, and AIG crises because they lacked similar data on each firm’s counterparty exposures with other financial firms. That experience showed that a line of sight into inter-firm exposures is essential for systemic risk oversight to be effective. But state insurance regulators do not remotely have access to that information and even if they did, they do not have the expertise, budget, or staffing to monitor those interconnections successfully. Finally, the international dimensions of systemic risk make it extremely difficult for other nations to reach omnibus agreements with all 50 state insurance regulators.

Consequently, any time the activities of an insurance group threaten the stability of the U.S. financial system – whether those activities are located within an insurer or are restricted to a non-insurance affiliate – the United States government must have the ability to monitor the situation from all angles and to act when necessary. The question is not whether the federal government should oversee insurance for possible systemic risk; rather, the question is the

appropriate type of systemic risk regulation and the relative roles of the federal government and state insurance regulators in conducting that oversight.\textsuperscript{177}

Monitoring for systemic risk will likely be the first area where the federal presence will expand over time. Currently, federal law only permits examinations of insurance groups where a group has been designated a SIFI or owns an insured depository institution.\textsuperscript{178} But the need to keep tabs on accumulations of systemic risk will create a broader need for federal reporting by insurance conglomerates generally. Anticipating that need, Dodd-Frank gave FSOC the authority to direct the Office of Financial Research (OFR) to collect information from nonbank financial companies (including insurance companies) for the purpose of assessing the extent to which a financial activity or financial market in which the firm participates, or the firm itself, poses a threat to the financial stability of the United States.\textsuperscript{179} So far, OFR has flagged data gaps in securities lending by insurance companies (and the associated reinvestment of cash collateral), management of funds in separate accounts maintained by insurers, and the financial condition of captive reinsurers as areas of concern.\textsuperscript{180} Potentially, any added federal reporting requirements in these areas for the purpose of systemic risk could apply to insurers across the board, regardless of size.

\textsuperscript{177} State insurance regulators, for instance, will continue to play an essential role in the microprudential regulation of individual insurance companies, which is a necessary part of systemic oversight.

\textsuperscript{178} Congress reaffirmed this need when it enacted provisions in Dodd-Frank giving the federal government expanded authority to require additional reporting by certain insurance companies in the wake of the crisis. As a consequence, all financial holding company subsidiaries – including any insurers – must now provide reports and supervisory information that they provide to their primary regulators to the Federal Reserve Board upon request. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 604(a)(2), 124 Stat. 1547 (2010), codified at 12 U.S.C. § 1844(c)(1)(C); see also id. § 604(c)(2) (repealing 12 U.S.C. § 1848a).


Across-the-Board Regulation of Systemically Risky Activities

A final implication of the concern over asset-liability mismatches implicates the debate about how runs can lead to contagion. Contagion resulting from a run can affect a failed institution’s short-term creditors and thus is a function of their interconnectedness. But experts debate whether the spread of contagion to a firm’s creditors requires more in order to spawn systemic risk. In particular, must the institution and/or its counterparties also be large enough in size before contagion will jeopardize U.S. or global financial stability?

The Dodd-Frank Act straddled this debate without resolving it. On the one hand, Dodd-Frank expressly defined bank SIFIs based on size\textsuperscript{181} and instructed FSOC to consider size when designating nonbank SIFIs.\textsuperscript{182} Elsewhere, though, Dodd-Frank and FSOC authorized the regulation of shadow banking activities considered to be systemically risky without reference to the counterparties’ size. Derivatives trading and money market funds are just two examples. These types of systemic risk from insurance are not just limited to SIFIs. They can be found in many corners of the insurance industry, regardless of a company’s size. Already, this has led to across-the-board federal regulation of those underlying activities by all financial services firms engaging in them, including insurers. While this type of across-the-board regulation of discrete activities for systemic risk is in its infancy, as it grows, it will affect many or all insurance companies enmeshed in those activities.

2. Supply-Side Dynamics

\textsuperscript{181} Dodd-Frank Act, Pub. L. No. 111-203, §§ 115(a), 121(a), 155(d), 163(b), 165(j), 166(a), 172(a), 210(o)(1)(A), 124 Stat. 1394 (2010).
As the previous section suggests, traditional discussions of systemic risk have focused on the demand for financing through systemically risky financial instruments, not on the supply. In all likelihood, that is because the traditional suppliers of short-term credit to commercial banks are depositors and deposits are viewed favorably for their important and essential role in providing liquidity through maturity transformation and the payment system.\textsuperscript{183}

In more recent debates over the dynamics of runs, however, analysts have increasingly paid attention to the supply side of risky asset classes.\textsuperscript{184} This new line of inquiry stems from concerns about the role played by investors during the run-up to the fall of 2008, when banks, insurance companies, and other regulated institutional investors, in search of yield, became major suppliers of funds for investment-grade residential mortgage-backed securities, collateralized debt obligations, and credit derivatives. In too many cases, these investors took the creditworthiness of those instruments on faith by placing undue reliance on credit agency ratings instead of doing their own due diligence.\textsuperscript{185} When the credit rating agencies downgraded those assets \textit{en masse} due to defaults on the underlying mortgages or securities that backed those assets, investors rushed to liquidate those investments, setting off a loss in liquidity and a freefall in prices.\textsuperscript{186}

To date, FSOC’s main concern has not been with investor demand for those asset classes \textit{per se}, but instead with the effects on financial markets if those assets are rapidly liquidated.\textsuperscript{187}

\begin{flushright}
\textsuperscript{184} For an illuminating discussion of this problem, see Daniel Schwarcz & Steven L. Schwarz, \textit{Regulating Systemic Risk in Insurance}, 81 U. Chi. L. Rev. ___ (2014).
\textsuperscript{185} See Kathleen C. Engel & Patricia A. McCoy, \textit{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps} 58-61 (Oxford University Press, 2011).
\textsuperscript{186} See Kathleen C. Engel & Patricia A. McCoy, \textit{The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps} 107-08, 111, 113-14 (Oxford University Press, 2011).
\textsuperscript{187} See, e.g., FSOC, Basis for the Financial Stability Oversight Council’s Final Determination Regarding Prudential Financial Inc. 6, 8-9 (Sept. 19, 2013), available at www.treasury.gov (last viewed Aug. 11, 2014).
\end{flushright}
When The Hartford and Lincoln National sought and received TARP infusions after suffering massive losses in their investment portfolios, those TARP payments highlighted the role played by those and other insurers in financing some of the asset classes that jeopardized the financial system in 2008. In response, federal regulators trained their sights on the correlated presence of such assets in insurance company portfolios and the potential domino effect if multiple institutional investors, including insurers, sought to sell off those assets at once. One of FSOC’s justifications for designating Prudential as a SIFI, for example, was that the “severity of the disruption caused by a forced liquidation of Prudential’s assets could be amplified by the fact that the investment portfolios of many large insurance companies are composed of similar assets, which could cause significant reductions in asset values and losses for those firms.” FSOC cited similar concerns with respect to MetLife.

Several potential consequences flow from this new attention to the supply side of the equation. For one thing, federal regulators are increasingly likely to increase reporting requirements to help them pinpoint the location of accumulations of specific risky asset classes, regardless of who is funding them, with no special carve-out for insurance companies. To the extent insurers come under scrutiny for their role in financing any of those asset classes, that could affect insurance company investment portfolio decisions and the institutional and regulatory dynamics driving those decisions. There would also be likely implications for the risk weights assigned by the risk-based capital framework and by the internal capital models for insurers.

As this discussion suggests, the new focus on systemic risk arising from asset-liability term mismatches in insurance has numerous implications for the possible expansion of the federal role in insurance regulation. To complicate this picture, FSOC is espousing another theory of systemic risk in insurance that could broaden these implications even further.

B. Systemic Risk Due to Other Causes of Macroeconomic Distress

The traditional definition of systemic risk in terms of runs is well-ensconced and will always raise grounds for concern. But recent federal pronouncements foreshadow another, significantly broader theory of systemic risk that does not depend on the threat of runs (either at the financial institution in question or at one of its counterparties). Under this latter conception, systemic risk could arise in insurance where major market participants are so dependent on a specific type of insurance coverage that widespread loss of that coverage could have major adverse macroeconomic repercussions. So far this discussion has been limited to broad market dependence on insurance coverage by individual insurers. But if this logic becomes entrenched, it could extend to entire insurance sectors as well.

This theory of systemic risk is considerably broader than the traditional theory in at least two respects. First, some iterations of this broader theory focus on whether an insurance company is unable or unwilling “to provide a critical function or service relied upon by market participants and for which there are no ready substitutes.” Under this formulation, FSOC could view certain voluntary decisions by individual insurers – or whole insurance sectors – to exit the market for coverage of a given “critical” risk as posing systemic risk and thus triggering

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federal oversight. FSOC hinted at this in the written justification for AIG’s SIFI designation, where the Council pointed to “the specialized policies underwritten by AIG’s excess and surplus lines insurers,” which “could be difficult for competitors to rapidly replace should AIG exit the market.”

This rationale alludes to a broader issue that is inherent in all of insurance, which is policyholders’ inability to procure other coverage once an insured risk materializes. While FSOC’s discussion is not exactly coherent on this score, the Council’s discussion of the millions of retirement product customers served by AIG and MetLife hinted at concerns about the ability of Baby Boomer customers to replace their AIG or MetLife annuities after retirement if either of those companies defaulted on those obligations.

In addition, this theory of systemic risk is broader than the theory based on runs because it defines systemic risk according to the result – mass financial distress to insureds or their third-party beneficiaries following loss of coverage – instead of according to the cause of the loss of

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191 In the health insurance sector, of course, a similar pattern of private market exit led to federal intervention in the form of Medicare, Medicaid, and the Affordable Care Act (with an added overlay of ERISA regulation for health plans provided through workplaces). The same pattern of federal intervention following loss of private coverage can be seen in segments of the market for catastrophic risk, including nuclear accidents, flood damage, and terrorism risk. None of these previous forays into federal intervention in insurance was justified in terms of systemic risk. FSOC’s innovation consists of reframing the question by asking whether a decision by private insurers to exit certain insurance markets could result in systemic risk.


coverage. According to this wider view, it is irrelevant whether loss of coverage is due to term mismatches or some other reason resulting in an insurer’s insolvency, such as a spike in claims due to correlated risks, other types of actuarial miscalculations or under-reserving, undercapitalization, or portfolio losses. Any cause of insurance insolvency that could inflict macroeconomic harm would give rise to systemic risk.

Intimations of this more expansive view of systemic risk can be seen in FSOC’s decisions naming all three insurers as SIFIs. In the case of Prudential, FSOC justified its SIFI designation in part because numerous corporations and pension plans depended on coverage by Prudential to meet their pension obligations.\(^{194}\)

Corporations, banks, and pension plans have exposures to Prudential through retirement and pension products, corporate- and bank-owned life insurance, and other group insurance products. Many employee benefit retirement plans have large exposures to Prudential through insurance and stable value products. Material financial distress at Prudential could impair the ability of pension plans to meet certain obligations to retirement plan participants.

FSOC raised similar concerns regarding AIG:\(^{195}\)

AIG provides group annuities for private pension funds through its life insurance subsidiaries, and its institutional business line offers stable value wrap products. If AIG were to experience material financial distress, the pension plan parties to these wrap contracts could be forced to write down their assets from book to market value, resulting in costs for the pension plan sponsors . . . and [putting] unprecedented strain on the [state guaranty fund] system.

It voiced similar comments in the case of MetLife:\(^{196}\)

\[M\]aterial financial distress at MetLife could force pension plans and other institutional users of these products to write down certain of their assets from book value to market


\(^{195}\) FSOC, Basis of the Financial Stability Oversight Council’s Final Determination Regarding American International Group, Inc. 6 (July 8, 2013), available at www.treasury.gov (last viewed Aug. 11, 2014).

value, which could result in significant costs for the pension plans and potentially also for their institutional sponsors.

... The exposures of MetLife’s individual policyholders and institutional customers could cause MetLife’s material financial distress to impair those entities and affect financial market functioning and the economy.

In proceeding down this path, FSOC proposed a sweeping new theory of systemic risk that is not necessarily self-evident when applied to insurance. The pension and annuity liabilities that FSOC identified should have a long tail. Absent any features of those contracts that allow immediate cash redemptions, their payout should be distributed over a long period of time. Due to this curve of anticipated payouts, if AIG, Prudential, or MetLife were to founder, there would be a relatively long time horizon to resolve policyholders’ claims as they came due.

Given the breathtakingly novel nature of this second definition of systemic risk, FSOC is therefore obligated to explain exactly how loss of these types of coverage by AIG, Prudential, or MetLife could threaten the financial stability of the United States. Unfortunately, there is no explanation of that causal nexus in any of the three insurance SIFI designations. FSOC did not explain why the exposure of the companies’ annuity counterparties was so enormous that their partial loss of coverage could actually trigger an economic downturn and, if so, how. Nor did it provide sufficient facts about the companies’ market shares or the relative market share and capacity of their pension and annuity product competitors to allow outside observers to determine whether the insurers’ inability to write new pension coverage due to insolvency would really trigger the risk of recession.197 If coverage loss really does present systemic risk in certain

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197 In the retail context, none of the sample metrics identified in FSOC’s guidance about how it will make nonbank SIFI designations addresses the causal nexus between market share and the risk of a recession or financial meltdown. See Financial Stability Oversight Council Guidance for Nonbank Financial Company Determinations, 12 C.F.R. pt. 1310, app. A.
circumstances, FSOC also needs to explain why systemic risk supervision is the answer instead social insurance in which the federal government provides that coverage itself.

For these reasons, FSOC’s stated justifications for this second, broader theory of systemic risk leave a lot to be desired. There is another notable area, however – financial guaranty insurance – where some of the concerns that FSOC identified about the larger consequences of any type of insurer insolvency actually came to pass during the 2008 financial crisis. What brought the bond insurers down was not a classic mismatch between assets and short-term liabilities. Rather, the bond insurers were hit with an avalanche of claims because they had guaranteed a correlated risk, *i.e.*, the risk that RMBS and CDOs would default. That risk was correlated because defaults on the underlying mortgages that served as collateral pushed down housing prices, making other home mortgage defaults more likely\(^{198}\) and increasing the probability of defaults on the RMBS and CDOs. Similar problems plagued private mortgage

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insurers, which suffered sharp losses from the subprime and Alt-A residential mortgages they guaranteed in the years leading to the 2008 financial crisis. 199

While FSOC and FIO have been strangely silent on the subject of financial guaranty insurers, concerns about private insurance of correlated risks have prompted the IAIS, not surprisingly, to identify those insurers as possible candidates for systemic risk oversight. 200 Probably, FIO and FSOC have been quiet about designating financial guaranty insurers as SIFIs because the industry shrank so drastically and is no longer insuring mortgage-backed securities in any significant amount. In contrast, private mortgage insurers are continuing to insure home mortgages, which may explain why FIO is calling for federal regulation of private mortgage insurers. 201

Nevertheless, financial guaranty insurers may come under renewed federal scrutiny if housing finance reforms take flight. Recent Congressional proposals for housing finance reform would designate financial guaranty insurers as the first loss guarantors in any new private-label RMBS system that emerges. If that were to occur, these proposals would place the guarantors under federal safety and soundness supervision. 202 Furthermore, in light of the events of 2008, financial guaranty insurers that began to guarantee RMBS would also likely come under scrutiny for systemic risk oversight, including SIFI designation.

If FSOC continues down this path, its focus on coverage losses that could result in major macroeconomic repercussions, regardless of cause, has major implications for the systemic oversight of insurance. There are many reasons why a broad spectrum of policyholders could

199 See FIO Modernization Report, supra note 1, at 31-32.
201 See FIO Modernization Report, supra note 1, at 7, 31-32.
suffer loss of coverage. Major individual insurers or entire insurance sectors could voluntarily
exit a market for financial reasons. In other circumstances, a dominant insurer’s insolvency
could lead to widespread, partial loss of coverage, both in the form of inadequate reserves for
current and future claims and in lost capacity to write future policies.

Such insolvencies could occur for a host of reasons other than the unlikely event of a run.
Insurers may under-reserve due to wrong actuarial assumptions or competitive underpricing.
They may founder due to steep, unexpected losses in their investment portfolios. Or they may
suffer an avalanche of claims when correlated risks materialize. Financial guaranty insurers,
private mortgage insurers, catastrophe insurers, and annuity insurers are especially susceptible to
these types of correlated risk. FSOC’s pronouncements to date suggest that the Council is
considering these other possible causes of insurance company insolvencies – in addition to any
risk of runs -- when contemplating SIFI designations. Consequently, the grounds for SIFI
designations of insurers may be broader than the narrow focus on runs would suggest and could
get the federal government more deeply involved in solvency regulation of insurers.

As part of that involvement, this focus on insurance company insolvencies could have
major implications for a federal hand in capital adequacy standards for insurers. Dodd-Frank
already requires the Federal Reserve Board to set higher capital standards for insurance group
SIFIs. This requirement has been highly controversial due to insurance industry fears that the
Fed’s approach to capital requirements will be too bank-centric and make the affected insurers

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203 State guaranty funds may reimburse some of those losses. However, those funds impose liability caps and
do not cover certain lines at all. Commercial lines are especially vulnerable to this lack of state guaranty fund
coverage.

204 See Daniel Schwarcz & Steven L. Schwarcz, Regulating Systemic Risk in Insurance, 81 U. CHI. L. REV.
(2014).

less competitive.\textsuperscript{206} While Congress addressed those concerns in late 2014 by amending Dodd-Frank to relieve the Board from any obligation to impose bank-like capital standards on insurance subsidiaries in nonbank SIFIs, the Board must continue to impose risk-based capital and leverage standards at the group level.\textsuperscript{207} Meanwhile, FIO and the Fed have been intimately involved in discussions of heightened global capital standards for internationally active insurance groups (regardless whether those groups have been designated SIFIs by FSOC or globally systemically important insurers by the IAIS).\textsuperscript{208} These twin developments could eventually produce a two-tier framework of minimum capital regulation in insurance in which larger, globally active insurance groups are subject to higher capital requirements than smaller insurers. The competitive inequalities and incentives for regulatory arbitrage that could result will produce pressure to harmonize the two tiers of standards and give the federal government a larger voice in state capital standards in the process.

V. Conclusion

The state-based model of U.S. insurance regulation has been remarkably enduring to date, in part because the traditional rationales for a greater federal role – efficiency, uniformity, and consumer protection – have not succeeded in displacing it. However, the 2008 financial crisis, the federal government’s unprecedented bailouts of parts of the insurance sector, and the need for a coordinated international approach radically shifted the terms of the debate by supplanting the old concerns about efficiency, uniformity, and consumer protection with a new,

\begin{itemize}
  \item \textsuperscript{206} See, e.g., Arthur D. Postal, Insurers Make Case Against 'Bank-Centric' Rules, but Others Urge Caution, \textit{PROPERTY CASUALTY 360}\textsuperscript{\textregistered}, March 11, 2014.
  \item \textsuperscript{207} Insurance Capital Standards Clarification Act of 2014, S. 2270, 113\textsuperscript{th} Cong., 2d Sess., § 2(2) (2014), codified at 12 U.S.C. § 5371(c)(1)-(c)(2).
  \item \textsuperscript{208} International Ass’n of Insurance Supervisors, \textit{Global Systemically Important Insurers, Initial Assessment Methodology} (July 18, 2013), available at www.iaisweb.org (last viewed Aug. 31, 2014).
\end{itemize}
high-stakes imperative to control systemic risk. In the process, solvency, which traditionally has been reserved to the states, is starting to become subsumed under the systemic risk rubric. Unprepared and ill-equipped to counter this tectonic shift in the logic of the debate, the states and the NAIC face the biggest threat to their domination of U.S. insurance regulation in years.

Already, the federal government has made inroads into insurance regulation for purposes of systemic risk oversight and global cooperation to contain that risk. That federal incursion creates several potential openings for a broader federal role in insurance than just SIFI regulation.

The least intrusive of those alternatives would be for the government to impose new reporting obligations on some or all insurance companies and groups to enable the government to locate and gauge accumulations of systemic risk. But broader federal intervention is entirely possible and already in play. For example, insurance groups engaged in activities that FSOC has tagged as systemically risky can increasingly expect across-the-board federal regulation of those activities, regardless of size. Already derivatives trading and money market mutual funds are the subject of such regulation and securities lending and asset management (possibly extending to insurance company separate accounts) are next in line.

FSOC’s preoccupation with redemption rights and guaranteed minimum benefits in certain life insurance and annuity policies raises a further question whether FSOC might treat those types of policy features as systemic as well. There is new and growing federal concern, moreover, over the systemic risk posed by insurance groups who effectively lower their
minimum capital requirements by ceding their insurance risks to their captive reinsurers.\footnote{See, e.g., Federal Insurance Office, U.S. Department of the Treasury, \textit{The Breadth and Scope of the Global Reinsurance Market and the Critical Role Such Market Plays in Supporting Insurance in the United States} 13 (Dec. 2014), available at www.treasury.gov (last viewed Jan. 1, 2015); FIO Modernization Report, \textit{supra} note 1, at 32.} If the federal government proceeded down either of these two paths, that would represent an unprecedented incursion by Washington into state oversight of the substantive terms of insurance contracts.

Consolidated insurance group oversight is another area where the drumbeat for reform and the states’ inability to successfully deliver that reform could pave the way for broader federal involvement in insurance regulation. Currently, most insurance groups escape holding company regulation at the federal level because the federal government’s authority over insurance holding companies is limited to SIFIs and to depository institution holding structures. But there are good prudential reasons and growing international pressure to subject more insurance groups to federal control. The Treasury Department and the Federal Reserve Board are immersed in those international discussions and in all likelihood concur with their conclusions. More importantly, internationally active insurance groups face the danger of growing intervention by European Union if the European Commission determines that state-based regulation does not provide equivalent consolidated supervision of those groups.

Finally, solvency regulation of insurance companies is in the federal government’s crosshairs for a variety of reasons that are swiftly coinciding. FSOC’s vague, unconventional, and highly expansive theory positing systemic risk from certain losses of coverage makes insurance company insolvencies a matter of federal concern, regardless of their cause. To the extent that FSOC continues to expound that novel theory of systemic risk, the federal government is likely to agitate for a more dominant role in shaping capital standards for the
insurance industry, particularly for large insurance groups. FSOC’s additional scrutiny of insurance companies’ potential role as the financiers of systemically risky assets will provide the Council and the Federal Reserve Board with yet another justification for scrutinizing the risk weights assigned under risk-based capital standards and internal capital adequacy models.

At the same time, there are growing pressures for harmonization of capital standards on the global front. The IAIS is increasing capital adequacy standards for approximately 50 to 60 internationally active insurance groups worldwide. This could directly affect U.S. insurers with overseas operations by superimposing new, international capital standards on top of the risk-based capital standards already mandated by the states. Meanwhile, the European Commission has the power to impose added capital requirements on U.S. insurers with European operations if it concludes that U.S. capital standards are not “equivalent” to EU standards. These developments will create two sources of pressure to harmonize the global capital standards with traditional state requirements. First, there will be pressure for harmonization from internationally active U.S. insurance enterprises, who will otherwise suffer a disadvantage with their U.S. competitors who are not affected by the harsher global standards. And global counterparts, including the FSB, the IAIS, and the European Union, will continue to lean heavily on Washington to harmonize U.S. capital regulation of insurers with the very different approach to capital regulation in the European Union. A formal initiative between the federal

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210 See FIO Modernization Report, supra note 1, at 24. This is a larger set of insurance enterprises than the group designated as G-SIIs.

211 See FIO Modernization Report, supra note 1, at 27.

212 In the United States, the states use a risk-based capital approach that assigns static risk weights to different classes of assets. This “RBC” model only applies capital requirements to individual insurance underwriters and not to insurance groups overall. In the European Union, in contrast, insurance regulators have adopted a more dynamic model known as Solvency II that uses statistical models to calculate a given insurer’s risk weights. Unlike the U.S. approach, Solvency II computes capital levels both for individual insurers and for insurance groups. See FIO Modernization Report, supra note 1, at 25-26, 29, 34-35.
government and international bodies called the “EU-U.S. Insurance Project” is already underway to achieve convergence in U.S. and European Union capital adequacy standards for insurance. 213

This state of affairs produces an unstable equilibrium that is not with the states’ control. Unless Congress repeals the relevant provisions of Dodd-Frank, the Executive Branch now has broad unilateral authority to designate and regulate individual insurance companies as SIFIs, to impose systemic risk reporting requirements more generally on insurers, and to regulate systemically risky activities by insurers industrywide. The federal government can also negotiate insurance treaties214 and declare that federal treaties preempt state insurance laws without permission from the states. States have little if any formal power to stop these inroads.

Although the federal government’s powers only apply to narrow segments and discrete activities of the insurance industry, nevertheless its toehold could create competitive inequalities pitting insurers under federal purview against those that are free from that oversight. The resulting market frictions could lead to political pressure to produce a uniform set of insurance rules at the federal level, threatening the states’ attempts to retain control. For the moment, consolidated group oversight and capital adequacy rules are the most likely areas where an unlevel playing field could occur, but other areas could emerge as well.

International pressures add to this instability. Technically, international fora such as the IAIS and the FSB do not have the sovereign power to impose their will on state regulators in the U.S. However, their decisions are harder for the states to shape and can gain traction in other ways. It is substantially easier for the federal government – with its single voice and international heft -- to exert influence in those organizations than the loose and sometimes

214 Subject, of course, to concurrence by at least two-thirds of the Senate.
discordant confederation of 50 state regulators. To the extent that global regulators advocate federal regulation in lieu of regulation by the states, Washington will virtually almost always concur, adding fuel to international recommendations for federal control. Any unilateral decision by Washington to adopt IAIS or FSB recommendations in the areas of insurance regulation that the federal government controls will give those recommendations teeth and exacerbate competitive disparity among insurers. Meanwhile, the European Commission’s power to declare aspects of U.S. insurance regulation not “equivalent” to EU regulation is a real and looming threat to the competitive standing of U.S. insurers with European operations. EU actions are one more area that the states cannot control.

This all bodes for growing tension in the allocation of authority over insurance between the federal government and the states. While discussion of the optimal design of future insurance regulation must be left for another time, a few closing remarks are in order. The biggest danger in this fluid situation is the risk of haphazard, incremental federal actions that gradually encroach on state regulation (either de jure or de facto) without careful consideration of the costs of undermining that system. While federal government is the only appropriate U.S. regulator for the macroprudential supervision of systemic risk in insurance, that does not necessarily make it the most appropriate regulator for the microprudential oversight of that industry. The disastrous recent experience with federal preemption in banking and the banking industry’s ease in capturing federal prudential banking regulators are just two indications of the potential risks of a unified federal regulatory system in insurance. Yet FSOC and the Federal Reserve Board seem to have given little if any consideration to how their regulatory initiatives could complement and strengthen state-based insurance regulation, instead of slowly eroding it. The time has come to have a serious, formal national discussion on the best way to design U.S.
insurance regulation going forward. Otherwise, our nation will risk drifting toward a fractured and fractious oversight system that is worse than what preceded it.