TESTIMONY OF DANIEL SCHWARCZ

Associate Professor, University of Minnesota Law School

before the

House Subcommittee on Insurance, Housing and Community Opportunity

regarding "Insurance Oversight and Legislative Proposals"

November 16, 2011

Thank you for the opportunity to address this subcommittee regarding several discussion drafts of proposed amendments to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"). Collectively, the proposed amendments limit the authority of federal entities to regulate and monitor insurers that may pose systemic risks. In particular, they exclude systemically significant insurers from heightened prudential standards set by the Federal Reserve, completely exempt insurers from the FDIC's orderly liquidation authority, and limit the capacity of federal entities such as the Office of Financial Research (OFR) and the Federal Insurance Office (FIO) to collect data directly from insurers. Accepting a core premise of Dodd-Frank – that systemic threats must be monitored and managed in a unified manner at the federal level – the proposed legislation implicitly embraces the assumption that insurance companies do not pose systemic risks. The proposals also limit the tools available to FIO to assess the state of the insurance industry with respect to issues extending beyond systemic risk, including the adequacy of state-based consumer protections.

Based on my preliminary review and analysis, I have four substantial concerns about the desirability of these proposed amendments.

First, the proposed legislation seems to ignore one of the central lessons of the 2008 Global Financial Crisis: that we do not always know what we do not know when it comes to systemic risk. Prior to 2008, of course, the vast majority of regulators, economists, and legal experts embraced various orthodoxies regarding systemic risk that turned out to be incorrect. In many ways, it was the failure of these people to consider the possibility that their views might be wrong that precipitated the Global Financial Crisis and consequent Great Recession. In my view, the proposed legislation makes this same mistake: it ensconces the traditional view that insurance activities pose limited systemic risk and restricts the capacity of federal regulators to learn as they go and adapt to evolving research and knowledge. It does this by effectively exempting insurers from the heightened prudential standards that ought to apply to systemically risky firms, by limiting the tools available to federal agencies to investigate systemic risk within insurance companies, and by undermining the capacity of federal regulators to respond to facts on the ground that reveal the threat of systemic risk.

This inflexible approach would perhaps be defensible if we could be completely confident in the view that insurance could never pose any systemic risk. But while it is indeed true that insurance is generally thought to pose limited systemic risks, this conclusion is hardly unassailable or absolute. Even traditional insurance activities can pose some systemic risks, particularly in the domain of life

insurance. In part, this is because life insurers, like banks, are theoretically susceptible to policyholder runs, as many life insurance products allow policyholders to borrow against their policy or cash out their savings. As a result, policyholders who become concerned about their carriers' solvency can demand withdrawals, producing a downward spiral analogous to those found in classical bank runs. In fact, several life insurers have experienced exactly these types of runs by their policyholders.

While there is limited historical evidence of policyholder runs at one insurer triggering runs at other insurers, this is hardly impossible, especially since state guarantee funds are much less reliable and complete than FDIC insurance. Such guarantee funds are not generally pre-funded, they are not backed by the full faith and credit of the federal government, and they limit payouts to amounts that are often well below the face value of policies. Moreover, state-based guaranty funds are premised on the capacity of non-troubled insurers to cover the obligations of failing insurers. As such, their capacity to handle several major insolvencies concurrently is highly doubtful. Indeed, attempting to force surviving carriers to shoulder the burden created by several large insolvencies could actually endanger the health of otherwise solvent insurers, thus generating a downward spiral in insurance markets.

Nor can it be said that the limited availability of insurance would be without systemic consequences. For instance, without property insurance or title insurance, real estate transactions become virtually impossible. Similarly, various vital

professional services can become seriously disrupted in the absence of liability insurance.

Perhaps most importantly, our experience with AIG in 2008 taught us that we do not fully understand the systemic risks involved in insurance holding company systems. To be sure, AIG's Financial Products division, which caused much of AIG's trouble, was not regulated as an insurer. Similarly, AIG was regulated on a consolidated basis by the Office of Thrift Supervision. But it is also true that AIG's various insurance companies engaged in securities lending transactions that exposed them to extensive, and largely unanticipated, risks. These risks were exacerbated by the actions of AIG's Financial Products unit, whose risk-taking had the impact of severely limiting AIG's liquidity and thus its capacity to meet collateral calls associated with its securities lending program. In short, the AIG experience suggests that, before 2008, state insurance regulation had largely failed to appreciate the risks that affiliates of insurance companies can pose to otherwise healthy insurers.

To be sure, the NAIC is currently studying and adjusting its approach to the supervision of insurance groups. Traditionally, insurance regulation has focused almost entirely on ring fencing individual insurance companies from the risks of their affiliates. But the NAIC is now embracing a "windows and walls" approach to group supervision, which would both strengthen the ring-fencing of insurance entities while attempting to appreciate the ways in which insurance entities may be subject to enterprise risk. Whether these approaches prove successful remains to

be seen. But what is clear based on the AIG fiasco is that state regulators do not have a proven track record of effectively managing non-insurance risk within insurance groups.

The second broad concern I have with the proposed legislation is that it may promote regulatory arbitrage. Another crucial lesson of the 2008 Global Financial Crisis is that, all else being equal, financial companies will seek to structure their operations to avoid regulatory scrutiny and costs. This is particularly true of firms that embrace systemically risky strategies, as these strategies can prove massively profitable in the short term if they are not restrained by effective regulation.

By defining a sphere of financial activity that is largely immune from systemic risk regulation, the proposed legislation could actually induce firms and individuals to conduct systemically risky activities within insurance structures. For instance, it may be possible under the proposed legislation for a non-insurance affiliate to conduct systemically risky activities within an insurance holding company, and thereby avoid scrutiny by systemic risk regulators. As noted above, insurance regulators generally do not have experience or a strong track record in identifying or accounting for the risk posed by such non-insurance affiliates. Nor is this the only way that the proposed legislation could produce regulatory arbitrage. For instance, it is possible that insurers seeking to embrace systemically risky activities could attempt to circumvent state insurance regulations restricting investment options.

The third concern I have regarding the proposed legislation is that it insulates the NAIC and state regulators from federal scrutiny. If there is one single theme in the history of insurance regulation, it is that state regulators and the NAIC are often woefully ineffective unless and until they face the prospect of scrutiny or preemption by the federal government or other state regulators. Thus, state solvency regulation was pitiful until several high-profile insurer insolvencies prompted a scathing congressional report in 1990, which led state regulators to embrace a more thoughtful and considered approach to safeguarding the financial health of insurers. Similarly, state insurance regulators entirely ignored the highly problematic compensation schemes for insurance brokers and agents until the New York Attorney General engaged in a series of high-profile lawsuits centered on this issue in 2004. Parallel stories can be told to explain virtually all of the significant advances in state-based insurance regulation over the last fifty years, including the streamlining of product filing and review, the coordination of agency licensing, the crack-down on mail-order insurance, and the establishment of investment restrictions for life insurers.

The proposed legislation essentially ignores this lesson by defining a domain in which state insurance regulators would not even face *the prospect of scrutiny* from federal officials. With this pressure removed, state insurance regulators are much less likely to police against systemic risks and identify problems that could pose systemic consequences. Indeed, engaging in this regulation is hard work: it involves rejecting the assurances of a knowledgeable and well-resourced industry that employs hordes of lobbyists who frequently were themselves insurance

commissioners, senior regulatory staff, and leaders within the NAIC. Regulators will naturally be more likely to succumb to these pressures if they are not held accountable by the prospect of scrutiny at the federal level.

My fourth, and final, broad concern about the legislation is that it substantially undermines the capacity of FIO to fulfill its mission of "monitoring all aspects of the insurance industry," as described in Dodd-Frank. Several months ago I testified before the Senate Subcommittee on Securities, Insurance and Investment regarding the substantial failures of state insurance regulators and the NAIC to facilitate transparent insurance markets. Now is not the time to restate that testimony. But one of my core themes was that insurance regulators have done a remarkably poor job of making data and information available to consumers, academics and the general public. FIO now has an important opportunity to highlight these failures and induce corrective measures either by the states themselves or by federal action. By depriving FIO of its capacity to collect data directly from carriers when necessary, the proposed legislation would substantially undermine the agency's capacity to achieve these objectives. In some cases, FIO would be unable to gather relevant information because state regulators do not themselves possess it and are unwilling or unable to acquire it. And even when states do possess requested information, the legislation would render FIO completely beholden to state insurance regulators, thus limiting the agency's capacity to identify state level regulatory failures or to act on those failures.

In the face of these various concerns, the proposed legislation is based on the claim that the underlying provisions in Dodd-Frank cause excessive regulatory uncertainty for the industry. In my view, though, the costs of any regulatory uncertainty are limited and, in any event, are substantially outweighed by the costs of the proposed amendments. In fact, each of the relevant provisions of Dodd-Frank already includes sufficient safeguards for the industry.

First, under recently proposed rules, the vast majority of insurers can be assured that they will not be subjected to heightened prudential standards under Title I of Dodd Frank. These rules provide a safe-harbor for any insurer with less than $50 Billion dollars in global assets. Additionally, the rules would also exempt from scrutiny companies that do not meet any specified quantitative thresholds corresponding to interconnectedness, leverage, liquidity risk, and maturity mismatch. Insurers that exceed the $50 Billion threshold as well as one additional quantitative threshold are subject to a more searching, and less mechanical, assessment of their systemic risk. But the number of carriers that will fall within this group is extremely small and is hardly likely to produce widespread regulatory uncertainty for the insurance industry.

Second, Dodd Frank already provides for substantial deference to the traditional state-based procedures for resolving insolvent insurers. Under 203(e) of Dodd Frank, insurance companies are generally resolved under state law processes by state regulators. The FDIC can only take over this process if the state fails to act after 60 days. Thus, Dodd Frank's current provisions regarding orderly liquidation

of insurers are principally geared towards allowing federal regulators to initiate the liquidation of an insurer. They also allow the FDIC to wind down non-insurance affiliates of insurers. These provisions present virtually no regulatory uncertainty for insurers: the bar that must be met for federal regulators to determine that a carrier presents a systemic risk such that it must be liquidated under Dodd-Frank is substantially higher than the bar that must be met for liquidation at the state level. Thus, the only time when federal regulators would be likely to act under this provision is when state regulators should have already acted, but failed to do so.

Third, Dodd-Frank's provisions regarding the subpoena powers of FIO and OFR are extremely limited. In particular, FIO is authorized to issue a subpoena "only upon a written finding by the Director that such data or information is required to carry out the functions described under subsection (c) and that the Office has coordinated with such regulator or agency as required under paragraph (4)." Similar restrictions apply to the OFR's subpoena authority. In either case, it is hard to imagine that this power will impose any meaningful costs on the insurance industry as a whole.

In sum, based on my review of the proposed legislation, it is my view that its costs well exceed its benefits. In particular, I believe that the legislation not only ignores the prospect of systemic risk arising from the insurance industry, but hamstrings federal regulators from even considering or responding to this risk. It does this even though we currently possess a deeply limited understanding of systemic risk and we know that insurance can, at least in certain circumstances,

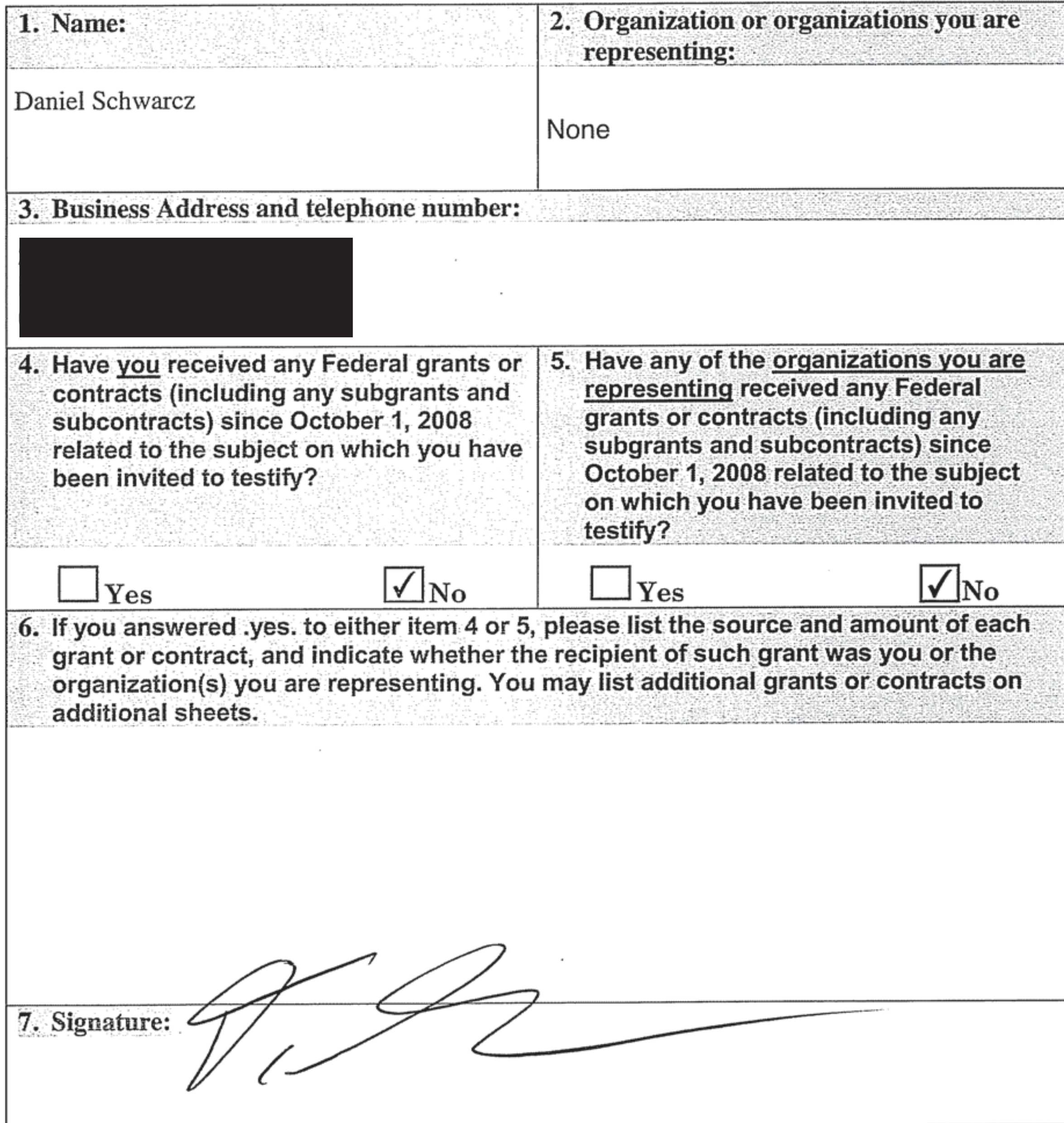
pose such risk. At the same time, the rationale for these amendments is simply not convincing: the existing provisions of Dodd-Frank that the legislation targets create only minimal costs and uncertainty for the insurance industry. Ultimately, it is simply premature to embrace a regulatory approach to systemic risk that defines away the domain of insurance.

United States House of Representatives

Committee on Financial Services

"TRUTH IN TESTIMONY" DISCLOSURE FORM

Clause 2(g) of rule XI of the Rules of the House of Representatives and the Rules of the Committee on Financial Services require the disclosure of the following information. A copy of this form should be attached to your written testimony.



1. Name:	**2. Organization or organizations you are representing:**
Daniel Schwarcz	None
3. Business Address and telephone number:	
[redacted]	
4. Have you received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?	**5. Have any of the organizations you are representing received any Federal grants or contracts (including any subgrants and subcontracts) since October 1, 2008 related to the subject on which you have been invited to testify?**
☐ Yes ☑ No	☐ Yes ☑ No
6. If you answered .yes. to either item 4 or 5, please list the source and amount of each grant or contract, and indicate whether the recipient of such grant was you or the organization(s) you are representing. You may list additional grants or contracts on additional sheets.	
7. Signature:	

Please attach a copy of this form to your written testimony.