TESTIMONY OF DANIEL SCHWARCZ

Associate Professor and Solly Robins Distinguished Research Fellow,

University of Minnesota Law School

before the House Housing and Insurance Subcommittee

regarding "Legislative Proposals to Reform Domestic Insurance Policy"

May 20, 2014

Chairman Neugebauer, Ranking Member Capuano, and members of the Subcommittee, thank you very much for this opportunity to discuss various proposed bills implicating the federal government's role in insurance regulation and monitoring. In my testimony, I will first explain my broad perspective on the appropriate role for the federal government in regulating and monitoring insurance markets. In doing so, I will emphasize that – as demonstrated by the 2008 financial crisis – the business of insurance can create important systemic risks to the larger financial system.[1] The specific contours and magnitudes of these systemic risks are constantly evolving based on shifts in the insurance industry and its regulation. For these reasons, consistent with the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), the federal government should maintain a robust

[1] *See generally* Daniel Schwarcz & Steven Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHICAGO LAW REVIEW (forthcoming, 2014), available at http://ssrn.com/abstract=2404492. For a more skeptical assessment of the possibility of systemic risk in insurance, see J. David Cummins & Mary A. Weiss, *Systemic Risk and the U.S. Insurance Sector* (2011), *available at* *http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1725512* and Scott Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation*, 76 J. RISK & INS. 785 (2009).

presence in regulating potentially systemically risky insurance entities and activities and in monitoring the insurance market for potential new sources of systemic risk.

After having reviewed these broad themes, my testimony will address elements of some of the proposed bills that I believe unwisely interfere with the federal government's ability to appropriately regulate and monitor the insurance industry. A common theme in the provisions that I identify is that they unduly limit the ability of federal agencies to regulate, identify, or respond to new and emerging sources of systemic risk in insurance markets. Given the importance of insurers to the 2008 financial crisis and the potential for insurers to pose various new types of systemic risks in the future, imposing excessive restrictions on federal agencies charged with regulating or monitoring systemic risk in insurance is unwise.

(1) Systemic Risk in Insurance

As exemplified by the dramatic failures of American International Group ("AIG") and various financial guarantee insurers, as well as the temporary but severe capital shortfalls of large life insurance companies that had issued long-term guarantees to policyholders, insurance companies and their affiliates played a central role in the 2008 financial crisis. It is now generally accepted that insurers and their affiliates that effectively provide insurance against the default of financial instruments – whether through formal insurance policies (as in the case of financial guarantee insurers) or through derivatives such as credit default swaps (as in the case of AIG) – can contribute to systemic risk. Other "non-traditional" insurance

activities, such as extensive use of securities lending (as in the case of AIG), can also prove systemically risky. [2]

But in the last several years, a narrative has emerged suggesting that these risks are vanishingly small. This argument emphasizes that very few traditional insurers actually failed during the financial crisis. It also stresses that AIG Financial Products – the division of AIG that was principally responsible for writing the credit default swaps that were an important source of the company's problems – was not regulated as an insurance company, in large part due to federal law. Finally, and perhaps most prominently, it argues that insurers, unlike banks, do not have a mismatch in their assets and liabilities that can make them susceptible to run-like dynamics.

This narrative, however, ignores important linkages between the insurance industry and the rest of the financial system as well as insurers' potential vulnerabilities to catastrophic events. Although the insurance industry is indeed less systemically risky than the banking and shadow banking sectors, it is also structurally capable of posing a variety of systemic risks to the larger financial system. Perhaps even more importantly, the magnitude and character of these risks are themselves constantly evolving and shifting. A decade ago, the notion that a company within an insurance group could threaten the global financial system through its portfolio of credit default swaps would have been viewed as preposterous. The lesson is that the regulation of systemic risk in insurance must

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

be designed to allow regulators and monitors to proactively identify, assess, and manage new potential sources of risk. With this in mind, consider several specific ways in which insurers could potentially threaten the stability of the broader financial system.

Asset Fire Sales: Insurers are among the largest and most important institutional investors domestically and internationally. They own approximately one-third of all investment-grade bonds and, collectively, own almost twice as much in foreign, corporate, and municipal bonds than do banks. Insurers' massive role as investors means that they can pose systemic risks by triggering or exacerbating "fire sales" of specific securities or types of securities. Emerging evidence suggests that a subset of insurers did stoke fire sales in mortgage-backed securities and related instruments in 2008, when they attempted to sell these securities in response to regulatory, rating agency, and market pressures.[3] Insurers' capacity to trigger fire sales is likely much stronger in corporate bond markets, where insurers are the dominant investors among all financial institutions. Thus, one recent study found compelling evidence that the downgrading of corporate bonds can prompt large numbers of insurers to sell the downgraded (or about-to-be downgraded) bonds in

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

a coordinated fashion, causing the price of the downgraded bonds to temporarily fall below their fundamental value.[4]

Credit Crunches: Apart from the risk of fire sales, disruptions in insurance markets could substantially impact corporate financing. Corporations fund themselves much more through debt than equity, and insurers are a central purchaser of corporate debt. If insurers were forced to liquidate a substantial percentage of their holdings and were unable to maintain their long-sustained investment appetite for corporate debt, the results could be catastrophic. U.S. corporations would have to either dramatically scale back their activities or find entirely new ways of funding their operations. This, in turn, could trigger new, and unpredictable, consequences in volatile financial markets.

Demand for Assets that Spread Systemic Risk: Financial markets, as with all markets, are impacted both by supply-side forces and demand-side forces. When insurers collectively demand certain types of financial assets, the amount supplied and prices of these assets will increase. In fact, recent evidence shows the insurance industry played a major role in increasing demand for mortgage-backed securities and related instruments in the years leading up to the financial crisis.[5] Recent evidence also shows that insurers' investments in corporate debt markets can

[4] Andrew Ellul, Chotibhak Jotikasthira, & Christian T. Lundblad, *Regulatory Pressure and Fire Sales in the Corporate Bond Market*, 101 J. FINANCIAL ECON. 596 (2011).
[5] Craig Merrill, Taylor D. Nadauld, & Philip Strahan, *Final Demand for Structured Finance Securities*, (Working Paper, January 17, 2014) *available at* http://ssrn.com/abstract=2380859.

produce capital market distortions that can directly amplify systemic risk by contributing to pro-cyclical build-ups in the holding of high-yield, risky assets.[6]

Simultaneous Failure of Several Large Insurers: Although insurers need not fail in order to contribute to systemic risk, the converse is not true: substantial failures of several large insurers could well disrupt the financial system as a result of insurers' status as massive investors. The failure of several large insurers is hardly unimaginable. Insurers are potentially subject to a wide array of catastrophe risks that could trigger a wave of claims across numerous insurers within a short time frame. Insurers also frequently adopt similar investment strategies in response to common product designs and regulatory pressures.

Interconnectedness through Reinsurance: Although insurers attempt to manage catastrophe risk through reinsurance arrangements, the reinsurance industry itself is potentially subject to catastrophe risk. The reinsurance industry is extremely concentrated in a few massive firms, such as Swiss Re, Munich Re, and Berkshire Hathaway. In 2009, for instance, five reinsurance groups provided approximately 60% of the world's reinsurance capacity.[7] This concentration creates deep interconnections among insurers, such that the failure of one or two major reinsurers could simultaneously impact a substantial segment of the insurance industry at once. This risk is exacerbated by the fact that reinsurer financial strength is itself highly opaque, and reinsurers often reinsure risks with one another,

---

[6] See Bo Becker, & Victoria Ivashina, *Reaching for Yield in the Bond Market*, JOURNAL OF FINANCE (forthcoming), *available at* http://www.hbs.edu/faculty/Publication%20Files/12-103_c2425c59-1647-42df-8d1b-7b8ed433fb76.pdf.

[7] INTERNATIONAL ASSOCIATION OF INSURANCE SUPERVISORS, REINSURANCE AND FINANCIAL STABILITY (July 2012).

creating the possibility that one reinsurer's failure could have a domino effect on other reinsurers.[8]

Exposure to Policyholder Runs: Despite their frequent protestations to the contrary, life insurers are also not immune to the possibility of a run on their products. This is because many life insurance products allow policyholders to withdraw funds or receive a significant cash surrender value.[9] Various market dynamics may lead to insurance policies in the future with more generous withdrawal or cash-surrender benefits. Meanwhile, other trends, such as insurers' embrace of "retained asset accounts" that function almost identically to bank accounts, can also increase the prospect that the long-term nature of insurers' liabilities may become short term in tail-end events. The risk of a policyholder run is exacerbated by the fact that state insurance guarantee funds do not generally fully guarantee the value of many insurance policies, cannot be spread among companies or policies to increase limits (unlike FDIC insurance), and are much less financially credible than FDIC insurance as they are not pre-funded or explicitly backstopped by the federal government.

Systematic Under-Reserving: There is a real risk that insurers may systematically underestimate reserves for certain types of policies or losses. Two

---

[8] GROUP OF THIRTY, REINSURANCE AND INTERNATIONAL MARKETS (2006).
[9] *See* FSOC, BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING PRUDENTIAL FINANCIAL INC. (Sept. 19, 2013). The most substantial policyholder run on a U.S. insurance company involved Executive Life, where policyholder cash surrenders exceeded over $3 billion in the year prior to its failure. Although this run was more a product of Executive Life's tenuous financial position than the cause of its tenuous position, it did indeed have the effect of forcing Executive Life to liquidate a substantial percentage of its portfolio. *See* Scott Harrington, *Policyholder Runs, Life Insurance Company Failures, and Insurance Solvency Regulation*, 15 REGULATION 27 (1992).

recent, and related, developments contribute to this risk. First, in the last decade or so, life insurers have increasingly used captive insurance companies to escape regulatory rules governing reserve setting, a process that some have referred to as "shadow insurance."[10] Recent estimates conclude that "shadow insurance reduces risk-based capital by 53 percentage points (or 3 rating notches) and raises impairment probabilities by a factor of four."[11] Second, state insurance regulation is currently embarking on a fundamental change to its regulatory approach, which would grant insurers broad discretion to use internal models to set reserve levels. The extensively documented inability of federal regulators to fully understand financial firms' internal risk models suggests that large-scale errors in life insurer reserving could be a problem in the future. This is particularly so given that state regulators currently lack sufficient technical expertise or resources to undertake a reasonable evaluation of these models on a firm-by-firm basis.[12]

(2) Federal Role in Insurance Regulation and Monitoring

Ultimately, it is surely true that the insurance industry currently poses less systemic risk than the banking sector or the shadow-banking sector. At the same time, however, the insurance industry is a crucial and dynamic component of the American and international financial systems, a fact that has been documented by various studies quantifying the connections between insurers and the rest of the

---

[10] *See* NY DEPARTMENT OF FINANCIAL SERVICES, SHINING A LIGHT ON SHADOW INSURANCE (June 2013).
[11] *See* Ralph S.J. Koijen and Motohiro Yogo, *Shadow Insurance* (NBER Working Paper No. 19568, (2013), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2320921.
[12] FEDERAL INSURANCE OFFICE, HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES, (December 2013).

financial system based on historical stock prices and similar metrics.[13] As such, the insurance industry can indeed present a meaningful source of systemic risk that cannot be easily limited to a pre-defined set of activities.

For all of these reasons, and as contemplated by Dodd-Frank, federal regulators should play a robust role in regulating potential systemic risk in insurance and in monitoring insurance markets for potential new sources of systemic risk. A central tenet of federalism is that regulatory responsibilities should be assigned, at least in part, to the unit of government that best internalizes the full costs of the underlying regulated activity.[14] The rationale for this principle is that government entities will only have optimal incentives to take into account the full costs and benefits of their regulatory decisions if the impacts of those decisions are felt entirely within their jurisdictions. Given that systemic risk in insurance is a negative externality whose effects are inherently felt nationally and internationally, national and international regulatory bodies should play a role in regulating systemically significant insurers.

Federal regulation and monitoring of systemic risk in insurance is particularly important because state insurance regulation is focused predominantly on policyholder protection rather than systemic stability. These differing regulatory perspectives can have important implications for a range of regulatory issues.

---

[13] Monica Billioa, Mila Getmanskyb, Andrew W. Loc, & Loriana Pelizzona, *Econometric Measures of Connectedness and Systemic Risk in the Finance and Insurance Sectors* 104 J FIN. ECON. 535 (2012); Faisal Balucha, Stanley Mutengab & Chris Parsons Baluch, *Insurance, Systemic Risk and the Financial Crisis*, 36 THE GENEVA PAPERS 126 (2011); Viral Acharya, Lasse Heje Pedersen, Thomas Philippon, & Matthew P. Richardson, *Measuring Systemic Risk* (2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1573171.

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

Consider one example: the regulation of financial guarantee insurers. Because state insurance regulators focus predominantly on policyholder protection, their central approach to regulating financial guarantee insurance prior to the crisis was to insist that such insurance be provided only by "monoline" companies, which would write only financial guarantee insurance. This approach shielded most ordinary policyholders from the potential implications of financial guarantee insurers' massive losses in connection with the financial crisis. From a policyholder protection perspective, then, this regulatory strategy was largely successful. However, from a systemic risk perspective this regulatory approach was woefully incomplete: merely segmenting financial guarantee insurance from other insurance policy lines did nothing to prevent financial guarantee insurers from insuring against the default of risky mortgage-backed securities in a way that exposed them to massive correlated risks that reverberated throughout the larger financial system.

(3) Proposed Bills Implicating the Federal Government's Role in Insurance Regulation and Monitoring

Contrary to the broad approach suggested above, several portions of the proposed bills excessively restrict the capacity of federal entities to effectively identify, regulate, and respond to systemic risk in insurance.

HR 4510: I support HR 4510's clarification of the Federal Reserve's (Fed) authority to tailor capital rules to meet the particular risks of insurance companies. As I have previously testified to the Senate Subcommittee on Financial Institutions and Consumer Protection, insurers do indeed present unique risks that differ from

those of banks. Mechanistically applying bank capital rules to insurers would be poor public policy. At the same time, capital rules for federally-regulated insurance companies or companies predominantly engaged in insurance should not simply replicate state risk-based capital rules, which focus primarily on policyholder protection. Instead, they should be tailored to meet the distinct federal interests associated with preventing systemic risk in insurance. As I understand HR 4510, it would preserve the Fed's ability to devise capital rules that accomplish this.

Nonetheless, I am concerned that one provision in HR 4510 would unnecessarily curtail the capacity of the Fed to demand important information from insurers whose financial statements are currently prepared using only Statutory Accounting Principles (SAP). SAP is not just an accounting system: it is premised on numerous state regulatory determinations. By forcing the Fed to work only with data produced pursuant to SAP, the bill would undermine the Fed's ability to regulate insurers for systemic risk concerns.

One important example of this point is that SAP is inherently focused on individual insurance entities, rather than entire holding companies. Under SAP, it is extremely difficult for regulators to get an accurate sense of the overall financial health of a holding company. Although SAP's entity-centric approach tends to work well in addressing policyholder protection concerns, it is substantially incomplete from a systemic risk orientation. Group-wide assessments of financial health are essential for systemic risk regulation because risk-management, investment strategies and business priorities are all generally determined at the holding

company level. Group solvency regulation can also limit the prospect of other problems that may have systemic consequences, such as double or multiple gearing or correlations in risk exposures across companies within a holding company structure.

Categorically preventing the Fed from demanding information outside of the SAP framework also severely inhibits the agency's ability to proactively identify and respond to new or emerging potential sources of systemic risk in insurance. As emphasized above, systemic risk in insurance is not static because the insurance industry and state regulation are constantly changing. If the Fed is to perform its statutorily mandated role, it must be able to adapt to these changing circumstances by demanding appropriate information in a form that will transparently reflect the regulated entity's true financial condition.

To take one potential, but I believe increasingly important, example, SAP incorporates state rules on reserving for policy liabilities. Such reserves are the central liabilities on insurers' balance sheets. However, as discussed above, recent evidence shows that life insurers are increasingly exploiting captive insurance companies to escape these regulatory rules. Meanwhile, state insurance regulation is moving to a system that would grant life insurers broad discretion to use internal models to set reserve levels. In order for federal regulators to monitor these developments for systemic risks, they must be able to demand financial information in forms that may depart from SAP.

In making these points, I am aware of the legitimate concerns of impacted insurance carriers, which might well be forced to incur expenses to prepare financial data in a form that differs from SAP. These concerns, however, may be exaggerated because Dodd-Frank already requires that the Fed shall to "the fullest extent possible use information that is obtainable from federal or state regulatory agencies." This existing safeguard limits the prospect that the Fed could demand information from insurers that it could acquire elsewhere. Additionally, instead of requiring, for instance, that the Fed should explore alternatives to GAAP reporting that might provide sufficient information for regulatory purposes while imposing reduced costs on regulated companies that otherwise report exclusively using SAP, the proposed language has the apparent effect of prohibiting the Fed from requiring any information from certain regulated entities that is inconsistent with SAP.

By limiting the capacity of the Fed to insist on financial information that may not be fully transparent or available in SAP, the provision undermines the Fed's capacity to regulate insurance companies that may pose systemic risks. It is impossible to foresee every possible risk that might lead the Fed to ask for information in a form that deviates from SAP. Effective systemic risk supervision requires adaptive regulation that is responsive to new and emerging potential risks. The proposed SAP mandate in HR 4510 undermines the Fed's ability to engage in such supervision.

Data Protection Act: As above, I believe that the proposed Data Protection Act is unwise public policy because it could unduly inhibit the ability of FIO and OFR to

identify potential or emerging sources of systemic risk in insurance.[15] This is a crucial supplement to the Fed's insurance-regulatory role: the Fed's authority extends only to a small subset of insurers and insurance-focused companies, but systemic risk in insurance can arise outside of individual large insurance companies due to correlations among insurance carriers' practices or risk exposures.[16]

In order to appropriately monitor the insurance industry for new or emerging sources of systemic risk, both FIO and OFR may well need information that is neither publicly available nor currently accessible from other agencies. The reason is simple: by their very nature, new or emerging sources of systemic risk may not be fully reflected in preexisting documentation or data. To be sure, this is likely to be rare, especially given the extensive nature of the financial data that state regulators currently collect. Indeed, FIO has not actually used its subpoena power to date.

This infrequency of insurance-focused data requests makes all the more bizarre the bill's provision requiring the Secretary of the Treasury (Secretary) to reimburse insurers for the costs of complying with FIO or OFR subpoenas. The costs of monitoring for potentially systemically risk activities are a classic negative externality: they are a social cost that results from private behavior. As with all negative externalities, these social costs should be borne by the responsible industry. The reimbursement provisions of 12 CFR 219, which are referenced in the

[15] Dodd-Frank charges FIO with several additional important roles, including assessing the availability and affordability of insurance for traditionally underserved communities and consumers.
[16] Daniel Schwarcz & Steven Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHICAGO LAW REVIEW (forthcoming, 2014), available at http://ssrn.com/abstract=2404492.

bill, apply to an entirely different, and quite narrow, set of information requests, which target customer financial records rather than information pertaining to risks within a broad market.

Reversing this universal and commonsense presumption that industry must bear the costs of complying with government information demands would excessively chill systemic risk monitoring in insurance. First, it is very hard to envision how the Secretary could budget for the expenditures that would be associated with the issuing of subpoenas to insurers under the proposed bill. Consequently, the Secretary could be put in the position of unexpectedly cutting back on important departmental functions in order to acquire important information from private insurance companies. Second, requiring potentially substantial government expenditures whenever FIO or OFR issues a subpoena would unduly politicize the exercise of this authority.

HR 605: This bill would, in my view, unwisely remove entirely insurance companies from Dodd-Frank's OLA process. Dodd-Frank was drafted so that insurance companies are already largely excluded from the OLA regime. Under Dodd-Frank, insurance companies must be resolved in state courts pursuant to state law even if they are a "covered financial company," meaning that a determination has been made by relevant federal authorities that the insurer is in default or in danger of default and its failure could pose broad systemic risks to the larger financial system. Moreover, as under ordinary insurance law, state insurance regulators would generally be in charge of initiating the resolution process. The

only exception is if a state insurance regulator refused to initiate resolution proceedings notwithstanding a federal determination that such a proceeding was necessary to safeguard the country's financial stability. In that event, the FDIC would be authorized to "stand in the place" of the state regulator to resolve the insurance company.

This framework represents a sensible balancing of state and federal interests with respect to the resolution of systemically significant insurance companies. Notwithstanding the FDIC's "backup authority," these provisions virtually guarantee that the appropriate state insurance regulator, rather than the FDIC, would conduct proceedings to resolve systemically significant insurance companies. It is hard to imagine that the appropriate state insurance regulator would refuse to initiate resolution proceedings for an insurer in the event that federal authorities had determined that its failure could produce systemic consequences. But it is even harder to imagine that the state insurance regulator would fail to initiate such proceedings knowing that the FDIC could do so in its place. The primary utility of the backup authority, then, is to encourage otherwise reluctant state regulators to resolve failing insurance companies when federal interests so require. In the exceedingly unlikely scenario that a state insurance regulator nonetheless refused to initiate resolution proceedings, the intervention of the FDIC would be appropriate. As described above, federal regulators generally have better incentives and knowledge than state regulators when it comes to managing systemic risk.

Risk Retention Modernization Act of 2014: Unlike each of the other bills addressed above, the proposed Risk Retention Modernization Act of 2014 does not implicate systemic risk issues. Instead, this proposed bill raises certain consumer protection concerns. The bill would expand the authority of Risk Retention Groups (RRGs) to offer commercial property insurance, in addition to commercial liability insurance. Historically, RRGs have played an important role in commercial liability insurance markets, which can be subject to extreme "hard markets" in which coverage is either completely unavailable or excessively expensive. Commercial property markets, however, generally experience only relatively mild underwriting cycles. The reason is that property insurance generally is provided only on an annual basis, in contrast to many types of liability insurance, which provide "long-tail" coverage. Long tail lines of coverage are susceptible to extreme underwriting cycles because of the inherent difficulty of setting premiums based on costs that may be incurred far into the future. Because commercial property insurance markets do not experience severe hard markets, there is much less of a need for the RRG structure in these markets than there is in commercial liability insurance markets.

Moreover, RRGs raise clear policyholder protection concerns. RRGs do not provide policyholders with the protection of state guarantee funds. Moreover, the essential structure of these entities – which are regulated only in a single state, but can operate nationally – can result in a "race to the bottom," where states compete to attract RRGs by offering reduced regulatory oversight. To be sure, these risks are more limited in commercial markets than in personal lines markets, because

policyholders are comparatively more sophisticated. Moreover, the fact policyholders own RRGs also provides a countermeasure against the risk of inadequate policyholder protection. Nonetheless, these safeguards are hardly foolproof: many policyholders in commercial lines are relatively unsophisticated about insurance, and member-ownership of RRGs does not preclude the risk of substantial governance problems.

Weighing the potentially significant policyholder protection costs of expanding RRGs against the limited benefits that such an expansion could provide, my view is that the proposed Risk Retention Modernization Act of 2014 is bad public policy.