Chairman Capito, Ranking Member Maloney, and members of the Subcommittee:

I am the Alan B. Miller Professor at the University of Pennsylvania’s Wharton School, where I also serve as director of the Wharton/Penn Risk and Insurance Program and executive director of the S.S. Huebner Foundation for Insurance Education. I have spent much of my career conducting research and teaching on insurance markets and regulation, including solvency regulation and capital requirements.1

I am pleased to have this opportunity to testify as an independent expert on the Financial Stability Oversight Council’s (FSOC’s) final rule on the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies and the Federal Reserve’s proposed rule for supervising such firms. My testimony first contrasts systemic risk between insurance and banking. I then provide specific comments on the FSOC’s final rule and the Federal Reserve’s proposed rule.

Systemic Risk in Insurance vs. Banking

The term “systemic risk” encompasses the risk to financial institutions with spillovers on the real economy from large, macroeconomic shocks and/or extensive interconnectedness among financial firms. There is a distinction, however, between the

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1I am a member of the Federal Advisory Committee on Insurance, which was created in November, 2011 to advise the Federal Insurance Office established by the Dodd-Frank Act.
risk of common shocks to financial firms and risk that arises from interconnectedness and attendant contagion. Rather than interconnectedness and contagion, the principal driver of the financial crisis in general and the collapse of American International Group, Inc. (AIG) in particular was direct exposure to the housing bubble and declines in values of mortgage related securities and instruments. The extent to which noninsurance activities at AIG presented significant risk of contagion is uncertain.

Consistent with the generally favorable performance of core insurance activities during the crisis, the consensus is that systemic risk is minimal in insurance markets compared with banking. Banking crises have much greater potential to produce rapid and widespread harm to economic activity and employment. This fundamental difference helps explain historical differences in regulation across the insurance and banking sectors.

Significant systemic risk strengthens the case for relatively broad government guarantees of bank obligations and relatively stringent financial regulation, including capital requirements. Because insurance poses little systemic risk, there is less need for relatively broad guarantees of insurers’ obligations to policyholders and stringent capital requirements. State insurance guarantees have been narrower in scope than federal guarantees in banking, and market discipline for safety and soundness is reasonably strong in insurance markets. Insurers commonly have held much more capital than required by regulation and have not faced strong incentives for regulatory arbitrage to evade capital requirements.

The FSOC’s Final Rule

Section 113 of the Dodd-Frank Act gives the FSOC the authority by a two thirds vote to designate a nonbank financial company as systemically important (by imposing a threat to the financial stability of the United States) and subject to enhanced regulation and supervision by the Federal Reserve. The Federal Reserve is required to establish, with input from the FSOC, enhanced risk-based capital requirements, leverage rules, resolution standards, and other requirements for systemically important nonbank financial companies. Section 113 specifies factors the FSOC must consider in determining whether a company will be subject to enhanced supervision including its leverage; off-balance sheet exposure; importance as a source of credit and liquidity for households, businesses, state and local
governments, and low-income communities; the nature, scope, size, and interconnectedness of its activities; the amounts and nature of its assets and liabilities; the degree to which it is already regulated by one or more primary regulators; and “any other risk-related factors that the Council deems appropriate.”

The FSOC issued an advanced notice of rulemaking for Section 113 in October, 2010, a notice of proposed rulemaking in January, 2011, a second notice of proposed rulemaking in October, 2011, and a final rule in April, 2012. Apart from a number of clarifications, the final rule and accompanying guidance are essentially the same as the notice of proposed rulemaking issued in October, 2011. Much of the detail concerning implementation remains in the interpretive guidance, which retains the six-category analytical framework first set forth in the January, 2011 notice. The categories include firm size, substitutability of its products/services, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The final rule’s interpretative guidance retains the three stage determination process proposed in October, 2011, including specific quantitative thresholds to be used in the first stage.

Stage 1 of the analysis would employ publicly available information and information from member regulatory agencies to identify nonbank financial companies for more detailed evaluation in Stage 2. A nonbank financial company would be evaluated further in Stage 2 if global consolidated assets are $50 billion or greater and it meets at least one of the following thresholds:

- $30 billion in gross notional credit default swaps
- $3.5 billion of derivative liabilities
- $20 billion of total debt outstanding
- 15 to 1 leverage ratio (total consolidated assets to total equity, excluding separate accounts)
- 10 percent ratio of short-term debt (maturity less than 12 months) to total consolidated assets (excluding separate accounts)

While the guidance refers to analysis of historical data as the basis for the thresholds, it provides little detail, and it is not clear why dollar amounts are used for credit default swaps, derivative liabilities, and outstanding debt, as opposed to thresholds that are scaled
by relevant measures of firm size.

The inclusion of the quantitative thresholds provides guidance to companies regarding their potential for designation. The thresholds presumably reflect the FSOC’s attempt to balance the desire of companies for some degree of certainty versus maintaining flexibility to designate nonbank financial companies that may not be readily identified by more precise quantitative standards. Indeed, the interpretive guidance indicates that “the Council may initially evaluate any nonbank financial company based on other firm-specific qualitative or quantitative factors, irrespective of whether such company meets the thresholds in Stage 1.” Thus, the $50 billion size threshold and requirement that a company meet at least one of the other thresholds are sufficient but not necessary for inclusion of a company in the “Stage 2 Pool” for further analysis.

Stage 2 would entail a review and prioritization of Stage 2 Pool entities based on analysis of each company using information available to the FSOC through existing public and regulatory agencies and information obtained from the company voluntarily. The analysis would use a wide range of quantitative and qualitative industry-specific and company-specific factors. The FSOC also would evaluate whether resolution of the company could pose a threat to U.S. financial stability and the extent to which the company is subject to regulation. Based on this analysis, the FSOC would notify companies it believes merit further evaluation in Stage 3 (the Stage 3 Pool).

In Stage 3, the FSOC (with assistance from the Office of Financial Research) would review each company identified for further analysis in Stage 2, including analysis of additional information collected directly from the company. The evaluation would consider the company’s resolvability, and the FSOC would consult with the company’s primary regulator. Following such analysis, a Proposed Determination would require a two-thirds vote of the FSOC, followed by a hearing if requested by the company, and, if so, a final vote by the FSOC.

Overall, the final rule and interpretive guidance provide the FSOC with broad discretion for designating systemically important nonbank financial companies. Some nonbank companies will likely face considerable uncertainty about possible designation and actions they might take to reduce risk and avoid that result. The specific application of the
final rule by the FSOC will determine whether the net is cast broadly or narrowly. In my opinion (and excluding AIG), appropriate application by the FSOC of the statutory criteria and the final rule should not result in designation of any companies that predominantly write property/casualty insurance as systemically important and very few, if any, life insurers. Given the uncertainty associated with the designation process and possible unintended consequences, consideration could be given to establishing some form of safe harbor that would reduce uncertainty and increase the likelihood of that result.

**Effects of Designation on Competitive Dynamics**

The designation of individual insurance entities and other nonbank financial companies as systemically significant, as opposed to a system of heightened scrutiny and supervision of specific types of activities that pose systemic risk, has significant drawbacks. There is little cause for optimism concerning the ability of enhanced supervision of individual companies designated as systemically important to reduce significantly the likelihood of any future crisis. Greater capital requirements and tighter regulation for individual companies designated as systemically important raise the risk that they could face excessive burdens and costs that would disrupt competition and harm customers, at least in the near term when memories of the financial crisis are fresh. On the other hand, sooner or later a “systemically important” designation of a nonbank financial company would likely translate as “too big to fail,” regardless of assertions that creditors and shareholders of companies will not be bailed out in the event of financial distress. That result would provide designees with a competitive advantage in attracting customers and capital and significantly undermine market discipline and incentives for safety and soundness.

These drawbacks favor narrow application of the FSOC’s statutory charge to identify systemically important companies. In the specific case of insurance, the potential benefits from designating some companies as systemically important are small, and the potential costs are large.

**The Federal Reserve’s Proposed Rule for Enhanced Prudential Standards**

The Federal Reserve’s January, 2012 proposed rule for enhanced prudential standards and early remediation requirements for large bank holding companies and
nonbank financial companies designated by the FSOC, including capital requirements, liquidity standards, and stress testing, is bank centric. Unless modified significantly for nonbank financial institutions, the proposed rule would apply standards developed for large banks to nonbanks without regard to fundamental differences in operations and risk profiles, with the potential for significant market disruptions and unintended consequences. This result obviously should be avoided.

Enhanced prudential standards for nonbank financial companies identified by the FSOC as systemically important should be tailored to the distinct nature of the operations and risks of specific nonbank financial services. In the case of insurance, careful consideration should be given to linking enhanced prudential standards to existing risk-based capital requirements for insurers and related state regulation.