

## Insurance Regulation in the Dodd-Frank Era

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The wrenching financial crisis of 2007 to 2009 triggered an intense period of regulatory reflection. The congressional response—the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)<sup>1</sup>—substantially reshaped the country’s financial regulatory framework. The new framework reflects a deep confidence in federal regulators to identify systemic problems and prevent them from causing systemic crises.<sup>2</sup>

State-based insurance regulation might have been a natural victim of the centralized approach to financial regulation. After all, the dramatic bailout of American International Group (AIG) brought the financial crisis into the headlines and elicited responses like this one from four members of Congress:

Clearly, some insurers have become too complex and too interconnected world-wide for the limited resources of state regulators to handle. What’s more, the state-based system drives up the price of insurance, because it is costly to comply with 50 different sets of regulations. But the stakes are much higher than more expensive premiums. Unless Congress provides an alternative to the state-based regulatory model, it is likely that the federal government (*i.e.*, American taxpayers) will be forced to pay for more bailouts in the future.<sup>3</sup>

Dodd-Frank, however, seemingly left the industry securely in state regulators’ hands, where it had been for well over a century. Although one of Dodd-Frank’s sixteen titles is devoted to insurance, that title creates a Federal Insurance Office (FIO) with a comparatively narrow mandate.<sup>4</sup> Dodd-Frank generally carves insurance out of the jurisdiction of the Bureau of Consumer Financial Protection.<sup>5</sup> Further suggesting the continuing relevance of the states, a state insurance commissioner selected by the states has a coveted—albeit nonvoting—spot on the Financial Stability Oversight Council.<sup>6</sup>

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<sup>1</sup> Pub L No 111-203, 124 Stat 1376 (2010).

<sup>2</sup> For an overview of the new framework, see DODD-FRANK: WHAT IT DOES AND WHY IT’S FLAWED (Hester Peirce and James Broughel, eds., 2012).

<sup>3</sup> John Sununu, Tim Johnson, Melissa Bean, and Ed Royce, *Insurance Companies Need a Federal Regulator*, WALL ST. J., Sept. 23, 2008.

<sup>4</sup> See Title V of Dodd-Frank, the Federal Insurance Act of 2010.

<sup>5</sup> For a discussion of the nuances of the Bureau’s regulatory reach into the insurance industry, see James Sivon and Adam Maarec, *The CFPB and the Business of Insurance: An Analysis of the Scope of the CFPB’s Authority Over Insurance Sales* (Barnett Sivon & Natter Perspectives Newsletter, March 2014), available at [http://www.bsnlawfirm.com/newsletter/OP0314\\_Extra1.pdf](http://www.bsnlawfirm.com/newsletter/OP0314_Extra1.pdf).

<sup>6</sup> 12 U.S.C. § 5321(b)(2)(C)(2014).

In the nearly five years that have passed since Dodd-Frank became law, the future of state regulation of insurance is not looking as secure as it did at the law's inception. Proponents of federal regulation as a replacement for uncoordinated, anachronistic state insurance regulation do not have cause for celebration. The emerging version of federal regulation may add unhealthy obstacles to the regulatory landscape, rather than eliminate them. In addition, the new approach may increase systemic risk, rather than reduce it. A better approach to reforming insurance regulation might be to embrace an idea that was suggested before the crisis—single state regulation of insurers.

## **I. The Current Regulatory Framework**

### **A. State Regulation**

#### **1. Origins of State Regulation**

Insurance regulation in the United States has historically been state-based. Over the span of multiple centuries, states have regulated the insurance companies that operate in their states, the agents that sell insurance in their states, and the insurance products that are sold in their states. States employ different regulatory approaches for life/health insurers, on the one hand, and property/casualty insurers, on the other. Most states operate guaranty funds for each line.<sup>7</sup>

By the time the Supreme Court decided that cross-border insurance transactions were interstate commerce subject to federal regulation,<sup>8</sup> state-based regulation was so engrained that Congress expressly embraced state regulation. The McCarran-Ferguson Act of 1945 provided that “the continued regulation and taxation by the several States of the business of insurance is in the public interest.”<sup>9</sup>

The passage of the McCarran-Ferguson Act did not end questions about state-dominated insurance regulation. After all, the market for insurance is not state-based; insurers routinely sell outside of their home states.<sup>10</sup> Critics cite the difficulty of national insurance companies having to comply with many sometimes conflicting state laws, the anti-competitive regulatory approaches employed by some states, and the challenges state regulators have in overseeing large insurance companies.<sup>11</sup>

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<sup>7</sup> For a discussion of state guaranty funds, see Peter G. Gallanis, *Policyholder Protection in the Wake of the Financial Crisis* in MODERNIZING INSURANCE REGULATION 207-40 (John h. Biggs and Matthew P. Richardson, eds. 2014).

<sup>8</sup> U.S. v. South-Eastern Underwriters Ass'n, 322 U.S. 533, 553 (1944) (“No commercial enterprise of any kind which conducts its activities across state lines has been held to be wholly beyond the regulatory power of Congress under the Commerce Clause. We cannot make an exception of the business of insurance.”).

<sup>9</sup> 15 U.S.C. § 1011.

<sup>10</sup> See, e.g., Martin F. Grace and Richard D. Phillips, *The Allocation of Governmental Regulatory Authority: Federalism and the Case of Insurance Regulation*, 74 J. RISK & INS. 207, 209-10 (2007) (demonstrating the national character of the insurance market).

<sup>11</sup> See, e.g., Elizabeth F. Brown, *Implementing Dodd-Frank Wall Street Reform and Consumer Protection Act: Will the Federal Insurance Office Improve Insurance Regulation?* 81 U. CIN. L. REV. 551 (2012) (outlining numerous difficulties with state regulation of insurance).

The National Association of Insurance Commissioners (NAIC), which was formed in 1871,<sup>12</sup> has brought a measure of uniformity and reciprocity across states and provided a forum for inter-state regulatory cooperation. Nudges from Congress (often in the form of proposed legislation to federalize insurance regulation), particularly when the insurance industry was having financial or other problems,<sup>13</sup> have helped to drive the NAIC's efforts. In addition, concerns about the costs of the multi-state approach have inspired NAIC-led initiatives to achieve uniformity. Nevertheless, many differences across states persist, and large states often reject the NAIC's model laws. Consequently, federalizing insurance regulation through, for example, an optional federal charter or mandatory federal standards, retains its allure.

## 2. The Case of AIG

Over the years, state regulators have effectively defended their role in insurance regulation from potential federal encroachment.<sup>14</sup> Insurance regulation is a lucrative business for states.<sup>15</sup> In the face of apparent failures, state insurers have defended the efficacy of the state-based system. For example, state insurance commissioners responded to the AIG bailout by suggesting that it was not an insurance company failure. Rather, they argued, AIG's failure stemmed only from the derivatives transactions of the company's non-insurance subsidiary, AIG Financial Products (AIGFP).<sup>16</sup>

Collateral calls in connection with AIGFP's credit default swap portfolio were a source of tremendous stress for the company in 2007 and 2008. Greatly compounding the problems at AIGFP, however, was the company's securities lending activity, which directly involved key AIG life insurance subsidiaries.<sup>17</sup> These subsidiaries contributed securities to a common lending

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<sup>12</sup> FEDERAL INSURANCE OFFICE, HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES 11 (Dec. 2013), available at <http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf> [hereinafter FIO MODERNIZATION REPORT].

<sup>13</sup> See, e.g., MARTIN F. GRACE, A REEXAMINATION OF FEDERAL REGULATION OF THE INSURANCE INDUSTRY 2 (Networks Financial Institute Policy Brief 2009-PB-02, February 2009) (explaining that “[a]most every wave of proposed regulatory reform resulted from the reaction to some sort of crisis”).

<sup>14</sup> For a discussion of the historical arguments for federal involvement in insurance regulation and the states' responses, see PATRICIA A. MCCOY, SYSTEMIC RISK OVERSIGHT AND THE SHIFTING BALANCE OF STATE AND FEDERAL AUTHORITY OVER INSURANCE 11-16 (Boston College Law School Legal Studies Research Paper No. 349, Jan. 1, 2015), available at

[http://papers.ssrn.com/sol3/Delivery.cfm/SSRN\\_ID2572401\\_code337546.pdf?abstractid=2548065&mirid=1](http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2572401_code337546.pdf?abstractid=2548065&mirid=1).

<sup>15</sup> See, e.g., Grace and Phillips, *supra* note 10, at 211 (finding that in 2000, “the average state used only 8.78 percent of the revenues collected from the insurance industry to finance the operations of the regulator in the state”).

<sup>16</sup> See, e.g., Written Testimony of Joel Ario on behalf of the National Association of Insurance Commissioners, Before the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the House Committee on Financial Services 4 (Mar. 18, 2009), available at [http://www.naic.org/documents/testimony\\_0903\\_ario.pdf](http://www.naic.org/documents/testimony_0903_ario.pdf) (“Federal Reserve Chairman Ben Bernanke recently described the source of AIG's troubles as coming from ‘a hedge fund, basically, that was attached to a large and stable insurance company.’ He was right on both counts. The ‘hedge fund’ is the AIG Financial Products unit, which, according to Chairman Bernanke, ‘made huge numbers of irresponsible bets’ and ‘took huge losses.’ The ‘large and stable insurance company’ is the 71 state regulated insurance companies.”).

<sup>17</sup> For a discussion of AIG's securities lending activities, see HESTER PEIRCE, SECURITIES LENDING AND THE UNTOLD STORY IN THE COLLAPSE OF AIG (Mercatus Center at George Mason University Working Paper No. 14-12, 2014), available at [http://mercatus.org/sites/default/files/Peirce\\_SecuritiesLendingAIG\\_v2.pdf](http://mercatus.org/sites/default/files/Peirce_SecuritiesLendingAIG_v2.pdf). For a broader and more entertaining discussion of AIG—including a description of AIG's securities lending, see RODDY BODY, FATAL RISK: A CAUTIONARY TALE OF AIG'S CORPORATE SUICIDE (2011).

pool, and the cash collateral received from lending the securities in the pool was reinvested in, for example, residential mortgage-backed securities (RMBS). During 2007 and 2008, many securities lending counterparties asked for their cash back (instead of extending the securities loans as had been common practice). Their cash was tied up in illiquid RMBS. Although lending through an agent, the insurance companies were ultimately responsible for the return of the cash collateral; as AIG's Annual Report for 2007 explained, "In addition to the invested collateral, the securities on loan as well as all of the assets of the participating companies are generally available to satisfy the liability for collateral received."<sup>18</sup> In the end, AIG repaid the securities lending counterparties with federal bailout money. Moreover, as the value of the RMBS investments fell, the capital positions of a number of AIG's life insurance subsidiaries were dangerously impaired.<sup>19</sup> Without capital contributions from AIG—funded by federal bailout money—some of these insurance companies likely would not have survived.<sup>20</sup>

Although insurance regulators—of which there were many here and abroad—eventually discovered the securities lending program's problems, the discovery came too late to prevent some of the life insurance companies from near insolvency. AIG's federal regulator, the Office of Thrift Supervision, also failed to stop the problem, which suggests that a federal solution may not be the answer for companies like AIG.<sup>21</sup> In any case, the failures of AIG's state and federal regulators serve as a reminder that—contrary to current public policy narratives—even a heavily regulated company is not immune from failure.

## **B. Federal Regulation of Insurance**

Although Dodd-Frank's insurance title did not end the states' dominant role in day-to-day insurance regulation, the statute opened the door to more extensive federal involvement over time. Dodd-Frank invites the federal government into insurance regulation by creating the FIO, strengthening the Federal Reserve's hand in holding company regulation, and empowering the Financial Stability Oversight Council (FSOC) to designate nonbank financial companies for special regulation by the Federal Reserve. As Professor Patricia McCoy points out, the resulting new cadre of insurance experts makes a larger future role for the federal government likely.<sup>22</sup>

### **1. Federal Insurance Office**

Dodd-Frank created the FIO without making it a direct regulator of the insurance industry. The FIO is an office within the Department of Treasury and is headed by a director appointed by the

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<sup>18</sup> AMERICAN INTERNATIONAL GROUP, 2007 ANNUAL REPORT 108 (2008).

<sup>19</sup> For a careful analysis of the financial state of the insurance subsidiaries, see DAVID MERKEL, TO WHAT DEGREE WERE AIG'S OPERATING SUBSIDIARIES SOUND (2009), available at <http://alephblog.com/wp-content/uploads/2009/04/To%20What%20Degree%20Were%20AIG%E2%80%99s%20Operating%20Subsidiaries%20Sound.pdf>

<sup>20</sup> See *id.* and Peirce, *supra* note 17.

<sup>21</sup> See Peirce, *supra* note 17, at 55 ("The Federal Reserve, AIG's new systemic overseer, may believe that it will do a better job, but the problems that prevented the OTS from doing a better job overseeing AIG—shifting personnel and organizational changes within the OTS—could as easily plague the Federal Reserve. Similarly, the insurance regulators' failure with respect to AIG—not timely recognizing the aggressive nature of AIG's securities-lending program—could as easily occur at the Federal Reserve, which also overlooked increasing risks during the last crisis.").

<sup>22</sup> McCoy, *supra* note 14, at 36.

Treasury Secretary.<sup>23</sup> The FIO's mandate includes all insurance except health insurance, long-term care insurance, and crop insurance.<sup>24</sup> Dodd-Frank empowers the FIO to monitor the insurance industry for systemic risk and accessibility; to recommend particular insurance companies to the FSOC for systemic designation; to assist with the administration of the Terrorism Risk Insurance Act; to coordinate federal policy on international insurance regulatory issues; to represent the United States at the International Association of Insurance Supervisors (IAIS); to assist the Treasury Secretary in negotiating international agreements; to decide when these agreements preempt state law; to consult with the states on insurance issues, and to advise the Treasury Secretary.<sup>25</sup> The FIO Director also must play a key role in any recommendation to the Treasury Secretary that an insurer should be wound down under Dodd-Frank's orderly liquidation authority.<sup>26</sup> Even though the FIO lacks direct regulatory authority, it is likely to play an increasingly large role in insurance regulation.

First, international discussions about insurance are likely to drive national regulatory efforts,<sup>27</sup> and the FIO is an important part of those discussions. A consistent federal voice is useful in international negotiations.<sup>28</sup> The FIO's role in negotiating international agreements relating to the prudential regulation of insurance and reinsurance is combined with a power to preempt inconsistent state insurance laws and regulations (albeit after a notice-and-comment process).<sup>29</sup> Depending on the breadth of the international agreements, the FIO could wield considerable preemption power.<sup>30</sup>

Second, the FIO has broad data collection powers. Dodd-Frank authorizes the FIO, after coordinating with state and federal regulators, to "require an insurer, or any affiliate of an insurer, to submit such data or information as the Office may reasonably require in carrying out [its] functions."<sup>31</sup> In order to encourage insurers and their affiliates to comply with such requests, Dodd-Frank gives the FIO director the power to issue a court-enforceable subpoena for the

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<sup>23</sup> Dodd-Frank § 502(a), 31 U.S.C. § 313(a), (b).

<sup>24</sup> Dodd-Frank § 502(a), 31 U.S.C. § 313(d).

<sup>25</sup> Dodd-Frank § 502(a), 31 U.S.C. § 313(c).

<sup>26</sup> Dodd-Frank § 203(a)(1)(C), 12 U.S.C. § 5383(a)(1)(C).

<sup>27</sup> For a brief overview of international developments, see McCoy, *supra* note 14, at 38-41. The Federal Reserve, which is active in the Financial Stability Board (FSB) and has also joined the International Association of Insurance Supervisors, may be using the international process strategically to influence the domestic process. A decision made in an international forum can effectively serve to bind domestic regulators. For a discussion of how this could work in the insurance realm, see S. Roy Woodall, Jr., *View of the Council's Independent Member Having Insurance Expertise* 4-5 (Dec. 18, 2014), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf> [hereinafter *Woodall MetLife Statement*]. The FSB favors a larger federal role in U.S. insurance regulation. FSB, PEER REVIEW OF THE UNITED STATES: REVIEW REPORT 36 (Aug. 27, 2013).

<sup>28</sup> The significance of the FIO's role depends, of course, on how active international negotiations are. See Brown, *supra* note 11, at 598 ("It is doubtful, however, that the Treasury Department and [U.S. Trade Representative] will be seeking to negotiate any binding international agreements on insurance prudential standards in the next few years. As a result, FIO represents only incremental progress on the international standards front.").

<sup>29</sup> Dodd-Frank § 502(a), 31 U.S.C. §§ 313(a), (f) and 314.

<sup>30</sup> Some academics have argued for broader preemptive authority. See, e.g., Daniel Schwarcz and Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI L. REV. 1569, 1635-36 (2014) (calling for the FIO to have authority, subject to the FSOC's sign-off, to preempt state law for systemic risk reasons).

<sup>31</sup> Dodd-Frank § 502(a), 31 U.S.C. § 313(e)(2).

information.<sup>32</sup> It is possible that the FIO could actively employ this power to obtain information about insurer affiliates, which are often beyond the reach of state insurance regulators.<sup>33</sup> Having this information could give the FIO leverage with state regulators, which it might use to secure a seat at the table in supervisory colleges.<sup>34</sup> In any case, an aggressive FIO director could make broad use of the reporting authority over non-insurance companies that are affiliated with insurers—thus potentially expanding the FIO’s reach far beyond insurers.

Third, the FIO’s modernization report indicates a long-term interest in expanding the federal role in insurance regulation. Dodd-Frank required the FIO to report to Congress on a number of issues, including “how to modernize and improve the system of insurance regulation in the United States.”<sup>35</sup> The resulting FIO report<sup>36</sup> does not, as some commenters might have liked,<sup>37</sup> recommend replacing the existing state regulatory regime with a federal one. Instead the report highlights “the inefficiencies and burdens for consumers, insurers, and the international community” associated with the existing state-based system and asks “whether there are areas in which federal involvement in regulation under the state-based system is warranted.”<sup>38</sup> However, the report suggests a number of areas for immediate federal involvement—including stand-setting for mortgage insurers and FIO involvement in supervisory colleges of large insurers.<sup>39</sup> In other areas such as guaranty funds and surplus lines, the report uses the threat of federal involvement to encourage states to achieve greater uniformity and cooperation.<sup>40</sup>

The report also raises questions about the propriety of using certain data in developing risk profiles for pricing purposes. While acknowledging that classifying customers by risk may “allow insurers to charge higher rates to individuals who engage in riskier behavior,” FIO worries that irrelevant data are being used in pricing decisions.<sup>41</sup> This section of the report seems to suggest that FIO may seek to play a role in the regulation of insurer risk-based pricing.

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<sup>32</sup> Dodd-Frank § 502(a), 31 U.S.C. § 313(e)(6).

<sup>33</sup> See, e.g., McCoy, *supra* note 14, at 56-7 (discussing the difficulty that states have in getting access to information about non-insurance entities).

<sup>34</sup> State regulators have argued that FIO is not a regulator and so should not participate in supervisory colleges. See, e.g., Arthur D. Postal and Elizabeth D. Festa, *NAIC to FIO: Participation in Supervisory Colleges ‘Inappropriate’*, PROPERTYCASUALTY360 (June 13, 2013), available at <http://www.propertycasualty360.com/2013/06/13/naic-to-fio-participation-in-supervisory-colleges>.

<sup>35</sup> Dodd-Frank § 502(a), 31 U.S.C. § 313(p).

<sup>36</sup> FIO MODERNIZATION REPORT, *supra* note 12.

<sup>37</sup> See, e.g., Letter from Advocates for Insurance Modernization to Michael T. McRaith, Director, FIO 2 (Dec. 16, 2011), available at <http://www.regulations.gov/contentStreamer?objectId=0900006480f8486a&disposition=attachment&contentType=pdf> (calling for a new approach to insurance regulation because “[f]rom the structural challenges created by a system of 51 sets of regulatory restrictions to the substantive impact of market regulations that fail to promote prudent risk management, the current system is incapable of efficiently regulating national and global commerce”).

<sup>38</sup> FIO MODERNIZATION REPORT, *supra* note 12, at 5.

<sup>39</sup> *Id.* at 7.

<sup>40</sup> *Id.* at 45, 59. Dodd-Frank included a subtitle regarding surplus lines. Dodd-Frank, Title V, Subtitle B. The FIO report observes that, out of concern for the effect on tax revenues, “states have not fulfilled [Dodd-Frank’s] vision” to “simplify and make uniform the regulation of surplus lines of insurance in the United States” and concludes that “[f]urther federal action on this issue may be necessary in the near term.” FIO MODERNIZATION REPORT, *supra* note 12, at 59.

<sup>41</sup> FIO MODERNIZATION REPORT, *supra* note 12, at 56-7.

The FIO report included a recommendation that Congress pass legislation to establish the National Association of Registered Agents and Brokers (NARAB).<sup>42</sup> Earlier this year, Congress followed that recommendation.<sup>43</sup> The Gramm-Leach-Bliley Act of 1999 empowered the president to appoint a NARAB board of directors unless, within three years, a majority of states had enacted laws or regulations providing for uniformity or reciprocity in connection with the licensing of individuals selling or soliciting the purchase of insurance.<sup>44</sup> The statutory target was met, so NARAB never materialized. This year's legislation established NARAB as a non-profit corporation that any state-licensed insurance producer can join in order to be eligible to sell insurance in other states without having to be separately licensed in each state. FIO's support for this initiative and plans to "monitor the establishment and implementation of NARAB II to ensure that" it achieves "an efficient and streamlined multistate licensing mechanism" are indicative of the FIO's intention to play at least an active coordinating role in regulation.<sup>45</sup>

## 2. The Federal Reserve as Holding Company Regulator

The Federal Reserve has a more direct supervisory role with respect to insurance companies than does the FIO. Before Dodd-Frank, the Federal Reserve regulated bank holding companies. Dodd-Frank added savings and loan (thrift) holding companies, which were formerly regulated by the Office of Thrift Supervision.<sup>46</sup> As Peter Ryan of the Bipartisan Policy Center points out, this change placed many insurers under the Federal Reserve's regulatory authority.<sup>47</sup>

In addition to adding a new set of holding companies to the Federal Reserve's supervisory jurisdiction, Dodd-Frank also increased the Federal Reserve's examination and enforcement authority over holding company subsidiaries, including functionally regulated subsidiaries.<sup>48</sup> As Professor McCoy explains, the Federal Reserve's authority is "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."<sup>49</sup> Insurers are among these functionally regulated subsidiaries. In addition, the Federal Reserve regulates any insurer that is designated systemic by the FSOC.<sup>50</sup>

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<sup>42</sup> *Id.* at 46-48.

<sup>43</sup> The National Association of Registered Agents and Brokers Reform Act of 2015 is Title II of the Terrorism Risk Insurance Program Reauthorization Act of 2015, H.R. 26, available at <http://www.gpo.gov/fdsys/pkg/BILLS-114hr26enr/pdf/BILLS-114hr26enr.pdf>. An effort to pass the bill in 2014 failed after Senator Tom Coburn objected that the NARAB legislation infringed on states' rights. See, e.g., Ted Besesparis, *Why TRIA Failed in the Senate*, PROPERTYCASUALTY360, Dec. 18, 2014, available at <http://www.propertycasualty360.com/2014/12/18/why-tria-failed-in-the-senate>.

<sup>44</sup> 15 U.S.C. § 6751 et seq.

<sup>45</sup> FIO MODERNIZATION REPORT, *supra* note 12, at 48.

<sup>46</sup> For an overview of the Federal Reserve's expanding authority, see HESTER PEIRCE AND ROBERT GREENE, THE FEDERAL RESERVE'S EXPANDING AUTHORITY INITIATED BY DODD-FRANK (Mercatus Center at George Mason University Nov. 2013), available at <http://mercatus.org/publication/federal-reserves-expanding-regulatory-authority-initiated-dodd-frank>.

<sup>47</sup> Peter Ryan, *How the Federal Reserve Became the De Facto Federal Insurance Regulator* (Bipartisan Policy Center blog, July 30, 2014), available at <http://bipartisanpolicy.org/blog/how-federal-reserve-became-de-facto-federal-insurance-regulator/> (estimating that 55 insurers accounting for 6 percent of total industry assets and 16 percent of property/casualty assets were organized as savings and loan holding companies at the end of 2013).

<sup>48</sup> Dodd-Frank § 604.

<sup>49</sup> McCoy, *supra* note 14, at 52.

<sup>50</sup> Dodd-Frank § 113(a), 12 U.S.C. § 5323(a).

### 3. Financial Stability Oversight Council Designations

Dodd-Frank created the FSOC to “identify risks to the financial stability of the United States,” “promote market discipline, by eliminating expectations” of bailouts, and “respond to emerging threats to the stability of the United States financial system.”<sup>51</sup> The FSOC brings together the heads of federal financial regulators and certain state representatives. One of its ten voting members is a presidentially appointed, Senate-confirmed insurance expert.<sup>52</sup> Among its five nonvoting members are the FIO director and “a State insurance commissioner, to be designated by a selection process, determined by the State insurance commissioners.”<sup>53</sup> A big part of the FSOC’s agenda has been the identification of “nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure, or because of their activities.”<sup>54</sup>

To date, three insurance companies are among the FSOC’s designees. FSOC has designated AIG, Prudential, and MetLife.<sup>55</sup> AIG “did not contest [the] designation and welcome[d] it.”<sup>56</sup> Prudential appealed to the FSOC, but did not challenge its designation in court.<sup>57</sup> MetLife sued the FSOC in an effort to have its designation overturned.<sup>58</sup> MetLife’s challenge raises constitutional and procedural issues, including the FSOC’s alleged failure “to understand, or give meaningful weight to, the comprehensive state insurance regulatory regime that supervises every aspect of MetLife’s U.S. insurance business, despite statutory and regulatory requirements that direct the Council to consider existing regulatory scrutiny.”<sup>59</sup>

The FSOC’s designations of Prudential and MetLife also raised objections from some of the FSOC’s own members. Edward J. DeMarco, former Acting Director of the Federal Housing Finance Agency, dissented from Prudential’s designation because of flaws in the underlying analysis, including aggregating small, dispersed exposures to Prudential into a purported

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<sup>51</sup> Dodd-Frank § 111(b)(1)(J), 12 U.S.C. § 5321(b)(1)(J).

<sup>52</sup> Dodd-Frank § 112(a)(1), 12 U.S.C. § 5322 (a)(1).

<sup>53</sup> Dodd-Frank § 112(b)(2)(B),(C), 12 U.S.C. § 5322 (b)(2)(B),(C). Given that three advisory (albeit nonvoting) members of the FSOC are selected by the states, the FSOC’s constitutionality is open to question under *Buckley v. Valeo*, 424 U.S. 1 (1976).

<sup>54</sup> Dodd-Frank § 112(a)(2)(H), 12 U.S.C. § 5322 (a)(2)(H).

<sup>55</sup> See FSOC, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL’S FINAL DETERMINATION REGARDING AMERICAN INTERNATIONAL GROUP, INC. (July 8, 2013), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group.%20Inc.pdf>; FSOC, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL’S FINAL DETERMINATION REGARDING PRUDENTIAL FINANCIAL, INC. (Sept. 19, 2013), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf>; FSOC, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL’S FINAL DETERMINATION REGARDING METLIFE, INC. (Dec. 18, 2014), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf> [hereinafter METLIFE DESIGNATION].

<sup>56</sup> AIG, AIG STATEMENT ON FINANCIAL STABILITY OVERSIGHT COUNCIL (FSOC) FINAL DETERMINATION (July 9, 2013), available at <http://phx.corporate-ir.net/phoenix.zhtml?c=76115&p=irol-newsArticle&ID=1836362>.

<sup>57</sup> Elizabeth D. Festa, *Prudential Concedes SIFI Designation*, LIFEHEALTHPRO (Oct. 18, 2013), available at <http://www.lifehealthpro.com/2013/10/18/prudential-concedes-sifi-designation>.

<sup>58</sup> Complaint, *MetLife v. FSOC*, 1:15-cv-00045 (Jan. 13, 2015), available at <http://online.wsj.com/public/resources/documents/011315metlife.pdf>.

<sup>59</sup> *Id.* at 2.



systemic risk and projecting bank-like run risks on the insurer.<sup>60</sup> The nonvoting state insurance commissioner representative, John Huff, likewise faulted the FSOC for “inappropriately appl[ying] bank-like concepts to insurance products and their regulation, rendering the rationale for designation flawed, insufficient, and unsupported.”<sup>61</sup>

Roy Woodall, the FSOC’s presidentially selected insurance expert, dissented from both designations. With respect to the MetLife designation, Woodall argued that the FSOC should have focused on the company’s “activities, particularly in the non-insurance and capital markets activities spheres,” rather than on “implausible, contrived scenarios.”<sup>62</sup> Similarly, in dissenting from Prudential’s designation, he noted that FSOC “utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems.”<sup>63</sup>

One consistent theme in objections to the designations is the absence of a clear explanation of what makes the company systemic. In his MetLife dissent, Woodall objected to the FSOC’s failure to pinpoint its precise areas of concern:

[T]he Council should be more transparent about which of MetLife’s activities, together or separately, pose the greatest risk to U.S. financial stability in order to provide constructive guidance for the primary financial regulatory authorities, the Board of Governors, international supervisors, other insurance market participants and, of course, MetLife itself, to address any such threats posed by the company.<sup>64</sup>

Woodall’s concerns were echoed by the Huff’s successor nonvoting state insurance commissioner representative, who concluded that “the Council has created an impossible burden of proof for companies to meet as it effectively requires companies to prove that there are no circumstances under which the material financial distress of the company could pose a threat to the financial stability of the United States” and “[w]ithout applying some sort of overlay of plausibility, any large company could meet the statutory standard as applied by the Council.”<sup>65</sup> The lack of clear standards for designation keeps the door open for additional insurer designations.

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<sup>60</sup> Edward J. DeMarco, *Views of the Acting Director of the Federal Housing Finance Agency* 1-2 (Sept. 18, 2013), available at <http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf>.

<sup>61</sup> John Huff, *View of Director John Huff, the State Insurance Commissioner Representative* 1 (Sept. 18, 2013), available at <http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf>.

<sup>62</sup> *Woodall MetLife Statement*, *supra* note 27, at 1-2.

<sup>63</sup> Roy S. Woodall, J., *View of the Council’s Independent Member Having Insurance Expertise* 1 (Sept. 18, 2013), available at <http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf>.

<sup>64</sup> *Woodall MetLife Statement*, *supra* note 27, at 2.

<sup>65</sup> *View of Adam Hamm, the State Insurance Commissioner Representative*, 12 (Dec. 8, 2014), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf>.

## II. The Current Mixed State-Federal Regulatory Approach is Costly and Systemically Dangerous

The existing regulatory system—a mixture of federal and state regulation—is costly and systemically dangerous. The state-by-state approach to insurance regulation continues to impose costs on insurers, many of which get passed on to consumers. The complexities of navigating the state regulatory system deter potential new entrants and potential new product offerings by existing companies. States' harmonization efforts have been inadequate. Sporadic federal interventions in the existing state regulatory system may help to increase uniformity across states, but also could multiply costs by adding another layer of regulation.

The greatest costs of the current framework may come from the designation of insurers by the FSOC. First, designated companies are subject to Federal Reserve regulation. As many have pointed out, the Federal Reserve's experience and perspective is bank-centric. How the Federal Reserve will regulate insurers remains uncertain,<sup>66</sup> but there is reason to worry that the regulatory model will not be sufficiently tailored to accommodate the unique features of insurance companies.<sup>67</sup> If the Federal Reserve applies a uniform approach to regulating all systemically important financial institutions, it risks homogenizing the financial system, which could make the system more prone to simultaneous failures. In any case, the addition of a Federal Reserve regulator will increase costs on designated companies, which will affect their ability to compete with their non-designated rivals.<sup>68</sup>

Designated insurers may nevertheless enjoy a competitive edge because of their designation. In deciding that an insurance company's failure would put the United States financial system at risk, the FSOC is making at least an implicit commitment to keep the company alive in perpetuity. The FSOC's lack of clarity about what drives its designations makes it difficult for companies to take steps that would warrant de-designation. Implicit government backing can make it cheaper for companies to fund themselves.<sup>69</sup> Moreover, a federal government commitment is particularly meaningful in the context of life insurers, whose long-term viability matters greatly to policyholders. Designated insurers are likely to highlight their status as a reason consumers should select them over their competitors.

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<sup>66</sup> For a discussion of the uncertainty surrounding the Federal Reserve's regulation of insurance companies, see PETER J. WALLISON, *THE AUTHORITY OF THE FSOC AND THE FSB TO DESIGNATE SIFIS: IMPLICATIONS FOR THE REGULATION OF INSURERS IN THE UNITED STATES AFTER THE PRUDENTIAL DECISION 12-13* (Networks Financial Institute Policy Brief No. 2014-PB-02, Feb. 2014).

<sup>67</sup> As a member of the FSOC, the Federal Reserve chairman apparently has accepted the analysis underlying insurance company designations. That analysis has assumed that insurance companies have bank-like characteristics and vulnerabilities, which suggests that the Federal Reserve will apply similar reasoning in constructing a regulatory framework.

<sup>68</sup> MetLife explained that "[o]ur concern with being a SIFI [systemically important financial institution] is that it will put us at a competitive disadvantage to our non-SIFI peers, potentially impacting MetLife's ability to deliver the comprehensive products and services that customers have come to expect from us." METLIFE, CUSTOMER AND INTERMEDIARY Q&A FOR LITIGATION, 1, available at [https://www.metlife.com/assets/cao/pr/SIFI\\_Designation-Customer\\_QA.pdf](https://www.metlife.com/assets/cao/pr/SIFI_Designation-Customer_QA.pdf).

<sup>69</sup> Any funding advantage could be offset by the additional regulatory costs. CHRISTOPHER PAYNE AND ROBERT LITAN, *BIG 3 INSURERS FACE TOUGHER REGULATION UNDER DODD-FRANK LAW 6* (Bloomberg Government Study, Feb. 27, 2013).

Moreover, designations of insurers—like other designations—carry with them moral hazard. Although the designation may bring enhanced regulatory oversight, designated companies’ managers, shareholders, and creditors will be less attentive to risk because they will assume that the government would step in to prevent the company’s failure. The state insurance guaranty system, by contrast, is limited to protecting policyholders and its ex post funding makes it less likely to be perceived as a bailout mechanism. Particularly in light of the government’s rescue of AIG, market participants will not feel the need to closely monitor designated insurance companies. Even though Dodd-Frank gives regulators new tools to oversee designated companies, regulators will have difficulty monitoring as effectively and efficiently as the now inattentive market participants would have absent bailout expectations.

Thus, although much of the current push for federal regulation is driven by concerns about systemic risk,<sup>70</sup> insurer designations and the resulting oversight by the Federal Reserve regulation could increase systemic risk. In light of the financial crisis, concerns about systemic risk are understandable, and an investigation of risks in the insurance industry should form the basis for more careful risk management by insurers, markets and regulators.<sup>71</sup> Nevertheless, a regulatory approach that is built upon a malleable and imprecise concept like systemic risk may in the end be less effective at safeguarding the financial system than a regulatory approach centered on traditional concepts of solvency, market conduct, and competition.

### III. Conclusion

Insurance regulation at the state level has a long history. Throughout that history, the costs of splintered state regulation have manifested themselves in the form of barriers to competition and innovation, which harm consumers and impair financial stability. In response, the states—often with federal government pressure—have worked toward greater uniformity and cooperation, but there is still room for improvement. Dodd-Frank’s FIO wants to play a role in encouraging improved coordination in insurance regulation, but the FIO may also have centralization in mind as it seeks a greater role for itself in establishing and perhaps enforcing uniform standards. Complicating matters greatly is the FSOC’s designation of insurance companies for systemic regulation by the Federal Reserve. As companies are designated, they will face greater costs, but they also are likely to face less market scrutiny as they operate under a presumption of government backing. The competitive implications for the insurance industry could be dramatic. Concentrating so much regulatory power over the financial system in the hands of the Federal

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<sup>70</sup> For an extensive and illuminating analysis of the role that systemic risk considerations play in current considerations of the proper regulatory structure for insurance, see McCoy, *supra* note 14.

<sup>71</sup> See, e.g., J. David Cummins and Mary A. Weiss, *Systemic Risk and the U.S. Insurance Sector*, 81 J. RISK & INS. 489, 523-34 (2014) (analyzing areas of systemic risk in insurance and finding that, while core insurer activities do not pose systemic risk, “noncore activities of insurers do constitute a potential source of systemic risk”); Craig B. Merrill, Taylor D. Nadauld, and Philip E. Strahan, *Final Demand for Structured Finance Securities* (Aug. 2014) (analyzing reasons, including regulatory requirements, for heavy insurance company investments in asset-backed securities), available at [http://papers.ssrn.com/sol3/Delivery.cfm/SSRN\\_ID2489458\\_code267092.pdf?abstractid=2380859&mirid=1](http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID2489458_code267092.pdf?abstractid=2380859&mirid=1); Schwarcz and Schwarcz, *supra* note 30, at 1592-1627 (extensively analyzing potential systemic risks in the insurance industry). See also SCOTT E. HARRINGTON, INSURANCE REGULATION AND THE DODD-FRANK ACT 7 (Networks Financial Institute Policy Brief no. 2009-PB-01, Mar. 2011) (arguing that “the consensus is that systemic risk is relatively low in insurance markets compared with banking, especially for property/casualty insurance”).

Reserve also carries with it potentially grave consequences for financial stability if the Federal Reserve employs a flawed or one-size-fits-all regulatory approach.

One way to achieve greater consistency without abandoning the state regulatory system or embracing a potentially harmful federal regulatory system would be to adopt a single-state licensing approach. States would be permitted to compete with one another to charter insurance companies. The chartering state would be the insurer's sole regulator, but the insurer would be able to operate nationwide. Unlike the current system, the oversight responsibility for a particular insurer would lie clearly with one state. Scale efficiencies of regulation could be captured.<sup>72</sup> Although some argue that systemic risk concerns demand a federal regulatory presence,<sup>73</sup> strong market discipline operating within a properly designed state regulatory framework could be more effective than nascent federal systemic risk regulation. Before the crisis, academics, including Henry Butler, and Larry Ribstein, have suggested a single-license approach as an alternative to a federal charter.<sup>74</sup> As Butler and Ribstein explained, "A major problem with federal chartering is that it does not take advantage of the potential for jurisdictional competition to generate a more efficient regulatory structure."<sup>75</sup> Professor Scott Harrington also points out that a federal charter is likely to carry with it a federal guarantee.<sup>76</sup> A state-based approach would leave intact state guaranty funds, which are less likely to be used to bail out shareholders and creditors.<sup>77</sup> Moreover, a state approach would allow for "reversal of inevitable policy mistakes that can easily become permanent at the federal level."<sup>78</sup> Now that the implications of federal involvement in insurance regulation are emerging and before federal regulation pushes out the states, the time might be ripe to try the single-state licensing approach.

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<sup>72</sup> For an analysis of regulatory efficiencies, see Grace and Phillips, *supra* note 10.

<sup>73</sup> See, e.g., Grace, *supra* note 13, at 12 ("A state regulator cannot realistically regulate an insurer for its possible systemic [e]ffects on national and international markets especially in situations where the insurer within the state is a separately organized corporation from the corporation which might induce a systemic risk issue."); McCoy, *supra* note 14, at 76 (calling for the federal government to serve in a macroprudential capacity); Schwarcz and Schwarcz, *supra* note 30, at 1627-34 (2014) (arguing that "[s]tate insurance regulation is poorly equipped to address systemic risk because state regulators will not internalize systemic externalities and lack the requisite expertise).

<sup>74</sup> Henry N. Butler and Larry E. Ribstein, *The Single-License Solution*, REGULATION 36-42 (2008-2009). See also Grace, *supra* note 13, at 21-2 (noting that the "competitive federalism model" has "some promise," if paired with "federal oversight of solvency and systemic regulation"). See also SCOTT HARRINGTON, FEDERAL CHARTERING OF INSURANCE COMPANIES: OPTIONS AND ALTERNATIVES FOR TRANSFORMING INSURANCE REGULATION 28-9 (Networks Financial Institute Policy Brief No. 2006-PB-02, Mar. 2006) (suggesting "primary state" insurance regulation as a potential solution to problems in insurance regulation).

<sup>75</sup> *Id.* at 36.

<sup>76</sup> Harrington, *supra* note 71, at 13 (raising possibility that "optional federal chartering could expand government guarantees of insurers' obligations, undermining market discipline and incentives for safety and soundness, and increasing the likelihood of future bailouts"). See also Butler and Ribstein, *supra* note 74, at 38 (explaining that national insurers all would opt in to a federal charter, which would lead to demand for "the stronger warranty the federal government can provide" and ultimately to the displacement of state guaranty funds); HAL S. SCOTT, OPTIONAL FEDERAL CHARTERING OF INSURANCE: DESIGN OF A REGULATORY STRUCTURE 33 (Networks Financial Institute Policy Brief No. 2007-PB-04, Mar. 2007) (in the context of a thoughtful consideration of how an optional federal charter regime should be structured, suggesting that a federal guaranty fund might be beneficial).

<sup>77</sup> Harrington, *supra* note 71, at 16 (explaining that "protection provided by state guaranty funds is relatively narrow, which reduces moral hazard and market discipline").

<sup>78</sup> Butler and Ribstein, *supra* note 74, at 39.