Regulating Insurance Companies and the FSOC Designation of SIFIs

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Introduction

The insurance sector is a crucial part of the real economy, directly and indirectly employing millions of people, with virtually every household and firm as a client. In addition, insurance companies are important financial intermediaries, as they are a primary source of capital, especially for corporations and commercial mortgages.

On the surface, traditional insurance companies pool and diversify idiosyncratic risks that have potentially catastrophic consequences for individuals and businesses. In competitive markets, insurers price diversifiable risks on an actuarial basis, yielding tremendous utility gains to the previously exposed individuals and businesses.

More recently, however, some insurers have deviated from this traditional business model by: (i) providing insurance or similar financial products protecting against macroeconomic events and other nondiversifiable risks; (ii) being more prone to runs due to changes in their liability structure; and (iii) having expanded their overall role in financial markets. These nontraditional insurance activities are more systemically risky than insurers' traditional activities and can lead to the insurance sector performing particularly poorly in systemic states—that is, when other parts of the financial sector are struggling.

In the United States, regulation of insurance companies—including prudential regulation—is carried out by the states, as has been the case since the 19th century. As the financial sector has become more interconnected, and financial activities and functions have become more blurred across institutional forms, the question arises whether insurance companies need Federal supervision and, in particular, enhanced supervision due to systemic risk creation.[89]

To this point, while the financial crisis of 2007-2009 was very much a banking (or "shadow banking") crisis, insurance companies played their role too. Monoline insurers of mortgage products (such as MGIC Investment Corporation, PMI Group and Radian Group) experienced severe financial distress that spilled over to other parts of the financial sector. Large life insurers (such as Hartford Financial Services Group) aggressively wrote investment-oriented life insurance and annuity products with minimum guarantees and other contract features that exposed them to equity and other investment markets. And the largest insurance companies (such as AXA, MetLife and Prudential) also came under stress with large spikes in their debt and credit default swap spreads. And, of course, AIG effectively failed through large losses in its securities lending business and writing insurance derivatives on a half-trillion dollars of nominal asset-backed securities. In hindsight, since AIG was vastly undercapitalized at the holding company level, and not subject to any serious regulation or oversight, it became the poster child for why enhanced prudential regulation may be needed for nonbank, large financial institutions.

While neither the Dodd-Frank Act nor the CHOICE Act addresses the insurance sector in any substantive way, there are a few key parts contained in these Acts that are especially relevant for insurance companies. We discuss these below.

The Dodd-Frank Act

[89] For two balanced books that analyze various points of view on insurance regulation, see Biggs and Richardson (2014) and Hufeld, Koijen and Thimann (2016).

As a result of the financial crisis, the Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act and it was signed into law by President Barack Obama on July 21, 2010. The Dodd-Frank Act affected insurance companies in two ways.

First, while the Dodd-Frank Act did not create a new direct regulator of insurance, it did impose on nonbank holding companies, potentially including insurance entities, a major new form of regulation for those deemed systemically important financial institutions (SIFIs).[90] This regulation called for stricter prudential standards, including additional leverage and liquidity requirements, possible restrictions on the concentration and mix of activities of the company, and resolution plans, among other regulations. To date, the Financial Stability Oversight Council (FSOC) has designated four nonbank companies as SIFIs, three of which are insurance companies: AIG, Prudential and MetLife.[91] MetLife fought its designation in courts, and the FSOC order was rescinded. The case is under appeal.

Second, the Dodd-Frank Act created a Federal Insurance Office (FIO) inside the Department of Treasury. While the FIO has no direct

[90] The designation decision is made by the newly formed Financial Stability Oversight Council, which is chaired by the Secretary of the Treasury and consists of the top financial officers from various governmental and regulatory agencies—the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Bureau of Consumer Financial Protection, the Securities and Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), the Commodity Futures Trading Commission (CFTC), the Federal Housing Finance Agency (FHFA), and the National Credit Union Administration (NCUA)—and an independent member with insurance expertise. The criteria for SIFI designation is to "identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies or that could arise outside the financial services marketplace." (HR4173, Title I, "Financial Stability," Subtitle A, "Financial Stability Oversight Council," Sec. 112, "Council Authority."

[91] The designation of the fourth company (General Electric) was removed after GE restructured its business, in particular, spinning off a large part of its capital arm.

regulatory powers, its mandate is to investigate and represent the insurance industry, and refer any regulatory problems that it identifies to other regulators. For example, it would recommend to FSOC any insurance companies that it believes to be systemically important.[92] Also, the Dodd-Frank Act created an odd structure that the voting member of FSOC would be a “member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise,” but not from the Federal Insurance Office.

The CHOICE Act

The CHOICE Act proposes changes to the Dodd-Frank Act in two regards: (i) combining the roles of the FIO director and FSOC Independent Member with Insurance Expertise; and (ii) repealing FSOC’s authority to designate nonbanks as SIFIs.

With respect to the former, it can be reasonably argued that the Dodd-Frank Act’s creation of two insurance roles is counterproductive. To the extent that there is currently little oversight of insurance at the federal level, consolidating the federal insurance positions into one unified role makes ample sense. Regardless of one’s views on FSOC’s designation of SIFIs, it is important to keep the FIO and to clearly outline its authority and responsibilities.

First, the FIO should aggregate information and disseminate this information to state regulators. For example, large insurance companies should be required to prepare the same “statutory

[92] While the FIO director plays an important initial role if, and when, a systemically important insurance company becomes distressed, there is no follow-on function. Specifically, for a failing insurance company to go through the Dodd-Frank orderly liquidation authority, the director and at least two-thirds of the Federal Reserve Board of Governors must make the recommendation to the Treasury secretary. However, the liquidation and/or receivership would be carried out by the relevant state regulator, who most likely does not have either experience or expertise at managing systemic risk.

accounting principles" (SAP) filings for all their captive reinsurance activities, and to share them with the FIO. The FIO can consolidate this information and return it to the state regulators.[93]

Of particular interest are assumptions about reserves, hedging programs involving derivatives, investment risks including securities lending, and letters of credit including all (parental) guarantees. This information should be provided for all captives, including those domiciled offshore (for instance, in the Cayman Islands). Without this information, it is virtually impossible for state regulators to analyze the risks in captives. It is nevertheless the case that when a captive fails, all reinsured policies transfer back to the balance sheet of the original insurance company, and a failure of the operating company would result in losses of the guarantee fund in the state in which the policy has been sold. Hence, as a first step to ensure the stability of the state guarantee funds and the insurance sector as a whole, the FIO needs to provide transparency to all state regulators of the activities of insurance companies in other states. In response to this information, state regulators can use their judgment and expertise to choose to no longer provide, for instance, reserve credit to certain reinsurance transactions if they deem the captive to be too risky or insufficiently capitalized.

Second, the FIO should try to coordinate regulation with international regulators. At this point, there is little coordination across different regulators, while many of the largest companies are global. For instance, among the top ten variable annuity sellers are Jackson National (Prudential UK), Voya (ING, the Netherlands), Aegon (the Netherlands), and AXA (France). The Solvency II

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[93] New York Department of Financial Services completed such an investigation for the companies doing business in New York in 2013, but this information should be readily available to all state regulators: **http://www.dfs.ny.gov/reportpub/shadow_insurance_report_2013.pdf**. Furthermore, the Iowa Insurance Division published the regulatory filings of captive reinsurers domiciled in Iowa for the years 2014 and 2015, **https://iid.iowa.gov/financial-statements?category=22**.

framework that was enacted in January 2016 is focused much more on mark-to-market valuation and one-year risk measures, which is very different from the SAP framework in the United States. Without proper coordination of regulatory frameworks across countries, loopholes undoubtedly open up, which can be exploited perhaps in particular by the largest and global insurance companies.

With respect to repealing FSOC's authority to designate nonbanks as SIFIs, we first outline the general arguments of the CHOICE Act and comment on its line of reasoning. Then, in the next section, we discuss the degree to which a large, modern insurance company may or may not fit into the SIFI designation.

The authors of the CHOICE Act basically make two arguments for repealing the FSOC's designation authority: First, the FSOC is made up of political appointees, i.e., the heads of the various regulatory agencies (see footnote 90), and these persons are not qualified to judge the systemic nature of financial firms. Second, the process for designating nonbanks as SIFIs is not well-defined. In other words, the specific criteria laid out in Dodd-Frank are too vague and therefore gives too much power to regulatory authorities.[94]

With respect to the first point, if it is truly about the qualifications of the FSOC members, then a reasonable suggestion might be to create a systemic risk board that is qualified to make such designations. That said, it is a sad state of affairs if the heads (or chairs) of the various financial regulatory agencies, with all their available staff (and commissioners) expertise, cannot be brought up to speed on the few nonbank firms or activities that fit into the SIFI category. The appropriate question is whether there exist nonbank SIFIs or systemic activities. If there is agreement on this point, then surely an inadequate governance structure of FSOC is not a good reason to repeal SIFI designation. Rather, the governance should be improved to make better decisions.

[94] The general criteria provided by Dodd-Frank is that the material financial distress, failure, or ongoing activities of large, interconnected financial institutions cause risk to the financial stability of the United States. Specific standards laid out are: “(A) the extent of the leverage of the company; (B) the extent and nature of the off-balance sheet exposures of the company; (C) the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies; (D) the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system; (E) the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities; (F) the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse; (G) the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; (H) the degree to which the company is already regulated by 1 or more primary financial regulatory agencies; (I) the amount and nature of the financial assets of the company; (J) the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and (K) any other risk-related factors that the Council deems appropriate.” (HR 4173, Title I, Subtitle A, Sec. 113, “Authority to require supervision and regulation of certain nonbank financial companies.”).

With respect to the second point, and the issue of what it means for nonbanks to be SIFIs and whether these SIFIs can be identified, the right solution is surely not to repeal the designation authority but instead to improve it. If there are possible problems with constitutional or practical implementation of the designation—or with too vague and poorly defined language—then this should be corrected. But the idea that banks can be SIFIs but nonbanks cannot is weak in light of the evidence, particularly based on the last financial crisis.

To this point, consider the last crisis as an example: Compare the Dodd-Frank Act to the CHOICE Act under a hypothetical scenario just prior to the emergence of the financial crisis in 2007. Without SIFI designation of nonbanks, the five large investment banks (Bear Stearns, Lehman Brothers, Goldman Sachs, Merrill Lynch, and Morgan Stanley) were for the most part under the regulation of the SEC. These investment banks engaged in capital market activities not unlike their large commercial bank counterparts, yet were extraordinarily levered and relied on wholesale liquid funding. During the crisis, at some point or another, all of them suffered bank-like runs on their liabilities; and, given their activities, some of the firms reached insolvency.[95] If large banks are considered SIFIs, then it is hard to comprehend why these large investment banks would also not be considered SIFIs. Under the CHOICE Act, these firms would not be SIFIs, and instead regulation would rest with the

[95] In March 2008, Bear Stearns was bought by JP Morgan Chase when it appeared insolvent and was suffering a run on its liabilities. The Fed provided a backstop to JP Morgan Chase for certain asset-backed securities of Bear Stearns. In September 2008, under similar circumstances, Lehman Brothers declared bankruptcy and Merrill Lynch was bought by Bank of America, which shortly after also received guarantees on particular Merrill Lynch holdings. While *ex post,* Goldman Sachs and Morgan Stanley were recognized as clearly solvent, both suffered bank-like runs and came under severe stress following Lehman's failure. Only after government intervention in markets as a whole and the transition of these firms to bank holding companies did the runs, especially on Morgan Stanley, curtail. The transition allowed access to the Federal Reserve's lending facilities, as well as other sources of funding, e.g., deposits.

SEC. Suppose, for example, large bank holding companies, like Goldman Sachs and Morgan Stanley, were to drop their bank status, or boutique investment banks were to accumulate large amounts of assets without future FSOC designation.[96] Would this not increase the likelihood of a financial crisis in magnitude similar to that of 2007-2009?

Of course, the relative systemic risk of large investment banks versus the universal commercial banks is plain to see. What about other nonbank financial institutions? During the recent financial crisis, there were runs on money market funds, collateralized repos, asset-backed commercial paper, and securities lending businesses. All these entities act very much like banks by borrowing in short-term markets, providing deposit-like liquid securities to investors, and investing in less liquid longer-term assets. Moreover, if, and when housing finance reform is enacted, possible counterparts to the Government-Sponsored Enterprises (GSEs)—Fannie Mae and Freddie Mac—might be created. Will these entities not be SIFIs? Finally, as the FSOC designation of SIFIs disappears, and higher capital requirements on banks are put in place, it seems likely that a number of activities will move outside the banking sector to a new (and yet unknown) *de facto* banking sector (sometimes called "shadow banking").[97] Without the possibility of enhanced prudential regulation of large firms that arise in this sector, regulatory capital arbitrage will result, putting the system in greater jeopardy.

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[96] In theory, under Dodd-Frank, Goldman Sachs and Morgan Stanley cannot undo their bank holding company status. But with FSOC's SIFI designation, this change would be moot. Obviously, this point is not true with the elimination of the SIFI designation.

[97] "De facto or shadow" banking is a system of financial institutions that mostly function like banks. These financial institutions borrow short term in rollover debt markets, leverage significantly, and lend and invest in longer-term and illiquid assets.

The authors of the CHOICE Act describe a potential inconsistency or flaw with Dodd-Frank's FSOC designation of SIFIs. They argue that, while the Dodd-Frank Act attempts to constrain leverage and risk-taking of SIFIs through enhanced prudential regulation, it creates moral hazard through a "too-big-to-fail" mantra that in turn encourages leverage and risk-taking.

But the authors of the CHOICE Act have the causality the wrong way. It is precisely because these SIFIs will be treated differently in a financial crisis—either through liquidity support if solvent (i.e., Walter Bagehot's dictum) or special bankruptcy proceedings if insolvent (whether the Orderly Liquidation Authority of Dodd-Frank or a new bankruptcy code for large, complex financial institutions under the CHOICE Act)—that these firms must be subject to enhanced regulation. If market participants recognize that these firms are "special," then excess leverage and risk-taking may take place unless these firms are constrained in the broader financial system. There is no better example than Fannie Mae and Freddie Mac, which were poorly regulated on a prudential basis and yet were repeatedly described as not having access to a government backstop. The financial markets rightly did not believe these claims, and the actions and subsequent failures of these two firms greatly contributed to the debacle of mortgage finance.[98]

The Regulation of Insurance Companies

As described above, three of the four SIFI designations by FSOC have been insurance companies. These designations have been controversial, and MetLife's was rescinded by the courts and is now under appeal. It seems worthwhile therefore to comment generally on the potential systemic risk of insurance companies.[99] Indeed, the

[98] See the book by Acharya, Richardson, Van Nieuwerburgh, and White (2011) for a detailed analysis of this point for the GSEs.
[99] For a detailed discussion and varied views of systemic risk of insurance companies, see Acharya and Richardson (2014), Cummins and Weiss (2014) and Harrington (2014).

authors of the CHOICE Act question the logic of designating financial companies that by and large just “sell insurance.”

In order to regulate and manage systemic risk, one needs to be able to define it. Dodd-Frank’s criteria are that “the material financial distress, failure, or ongoing activities of large, interconnected financial institutions cause risk to the financial stability of the United States.” These criteria highlight an important idea: The core problem is a firm’s difficulty in performing financial services when it fails—i.e., when its capital falls short—and that systemic risk matters only to the extent there is an impact on the broader economy.

Specifically, systemic risk can only arise when there is a breakdown in aggregate financial intermediation that accompanies the firm’s failure. When one financial firm’s capital is low, that firm can no longer perform intermediation services (e.g., obtain funds from depositors or investors and provide financing to other firms or entities). This generally has minimal consequences because other financial firms can fill in for the failed firm. But when capital is low in the aggregate, it is not possible for other financial firms to step into the breach. When investors or depositors question the extent to which a class of financial institutions or the financial system as a whole can absorb losses, access to short-term funding and liquidity dries up, preventing even solvent institutions from taking over the financial intermediation activities of failed firms. Thus, it is this breakdown in aggregate financial intermediation that causes severe consequences for the broader economy.

Acharya, Pedersen, Philippon, and Richardson (2015, 2016) develop a framework to measure systemic risk of financial firms. They incorporate externalities arising from an aggregate capital shortfall, which leads to a reduction in intermediation activity, and from fire sales caused by the degree to which liabilities are liquid and under the threat of potential runs. The question is whether large insurance companies fall into this class of financial firms or are just simply selling insurance.

Historically, with respect to their liability structure, insurance liabilities have been mostly long-term and relatively illiquid. This is quite different from bank liabilities, which are predominantly short-term and withdrawable at will. That said, life insurance premiums are no longer as sticky for modern insurance companies. Paulson, Plestis, Rosen, McMenamin, and Mohey-Deen (2014) provide a detailed analysis of this issue. They provide evidence that approximately 50% of liabilities are in a moderately to highly liquid category, allowing for some type of withdrawal. Projected onto stress scenarios, they estimate that, respectively, 43% or 31% of the life insurance industry's liabilities are subject to withdrawals in an extreme or moderate stress environment. This is important because life insurance companies are prominent investors in commercial mortgage-backed securities and corporate bonds, both of which are susceptible to fire sales. Indeed, the evidence supports this being a potential problem in the life insurance sector.[100]

In terms of understanding the risk of insurance companies, it is important to distinguish idiosyncratic risks that are unique to the insurance sector, such as property, health, and life risks, and aggregate financial risks coming from modern insurance products (such as variable annuities) and investments in assets that create an aggregate risk mismatch between assets and liabilities. This latter risk can expose the insurance sector to common shocks, even if insurance companies are not directly connected to each other.

For example, some large life insurers aggressively wrote investment-oriented life insurance policies with minimum guarantees and other contract features that exposed them to equity and other asset markets. These policies expose the insurers

[100] See Becker and Opp (2014), Ellul, Jotikasthira, and Lundblad (2011, 2016), and Ellul, Jotikasthira, Lundblad, and Wang (2015).

to potentially large losses when markets decline. Other insurers have deviated from the traditional insurance business model by providing so-called insurance or similar financial products, protecting against loss due to macroeconomic events and other nondiversifiable risks. For example, in the years leading up to the financial crisis, the monoline insurers and AIG wrote financial guarantees on structured financial products tied to subprime mortgages. If these risks materialize (and the risks by nature are more likely to do so during a financial and economic crisis), then insurance companies collectively will suffer investment losses. For example, the credit default swap (CDS) premiums—the cost of buying protection against default of senior, subordinated bonds—of large life insurance companies, among others, rose well above 500 basis points in the fall of 2008 after Lehman's collapse.

More broadly, the line between insurance companies and other financial services companies has become blurred over time. New tools that insurance companies use to manage their capital—securities lending, new reinsurance schemes between affiliated companies ("shadow insurance"), and derivatives—have been developed. Koijen and Yogo (2016b) measure the trends in these activities from 2002 to 2014 in the U.S. and use the financial crisis as a case study to quantify the risks. One example is detailed in Koijen and Yogo (2016a) and is reminiscent of the special purpose vehicles of large complex banks during the financial crisis.[101]

As a final comment, because the insurance sector can perform poorly in systemic states—that is, when other parts of the financial

[101]Koijen and Yogo (2016a) show that some of the larger life insurance companies are now using reinsurance to move liabilities from operating companies that sell policies to less regulated (i.e., less capitalized) "shadow insurers" in regulation-friendly U.S. states (e.g., South Carolina and Vermont) and offshore locales (e.g., Bermuda and the Cayman Islands). Since the liabilities stay within the insurer's holding company, there is not the usual risk transfer between the insurer and reinsurer. The authors show that this type of regulatory arbitrage has grown from $10 billion to $363 billion over the past decade, and, when accounted for, expected losses are almost $16 billion higher in the industry.

sector are struggling—and because the insurance sector is an important part of the economy-wide financial intermediation process, it follows that significant capital shortfalls of the insurance sector contribute to systemic risk. The source for an aggregate capital shortfall can take many forms, including exposure to common aggregate shocks, interconnectedness, fire sales and bank-like "runs" on liabilities. As described earlier, the emergence of systemic risk means that financial firms will no longer be able to provide intermediation, causing knock-on effects to households and businesses. As an important source for financing (i.e., corporate bonds and commercial mortgages), disintermediation of the insurance sector can have important consequences.[102] Moreover, households may reduce their demand for insurance if they experience losses when an insurance company fails. This additional exposure to idiosyncratic risk can lead to significant welfare costs.

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