FIXING WHAT ISN'T BROKEN: WHY THE FEDERAL RESERVE'S POTENTIAL APPLICATION OF BANKING STANDARDS ON "SYSTEMICALLY SIGNIFICANT" INSURERS IS AN UNJUSTIFIED INCURSION THAT MAY NEGATIVELY IMPACT ECONOMIC STABILITY*

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I. INTRODUCTION

In the summer of 2012, Rep. Scott Garrett, a senior member of the House Financial Services Committee, asked then Treasury Secretary Timothy Geithner during a Congressional hearing why the federal government should "spread the problems from the banking sector" to the insurance industry.[1] Rep. Garrett's concern was prompted by recent legislation empowering the federal government to place large insurance companies within the purview of the Federal Reserve, thereby potentially subjecting insurers to bank-centric regulations.[2]

Signed into law in July of 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) creates the Financial Stability Oversight Council (FSOC): a collaborative body of federal and state financial regulators.[3] Because an insurer, American International Group (AIG), played a central role in the 2008 economic collapse, Dodd-Frank gave FSOC the power to subject an insurer (or other nonbank company) to supervision by the Federal

* The opinions and views expressed herein are solely those of the author's, and do not necessarily reflect the views of the Office of the Kansas Securities Commissioner, its employees, nor the State of Kansas.

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1. Arthur D. Postal, *Bill to Be Introduced Exempting Insurers from SIFI Designation*, LIFEHEALTHPRO (Aug. 1, 2012), http://www.lifehealthpro.com/2012/08/01/bill-to-be-introduced-exempting-insurers-from-sifi.

2. *Id.; see* 12 U.S.C.A. §§ 5321-22 (West 2010).

3. 12 U.S.C.A. §§ 5321-22 (West 2010); *see also Financial Stability Oversight Council*, U.S. DEP'T OF THE TREASURY (Oct. 24, 2012, 4:13 PM), http://www.treasury.gov/initiatives /fsoc/about /Pages/default.aspx.

Reserve if FSOC determines that such a firm's potential failure could pose a threat to the nation's financial stability.[4] Thus, if FSOC determines an insurer is "systemically significant," the insurer would be financially regulated by the Federal Reserve and, as such, potentially held to the same capital and accounting standards as banks;[5] a scenario worrying insurers, state regulators, and some federal legislators.[6]

Dodd-Frank served as a widespread overhaul of perceived regulatory weaknesses that Congress believed contributed to the 2008 economic crisis, affecting all participants in financial markets including the insurance industry.[7] However, the downfall of corporate giant AIG that blew over the house of cards supporting the American financial sector had nothing to do with state-regulated insurance transactions.[8] As such, Dodd-Frank's authorization of FSOC to subject insurers to new regulations when it deems one "systemically significant" is an unwarranted intrusion by the federal government into an area traditionally regulated solely by the states.[9] Moreover, by regulating insurers as bank-like entities, the Federal Reserve replaces regulations specifically tailored to ensure insurer solvency with rules only designed for keeping banks afloat — thus implementing measures that could help cause, rather than prevent, another financial disaster.[10] Although the Federal Reserve has recently shown a desire to specially tailor capital standards to insurers,[11] still more effective courses of action for the federal government would be passing legislation permanently exempting insurers from bank-centric capital requirements and instead monitoring only those non insurance-related activities and transactions that contribute to systemic risk.

II. AN OVERVIEW OF AMERICAN INSURANCE REGULATION

Unlike banking and the securities markets, the insurance industry is unique within the financial sector as its sole regulators are state governments.

4. 12 U.S.C.A. § 5323 (West 2010).

5. Elizabeth D. Festa, *The Implications of Federal Regulation: How Will This All Play Out?*, LIFEHEALTHPRO (Aug. 14, 2012), http://www.lifehealthpro.com/2012/08/14/the-implications-of-federal-regulation.

6. Elizabeth Festa, *Senators Join Industry in Calling on Regulators to Avoid Bank-Centric Rules for Insurers*, PROP. CAS. 360 (Oct. 18, 2012), http://www.propertycasualty360.com/2012/10/18/senators-join-industry-in-calling-on-regulators-to.

7. *See generally* Scott E. Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation,* NAT'L ASS'N OF MUT. INS. COS., Sept. 2009, http://www.naic.org/documents/topics_white_paper_namic.pdf.

8. *Id.* at 28-29.

9. Frank A. Mayer, III, Deborah F. Cohen & David W. Freese, *The Dodd-Frank Act and the Insurance Industry*, PEPPER HAMILTON, LLP (Mar. 10, 2011), http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2036.

10. Arthur D. Postal, *Insurer Thrifts to be Subject to Bank Rules*, LIFEHEALTHPRO (Aug. 10, 2012), http://www.lifehealthpro.com/2012/08/10/insurer-thrifts-to-be-subject-to-bank-rules.

11. Elizabeth Festa, *Bernanke Comments on Collins Amendment*, LIFEHEALTHPRO (July 17, 2013), http://www.lifehealthpro.com/2013/07/17/bernanke-comments-on-collins-amendment?t=regulatory&page=2.

State insurance commissioners promote equitable business practices amongst insurance companies while seeing that insurers will be able to meet their financial demands. To reach these goals, regulators often collaborate resources so as to more effectively protect consumers.

A. The Development of Modern-Day Insurance Regulation

Despite qualifying as "interstate commerce" under Article I of the Constitution,[12] Congress specifically exempted the business of insurance from federal supervision by passing the McCarran-Ferguson Act in 1945.[13] McCarran-Ferguson preserved the regulatory status quo by giving supremacy to states to the extent they chose to regulate the "business of insurance."[14] McCarran-Ferguson nonetheless also preserved the federal government's ability to regulate insurance if Congress passes a statute "specifically relat[ing] to the business of insurance."[15] Thus, states enjoy primacy in regulating the insurance industry until Congress chooses to intervene by enacting a law that "specifically relates" to the business of insurance.[16]

Although McCarran-Ferguson does not define "the business of insurance,"[17] many states have enacted similar legislation defining the term.[18] These only-slightly varying definitions of insurance can be summarized as "the pooling of fortuitous losses through transfer of risk to insurers who agree to indemnify insureds for such losses"[19] in exchange for premiums. Additionally, courts have imposed the requirement that the insured has an "insurable interest" in the underlying property.[20] Insurable interest is the principle that the insured must suffer some sort of loss or harm if the covered event occurs.[21] The insurable interest requirement thus deters moral hazard by preventing an insured from deliberately allowing a covered event to take place so as to gain from the insurance payout, rather than merely be reimbursed.[22]

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12. United States v. South-Eastern Underwriters Ass'n*,* 322 U.S. 533 (1944) (holding that insurance transactions were subject to federal regulation under the Commerce Clause).

13. 15 U.S.C. §§ 1011-15 (2012).

14. ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW 69 (4th ed. 2007).

15. 15 U.S.C. § 1012 (2012).

16. JERRY & RICHMOND, *supra* note 14, at 26.

17. *Id.* at 72.

18. *See, e.g.*, ARIZ. REV. STAT. ANN. § 20-103 (2007); CAL. INS. CODE § 22 (West 2006); FLA. STAT. ANN. § 624.02 (West 2006); KY. REV. STAT. ANN. § 304.1-030 (West 2006); N.D. CENT. CODE § 26.1-29-01 (2005); W. VA. CODE § 33-1-1 (2005).

19. ROBERT W. KLEIN, A REGULATOR'S INTRODUCTION TO THE INSURANCE INDUSTRY 229 (2d ed. 2007); *see also* ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES, AND COMMERCIAL PRACTICES 3 (Student ed., 1988) ("Insurance is generally understood to be an arrangement for transferring and distributing risks.").

20*.* *See generally* JERRY & RICHMOND, *supra* note 14, at 273-316.

21. KLEIN, *supra* note 19, at 14; *see also* JERRY & RICHMOND, *supra* note 14, at 274-75 (providing examples of comparable jurisdictional definitions of "insurable interest").

22. KLEIN, *supra* note 19, at 14; JERRY & RICHMOND, *supra* note 14, at 277.

B. The Current Framework of State-Based Insurance Regulation

1. Regulatory Objectives and Practices

Under the state-based system of insurance regulation, insurance commissioners are free to tailor regulations according to local social and economic conditions, thereby more adequately protecting regional consumers.[23] State insurance departments keep insurers accountable to their constituents by ensuring that insurers do not incur excessive insolvency risk or refuse to pay out claims.[24] Commissioners accomplish these goals primarily by monitoring insurer market practices and financial obligations.[25]

Market regulation aims to promote fair and reasonable insurance prices, products, and trade practices in order to protect consumers.[26] Financial regulation, on the other hand, provides a safeguard for insurance beneficiaries by ensuring that insurers will be able to meet financial obligations.[27] When a regulatory examination reveals that an insurer is insolvent, a state insurance department will either take control of the company or will pay out claims from guaranty funds.[28] However, for market regulation and financial regulation to operate effectively, they must be appropriately coordinated as they are inextricably linked; market regulation affects insurers' financial performance whereas financial regulation determines the prices and products insurers can reasonably offer.[29]

2. The National Association of Insurance Commissioners

Effectively coordinating the regulation of multistate companies' market and financial practices is challenging for individual states.[30] The National Association of Insurance Commissioners (NAIC), however, aims to facilitate this process by serving as a vehicle by which state commissioners can regulate collectively by drafting model laws and regulations.[31] By providing analytical information of insurers' financial conditions and market conduct, the NAIC serves as a resource for commissioners so that they may efficiently regulate interstate insurers.[32] Further, the NAIC's accreditation process encourages

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23. JERRY & RICHMOND, *supra* note 14, at 103.

24. KLEIN, *supra* note 19, at 119; JERRY & RICHMOND, *supra* note 14, at 91.

25. KLEIN, *supra* note 19, at 122; JERRY & RICHMOND, *supra* note 14, at 91.

26. NAT'L ASS'N OF INS. COMM'RS, *State Insurance Regulation: History, Purpose and Structure*, http://www.naic.org/documents/consumer_state_reg_brief.pdf; *see also* JERRY & RICHMOND, *supra* note 14, at 91-95 (tracing the history of rate regulation and describing various rate-making methods used by states); JERRY & RICHMOND, *supra* note 14, at 96-99 (detailing state regulatory role in combating unfair insurance practices).

27. NAT'L ASS'N OF INS. COMM'RS, *supra* note 26; JERRY & RICHMOND, *supra* note 14, at 95-96 (describing methods of detecting and preventing insurer insolvency).

28. NAT'L ASS'N OF INS. COMM'RS, *supra* note 26; JERRY & RICHMOND, *supra* note 14, at 95-96.

29. KLEIN, *supra* note 19, at 122; JERRY & RICHMOND, *supra* note 14, at 91.

30. KLEIN, *supra* note 19, at 130; *see* JERRY & RICHMOND, *supra* note 14, at 105-06 (describing some of the "cons" of the state-based regulatory framework).

31. KLEIN, *supra* note 19, at 131; JERRY & RICHMOND, *supra* note 14, at 104-05.

32. *Id.*

states to enact core sets of NAIC model solvency regulations and to maintain minimum standards of solvency regulation.[33] Thus, with its pooling of resources, the NAIC serves as an important player in insurance regulation as it helps standardize regulation while maintaining the states' individual freedoms to adjust oversight policies to meet their specific needs.[34]

III. AN OVERVIEW OF THE 2008 FINANCIAL COLLAPSE

While the names "AIG" and "Lehman Brothers" are frequently associated with the infamous 2008 financial crisis, the causes of the recession that would plague markets for years to come are multifarious and far-reaching. Financial deregulation and overly generous lending practices helped create a housing bubble that attracted Wall Street's interests. Major financial institutions such as AIG eagerly wrote makeshift insurance policies that would pay out in the "unlikely"[35] event that an underlying mortgage-backed security went into default, all the while reaping profits. However, when the housing market came to a standstill, AIG's overpromising of Credit Default Swap protection would cause the corporate giant's implosion.

A. Primary Economic Causes of the Collapse

Although the complex causes of the 2008 financial crisis will be studied and debated for decades, deregulation exploited by Wall Street "corporate greed" appears to be a primary cause for the collapse.[36] 1999's Gramm-Leach-Bliley Act[37] knocked down longstanding barriers that had prevented commercial and investment banks, securities firms, and insurance companies from consolidating.[38] Thus, insurers like AIG could enter into other financial markets by, for instance, buying small savings and thrifts.[39]

As a result of acquiring thrifts, giant conglomerates such as AIG were able to enjoy the lessened regulatory constraints of the ill-equipped Office of Thrift Supervision (OTS).[40] Additionally, the Commodity Futures Modernization Act's (CFMA) exemption of credit default swaps (CDSs) from the oversight of the Securities Exchange Commission, Commodity Futures Trading Commission, and state insurance commissions left these products largely unsupervised, and in turn prompting an uptick in CDS activity amongst

33. JERRY & RICHMOND, *supra* note 14, at 104.

34. KLEIN, *supra* note 19, at 131; JERRY & RICHMOND, *supra* note 14, at 104-05.

35. *See* William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 957 (Summer 2009) (referencing an AIG executive's assumption that CDSs would never cost AIG).

36. Harrington, *supra* note 7, at 6.

37. 15 U.S.C.A. §§ 6801-09 (West 2012).

38. *See* R. Rex Chatterjee, *Dictionaries Fail: The Volcker Rule's Reliance on Definitions Renders It Ineffective and a New Solution is Needed to Adequately Regulate Proprietary Trading*, 8 BYU INT'L L. & MGMT. REV. 33, 36-38 (2011) (describing how the Glass-Steagall Act of 1933 banned proprietary trading and was later effectively repealed by Gramm-Leach-Bliley).

39. Jeff Gerth, *Was AIG Watchdog Not Up to the Job?*, PROPUBLICA (Nov. 10, 2008), http://www.propublica.org/article/was-aig-watchdog-not-up-to-the-job.

40. *Id.*; Harrington, *supra* note 7, at 14-16.

AIG and investment banks.[41]

Liberalized lending practices in residential mortgages and real estate also contributed to the financial collapse.[42] During the early 2000s, federal initiatives to expand Fannie Mae and Freddie Mac's mortgage lending, pressure from the Department of Housing and Urban Development and the longstanding Community Reinvestment Act, along with The Federal Reserve's decision to keep interest rates at historical lows were all factors that encouraged commercial banks and savings associations to overextend credit to low-and moderate-income homebuyers.[43] Some savings institutions even went so far as to lend with no money down and interest payments deferred upon request to homebuyers with bad credit or no proof of income.[44] In one illustrative episode, a non-English speaking migrant strawberry picker with an income of $14,000 was lent $724,000 to buy a house in Bakersfield, California.[45] Thus, deregulation, low mortgage rates, and liberalized lending standards combined with Wall Street's "irrational exuberance" of the housing market's strength all contributed to the creation of a housing bubble.[46] However, before the bubble burst, firms would capitalize on this rise in subprime and Alt-A mortgage lending by accelerating the growth in mortgage-backed securities and CDSs.[47]

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41. Barry Ritholtz, *Credit Default Swaps Are Insurance Products. It's Time We Regulated Them as Such*, WASH. POST, Mar. 10, 2012, *available at* http://www.washingtonpost.com/business/credit-default-swaps-are-insurance-products-its-time-we-regulated-them-as-such/2012/03/05/gIQAAUo83R_story.html; Harrington, *supra* note 7, at 9-10.

42. *Id.*; *see generally* THE FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT, January 2011, *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf (identifying collapsing mortgage-lending standards and the mortgage securitization as primary causes of the financial crisis); *see generally* MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010) (providing an overview of the relationships between liberalized lending practices, the mortgage market, CDSs, and the subsequent financial collapse).

43. Harrington, *supra* note 7, at 6; Ezra Klein, *Bill Clinton and the Housing Bubble*, WASH. POST, May 28, 2009, http://voices.washingtonpost.com/ezra-klein/2009/05/bill_clinton_and_the_housing_b.html; Jeff Holt, *A Summary of the Primary Causes of the Housing Bubble and the Resulting Credit Crisis: A Non-Technical Paper*, 8 J. OF BUS. INQUIRY, 120, 120-29 (2009).

44. LEWIS, *supra* note 42, at 97.

45. *Id.*

46. Holt, *supra* note 43, at 125.

47. Harrington, *supra* note 7, at 6-7; *see generally* Radjeep Senguta, *Alt-A: The Forgotten Segment of the Mortgage Market,* Federal Reserve Bank of St. Louis *Review,* January/February 2010, *92*(1), pp. 55-71, at 56 (distinguishing Alt-A from Subprime Mortgages: "Typically, Alt-A mortgages are underwritten to borrowers of good credit quality […] However, Alt-A borrowers do not satisfy the underwriting rules for prime loans because they are unwilling or unable to provide full documentation on their mortgage application [generally regarding their income]. Subprime originations are primarily to borrowers with incomplete or impaired credit histories. Therefore […] credit quality for Alt-A pools is characteristically better than that for subprime pools"); *but c.f.* LEWIS, *supra* note 42, at 127, ("Alt-A was just what [Deutsche Bank] called crappy mortgage loans for which they hadn't even bothered to acquire the proper documents – to verify the borrower's income. [S]ay, 'A' was the designation attached to the most creditworthy borrowers; Alt-A [meant] an alternative to the most creditworthy…").

B. Credit Default Swaps

While relatively unknown to the general public before the late 2000s,[48] CDSs served as one of the primary investment vehicles used by major firms to bring about the financial collapse.[49] Although state insurance departments do not regulate CDSs, a CDS is nonetheless comparable to an insurance policy.[50] One party, in exchange for a fee, agrees to indemnify another party if a specified "credit event" (such as bankruptcy or failure to pay) occurs with respect to a company or a debt obligation, thereby transferring risk.[51] However, unlike regulated insurance transactions, investment banks buying "protection" in a CDS did not have insurable interests in the underlying securities, thus allowing the banks only to gain — rather than be indemnified — in case of a default.[52] Moreover, apart from CDSs inviting obvious moral hazard from investment banks, the CFMA's essential deregulation the entire derivatives market from the purview of state and federal regulators made CDSs only more volatile.[53]

During the 2008 financial crisis, residential mortgage bonds served, in a nutshell, as the underlying securities which major investment firms predicated CDSs upon.[54] The securitization process that turns a mortgage into a security begins with a mortgage lender selling the loan to an institution called an arranger or issuer who in turn sells multiple loans to a newly formed special purpose vehicle.[55] The special purpose vehicle is able to buy the loans from the arranger by selling investors debt obligations representing claims to the cash flow from the pool of residential mortgage loans.[56] Investors may seek credit protection in the event of a default on cash flows from these mortgage-backed securities, often in the form of a CDS.[57]

With the housing market bubbling, firms such Lehman Brothers and AIG,

48. Sjostrom, *supra* note 35, at 943, 945.

49. *Id.*; Ritholtz, *supra* note 41.

50. Harrington, *supra* note 7, at 9 (noting that existing insurance regulation prohibits insurers from writing CDSs).

51. Harrington, *supra* note 7, at 9; *see* Sjostrom, *supra* note 35, at 947-48 (providing examples of CDSs).

52. Harrington, *supra* note 7, at 9; *see* Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. CIN. L. REV. 1019, 1034–35 (2007) ("with a short position […] a lender that has purchased credit default swap [on a company] may have an incentive to use its position as a lender to affirmatively destroy value [because it] will benefit more if the company defaults than if it successfully averts default"); *see also* LEWIS, *supra* note 42, at 29-30, 53, 65-66 (generally describing how subprime mortgage bond traders sought to profit from CDS "insurance on bonds [they] had handpicked to explode").

53. Ritholtz, *supra* note 41.

54. *See* Harrington, *supra* note 7, at 7; Sjostrom, *supra* note 35, at 947-61.

55. Sjostrom, *supra* note 35, at 953; *see also* CURTIS J. BERGER, QUINTIN JOHNSTONE, & MARSHALL TRACHT, LAND TRANSFER & FINANCE: CASES AND MATERIALS 99 & n.5 (6th ed. 2011) (describing the securitization process).

56. Sjostrom, *supra* note 35, at 953.

57. *Id.* at 955.

the largest insurance company in the United States,[58] seized upon the opportunity to cash in. Wall Street wrote trillions of dollars on over-the-counter CDSs that offered investing banks and financial institutions relatively low-cost protection against reductions in values of securities comprised of subprime residential mortgages.[59] In the mid-2000s, the idea of home prices falling was unforeseeable for interested parties capitalizing off of the subprime lending business, given that home prices had not fallen nationwide in any single year since the Great Depression.[60] Indeed, as one AIG executive put it, writing CDSs on mortgage-backed securities was like "gold" and "free money," as Wall Street assumed that the underlying securities would never go into default while it pocketed premiums.[61] However, this assumption was severely misguided.

C. The Housing Bubble Bursts

By the second quarter of 2006, the housing bubble had burst, with home prices beginning to fall and foreclosures on the rise.[62] Homeowners with adjustable rate mortgages were unable to refinance their homes because decreasing home prices coupled with rising rates made monthly payments harder to make.[63] To add insult to injury, the declining home market produced a domino effect, rippling through the economy. The rise in foreclosures added to the number of vacant homes, thereby decreasing home prices across the market and, in a vicious cycle, only adding to the number of foreclosures.[64] Moreover, increasing foreclosures drastically decreased the value of the trillions of dollars worth of mortgage-backed securities owned by investment banks.[65] These widespread defaults by subprime borrowers would prompt massive write-downs on AIG's ill-funded CDSs, ultimately causing the conglomerate's near implosion.[66]

To put it simply, the CDSs sold by AIG subsidiary AIG Financial Products (AIGFP) and other firms were not backed by enough capital in case

58. *Id.* at 944.

59. *Id.* at 950 (noting that the CDS market has increased approximately 540% between 2001 to 2008, with a $918.9 billion national amount to $54.6 trillion in seven years); Harrington, *supra* note 7, at 7.

60. Holt, *supra* note 43, at 126; *see also* BERGER ET AL., *supra* note 55, at 104 (explaining that lending institutions made vast numbers of mortgage loans to low- and moderate-income home buyers because many loan originators were assuming little risk as the loans would be sold to securitizers. The terms of the loans were so favorable to lenders that they could retain them as investments while they mistakenly assumed that mortgaged home prices would continue to rise, thereby reducing the risk of mortgagor default).

61. Sjostrom, *supra* note 35, at 957.

62. Holt, *supra* note 43, at 126.

63. *Id.* at 127.

64. *Id.*

65. *Id.*

66. *See* Sjostrom, *supra* note 35, at 959-60 (describing the causes behind AIG's near collapse attributable to AIG's CDS exposure and large scale subprime mortgage defaults).

of a catastrophic hit.[67] When AIGFP could not satisfy claims filed by buyers of CDSs, AIG, pursuant to contract, assumed "all present and future payment obligations and liabilities of AIGFP arising transactions entered into by AIGFP."[68] It would thus be AIGFP's over-promising of CDS coverage that would take down the massive AIG corporate umbrella.

Later analysis of AIG's portfolio would reveal that AIG's CDSs were severely underpriced given the risk these contracts were assuming.[69] Furthermore, as mortgage-backed securities plummeted in value, AIG suffered from a lack of available cash since the company was obligated to post increasing amounts of cash collateral to reduce counterparty credit risk assumed by a CDS protection buyer.[70] AIG's collateral offered, on account of the write-downs, totaled $6 billion in the summer of 2008, or about a third of AIG's available cash.[71] Furthermore, AIG only worsened its illiquidity by loaning securities from the investment portfolios of AIG's insurance companies to various financial institutions in exchange for collateral.[72] When borrowers learned about AIG's massive CDS write-downs and increasing collateral posting obligations, many decided to return lent securities and get their collateral back.[73] Furthermore, AIG's investment arm had billions invested in mortgage-backed securities, which had plummeted in value and liquidity.[74] As a result of a lack of funds to satisfy collateral-return obligations, AIG was forced to transfer billions from other portfolios to satisfy borrowers.[75] In a final blow, credit rating agencies, watching AIG's implosion, were forced to significantly downgrade AIG's credit rating on September 15, 2008, triggering $20 billion of more collateral calls by borrowers.[76] The federal government stepped in the next day with a $182 billion dollar bailout to rescue AIG before bankruptcy due the corporate giant's inability to meet margin calls on what amounted to $2.77 *trillion* in CDSs.[77] Firms such as Lehman Brothers, on the other hand, were not as fortunate.[78]

67. *See* Harrington, *supra* note 7, at 8-12 (detailing financial statistics of AIG's portfolio).

68. Sjostrom, *supra* note 35, at 951.

69. Harrington, *supra* note 7, at 10.

70. Sjostrom, *supra* note 35, at 960; *see also* THE GENEVA ASS'N, SYSTEMIC RISK IN INSURANCE: AN ANALYSIS OF INSURANCE AND FINANCIAL STABILITY 55–57 (2010) [hereinafter SYSTEMIC RISK IN INSURANCE] (describing AIG's liquidity crunch), *available at* http://www.genevaassociation.org/PDF/BookandMonographs/Geneva_Association_Systemic_Risk_in_Insurance_Report_March2010.pdf.

71. John Patrick Hunt, *Rating Dependent Regulation of Insurance*, 17 CONN. INS. L.J. 101, 134 (Fall 2010).

72. Sjostrom, *supra* note 35, at 961.

73. *Id.*

74. *Id.*

75. *Id.* at 962.

76. *Id.*; Hunt, *supra* note 71, at 134; SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 17.

77. Arthur D. Postal, *Industry Officials Warn of 'Armageddon' if Bank-Centric Rules Applies to Insurers*, PROP. CAS. 360 (Oct. 23, 2012), http://www.propertycasualty360.com/2012/10/23/industry-officials-warn-of-armageddon-if-bank-cent.

78. Press Release, Lehman Bros., Lehman Bros. Holdings, Inc. Announces It Intends to File Chapter 11 Bankr. Petition, (Sept. 18, 2008) http://www.lehman.com/press/pdf_2008/091508_

IV. DODD-FRANK'S ESTABLISHMENT OF THE FEDERAL STABILITY OVERSIGHT COUNCIL

Perhaps the most conspicuous cause of 2008's collapse was the ability of large financial conglomerates to seize upon rifts in regulatory supervision. Accordingly, legislators sought to seal off such oversights by granting regulators increased supervision over companies with pervasive economic influence.[79] Once identified as possibly "pos[ing] risks to the financial stability of the United States," recent legislation[80] empowers the Federal Reserve to subject such firms to minimum capital requirements — regardless as to whether the regulated entity is a bank. This designation may therefore have major ramifications for the insurance industry, as state governments no longer solely regulate some large insurers.

A. Objectives of the Financial Stability Oversight Council

In direct response to the financial meltdown, Congress passed The Dodd-Frank Wall Street Reform and Consumer Protection Act.[81] Despite the state-regulated insurance industry not contributing to the financial crisis, Congress nonetheless started analyzing a federal role in insurance regulation through Dodd-Frank after the operations of insurance companies and banks had become increasingly intertwined.[82]

Stemming from the belief that the economy's financial regulatory authorities were unable to foresee the financial collapse due to a lack of effective communication, Dodd-Frank created FSOC to align regulators.[83] Chaired by the Treasury Secretary, FSOC is comprised of fifteen federal and state financial regulatory heads, ten of which have voting powers.[84] Congress assigned FSOC the threefold task of: (1) identifying risks to the nation's financial stability that interconnected banks or nonbank financial companies could present from their failure or ongoing activities; (2) promoting market

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79. *See* 12 U.S.C.A. § 5322 (West 2010) (legislation mandating FSOC to identify material gaps in financial regulation and requiring the Federal Reserve to supervise nonbank entities that pose a risk to the United States' financial stability).

80. 12 U.S.C.A. § 5322(a)(2)(H) (West 2010).

81. H.R. 4173, 111th Cong. (2010).

82. B. SCOTT BURTON, THE IMPACT OF DODD-FRANK AND OTHER GOVERNMENT INITIATIVES ON THE PRACTICE OF INSURANCE LAW IN 2011 AND BEYOND *2 (Aspatore 2011) 2011 WL 601375.

83. 12 U.S.C.A. § 5321 (West 2010); Mayer et al., *supra* note 9.

84. Mayer et al., *supra* note 9 (specifically, voting members include the Treasury Secretary and the heads of the Federal Reserve Board, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission, the Commodity Futures Trading Commission, the Federal Housing Finance Agency, the National Credit Union Association, the Bureau of Consumer Financial Protection, and an insurance industry expert appointed by the President. Non-voting members include the director of the Office of Financial Research, a state banking commissioner, a state securities commissioner, and, of importance to the insurance industry, a state insurance commissioner and the director of the Federal Insurance Office).

discipline by eliminating public expectations that the Government will protect interested parties from losses in the event of corporate failure; and (3) responding to emerging threats to the stability of the financial system.[85] To accomplish these goals, Congress charged FSOC to identify material gaps in financial regulation and require supervision by the Federal Reserve Board (which took some regulatory duties previously held by the Office of Thrift Supervision)[86] over nonbank financial companies operating thrifts that may pose risks to U.S. financial stability in the event of their material financial distress or failure.[87]

Unlike banks, which originally sought to facilitate commerce, thrifts came to prominence during the nineteenth century with the aim of helping individuals with modest incomes save enough money to buy a home.[88] Otherwise known as "savings and loan institutions," thrifts served the working class rather than shareholders, and as such depositors themselves owned the thrift.[89] However, after the passage of Gramm-Leach-Bliley and other legislation, the lines between banks and thrifts blurred, with thrifts being able to offer consumer loans, checking accounts, and stock, while banks originate large proportions of home mortgages.[90] Indeed, thrifts and banks soon shared comparable capital standards and other regulations.[91] Dodd-Frank further extended this increasingly similar regulatory framework for depository institutions with the Collins Amendment (Section 171): a mandate requiring the Federal Reserve to apply minimum leverage and risk-based capital requirements to insured depository institutions, bank and thrift holding companies, and systemically important nonbank financial companies.[92]

To assist FSOC in meeting these goals of effectively monitoring developments in financial services markets, Dodd-Frank established an Office of Financial Research.[93] Dodd-Frank empowers the Office of Financial

85. 12 U.S.C.A. § 5322(a)(1) (West 2010).

86. Arthur D. Postal, *AIG on the Verge of Federal Regulation*, LIFEHEALTHPRO (Sept. 20, 2012), http://www.lifehealthpro.com/2012/09/10/aig-on-the-verge-of-federal-regulation; Festa, *supra* note 5; *see also* OFFICES OF THE INSPECTOR GENERAL, STATUS OF THE TRANSFER OF OFFICE OF THRIFT SUPERVISION FUNCTIONS (March 27, 2013), *available at* http://www.federalreserve.gov/oig/files/FRB_OTS_transfer_status_March2013.pdf (describing the division of former OTS responsibilities amongst the Federal Reserve, FDIC, and Office of Comptroller of the Currency).

87. 12 U.S.C.A. § 5322(a)(2)(G),(H) (West 2010).

88. RICHARD SCOTT CARNELL, JONATHAN R. MACEY, & GEOFFREY P. MILLER, THE LAW OF BANKING AND FINANCIAL INSTITUTIONS 12 (4th ed. 2009).

89. *Id.*

90. *Id.* at 27-28.

91. *Id.* at 28.

92. Davis Polk, DAVIS POLK & WARDWELL, LLP, *Collins Amendment – Minimum Capital and Risk-Based Capital Requirements* (June 28, 2010), http://www.davispolk.com/sites/default/files/files/Publication/b051fc39-71f8-4b4c-9fdb-9b6934f4c2d9/Preview/PublicationAttachment/07baf8e6-3c02-424a-afeb-9e3636532e10/062810_collins_summary.pdf.

93. Leah Campbell, WILLKIE FARR & GALLAGHER, LLP, *Insurance Industry Implications of the Dodd-Frank Act* (Aug. 26, 2010), http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C3483%5CInsurance-Industry-Implications-of-Dodd-Frank-Act.pdf.

Research to collect information from financial companies and state regulators for the purpose of measuring risk.[94] Using this information, FSOC may recommend that primary regulators apply new or heightened standards for certain financial activities that threaten market stability.[95] Dodd-Frank requires that the primary regulator impose FSOC's recommendations, or substantially similar ones, or explain in writing why the agency chose not to follow FSOC's changes.[96]

B. How FSOC May Affect Insurers

However, the most pertinent effect that FSOC's actions will have on the insurance industry is its ability to require Federal Reserve supervision of certain "Nonbank Financial Companies."[97] Where a nonbank financial company's potential financial distress or failure would threaten the United States' economic stability, FSOC, by a two-thirds vote including an affirmative vote by the Treasury Secretary, may subject the company to Federal Reserve supervision and enhance prudential standards.[98] In other words, where FSOC labels an entity operating thrift a "systemically important financial institution," the Federal Reserve could largely regulate insurers as a bank, thereby subjecting them to banking capital standards.[99]

FSOC has set forth specific criteria it will consider before labeling a nonbank financial institution "systemically significant" thus meriting Federal Reserve board monitoring.[100] FSOC will consider a company's size, lack of substitutes for the financial services and products the company provides, interconnectedness with other firms, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny.[101] Thus, when a company becomes so economically significant due to financial interdependency with other firms that its failure would spillover into the larger economy, FSOC will place the firm under the Federal Reserve's regulatory jurisdiction.[102] Indeed,

94. *Id.*

95. 12 U.S.C.A. § 5322(d)(3)(A), (B) (West 2010); *see also* Campbell, *supra* note 93.

96. 12 U.S.C.A. § 5322(a)(2)(I), (K) (West 2010); *see also* Campbell, *supra* note 93.

97. 12 U.S.C.A. § 5323(a)(2)(H) (West 2010).

98. *See* Campbell, *supra* note 93, at 2; Mayer et al., *supra* note 9; *see generally*, Gerald P. Dwyer, *What is Systemic Risk, Anyway?*, FED. RESERVE BANK OF ATLANTA (Nov. 6, 2009) http://macroblog.typepad.com/macroblog/2009/11/what-is-systemic-risk-anyway.html.

99. Festa, *supra* note 5; Postal, *supra* note 10.

100. Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4,555, 4,560 (proposed Jan. 26, 2011) (to be codified at 12 C.F.R. pt. 1310).

101. *Id.*; *see also* Arthur D. Postal, *What Does it Mean to be SIFI?*, LIFEHEALTHPRO (Oct. 12, 2011), http://www.lifehealthpro.com/2011/10/12/what-does-it-mean-to-be-sifi?page=2 (reporting that FSOC will consider firms for potential federal supervision that have $50 billion or more in total consolidated assets and meets or exceeds any of the following: the firm has $30 billion in gross notional CDSs outstanding, $3.5 billion in derivative liabilities, $20 billion of outstanding loans borrowed and bonds issued, 15-to-1 leverage as measured by total consolidated assets to total equity, or 10 percent ration of short-term debt to total consolidated assets).

102. Harrington, *supra* note 7, at 2; Arthur D. Postal, *Paving the Way for a Federal Hand in*

at the time of this writing, FSOC had officially designated AIG, GE Capital, and Prudential Financial as systemically important financial institutions, thus marking the first time in over 150 years that an insurer has been federally regulated.[103] A systemically significant label therefore has significant implications for the insurance industry, as federal oversight standards for minimum leverage, risk-based capital, dividend payments, and share buybacks, for instance, may be potentially more stringent than those currently implemented by state regulators.[104]

V. INSURERS DO NOT CREATE SYSTEMIC RISK

Although prompted in an effort to curb economic instability, FSOC's historic decision to potentially replace well-established insurance regulations with banking standards nonetheless seems to overlook the fact that the causes financial collapse are not attributable to state-regulated insurance. Rather, it was financial deregulation, blunders by inept federal regulators, and other activities existing wholly outside of the traditional business of insurance that are to blame for the recession.

A. The State-Regulated Insurance Industry Did Not Contribute to the Crisis

After speaking out against the possibility of the federal government regulating insurers like banks, Rep. Scott Garrett planned to introduce legislation in August of 2012 that would bar federal regulators from labeling insurers as systemically significant.[105] Rep. Garrett's opposition of FSOC's decision to potentially label insurers systemically significant was perhaps prompted by a desire to correct misunderstandings of what caused the 2008 financial crisis. This is because the state-regulated "business of insurance" had nothing to do in contributing to the recession.

AIGFP, AIG's subsidiary, was not a player in the insurance business when it wrote CDSs on mortgage-backed securities.[106] During a 2009 Senate hearing on the federal budget, Federal Reserve Chairman Ben Bernanke testified that AIGFP "was a hedge fund, basically, that was attached to a large and stable insurance company, made huge numbers of irresponsible bets—took huge losses."[107] Indeed, the CDSs AIGFP wrote do not qualify as the "business of insurance" because a CDSs purchaser (such as an investment bank) does not need an insurable interest in the underlying securities or

Insurance Regulation, LIFEHEALTHPRO (Sept. 1, 2012), http://www.lifehealthpro.com/2012/09/01/paving-the-way.

103. Arthur D. Postal, *It's Official: FSOC Says AIG is 'Important'*, PROP. CAS. 360 (Jul. 10, 2013), http://www.propertycasualty360.com/2013/07/10/its-official-fsoc-says-aig-is-important.

104. Campbell, *supra* note 93, at 6; Postal, *supra* note 86.

105. Arthur D. Postal, *supra* note 1.

106. Harrington, *supra* note 7, at 9.

107. Brady Dennis, *Bernanke Blasts AIG for 'Irresponsible Bets' That Led to Bailouts*, WASH. POST, Mar. 4, 2009, *available at* http://www.washingtonpost.com/wp-dyn/content/article/2009/03/03/AR2009030303810.html.

exposure.[108] In other words, CDS purchasers may be induced by the contract's indemnification feature in allowing the underlying securities to go into default so as to monetarily *gain* from the CDS payment, rather than mere reimbursement.[109]

Moreover, the passage of the CFMA officially barred the Commodities Futures Trading Commission and the Securities Exchange Commission from regulating CDSs.[110] The CFMA also specifically exempted CDSs and other derivatives from state insurance regulatory oversight.[111] Hence, as columnist Barry Ritholtz notes, the CFMA "created a unique class of financial instruments that was neither fish nor fowl: It trades like a financial product but is not a security; it is designed to hedge future prices but is not a futures contract; it pays off in the event of a specific loss-causing event but is not an insurance policy."[112] Believing itself free from regulatory oversight, investment banks, as Chairman Bernanke testified, "exploited a huge gap in the regulatory system," as there "was no oversight of the Financial Products division."[113] However, because AIG owned a savings and loan subsidiary, the federal government was ultimately responsible for monitoring the financial giant as overseeing AIG's consolidated operations fell within the purview of the now-defunct OTS.[114]

B. Oversights by Federal Regulators in Monitoring AIG's Operations

After 1999's Gramm-Leach-Bliley Act[115] repealed portions of the Glass-Steagall Act,[116] which had prevented commercial and investment banks, securities firms, and insurance companies to consolidate, many different regulators could oversee a firm's operations depending on the types of financial services a company offered.[117] As such, companies buying thrifts fell under the purview of OTS, including AIG that obtained a thrift charter in 1999 and bought a savings and loan firm the following year.[118]

Established in 1989 as an autonomous bureau of the Treasury, OTS's regulated savings and loan associations, some savings banks, and those savings

108. Harrington, *supra* note 7, at 9.

109. *See generally* JERRY & RICHMOND, *supra* note 14, at 273-316 (describing the insurable interest requirement).

110. 15 U.S.C.A. §§ 77b-1, 78c-1 (West 2000); Ritholtz, *supra* note 41.

111. Ritholtz, *supra* note 41.

112. *Id.*

113. Dennis, *supra* note 107.

114. *See* Harrington, *supra* note 7, at 15 (noting that OTS was recognized as AIG's consolidated regulator such for the purpose of meeting the 2005 E.U. regulatory criterion for group supervision); Gerth, *supra* note 39.

115. Gramm-Leach-Bliley Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of Titles 15 & 12 U.S.C.).

116. The Banking Act of 1933, Ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.).

117. Gerth, *supra* note 39.

118. *Id.*

and loan holding companies that are not also bank holding companies.[119] As a consolidated regulator, OTS's task was to assess the overall risk for the AIG corporate umbrella by, in part, ensuring that AIG did not assume a disproportionately large amount of risk in relation to its liquid assets.[120] OTS nonetheless failed to foresee and prevent the collapse of the nation's largest insurer.

Indeed, OTS was aware of its regulatory obligation regarding AIG and AIGFP, as the regulator maintained continuous consolidated supervision of AIG, conducted on-site examinations at AIG's New York headquarters, and had several meetings with senior management and auditors.[121] Furthermore, OTS presented AIG's board of directors with a report recommending courses of action concerning risk management including a discussion of significant weaknesses at AIGFP.[122] However, AIG's operations raised several red flags indicating that its liquidity situation necessitated remedy by OTS formal enforcement action.

Between 2005 and 2008, AIG reported approximately $3.6 billion in accounting errors, of which $1.1 billion pertained to derivative-related assets.[123] Additionally, in mid-2007, Goldman Sachs, AIGFP's frequent CDS counterparty, demanded more collateral from the financial division, which prompted AIG's outside auditors to conduct reviews of AIGFP's books.[124] As such, by early November, the financial unit's third-quarter losses had increased from $45 million to $350 million.[125] But after three years of significant accounting misstatements and questionable activity, the OTS merely requested AIG submit a "corrective action plan" concerning its shaky CDS portfolio within the thirty days; a deadline that the corporate giant missed.[126]

OTS's failure to identify and correct liquidity weaknesses in AIG's portfolio is not as surprising after considering that it was under OTS's watch that large mortgage finance organizations such as Countrywide, Washington Mutual, and Indy Mac failed, only to be acquired by other firms with FDIC financial assistance.[127] Although Dodd-Frank disbanded OTS in July of 2011 with the Federal Reserve and the Office of the Comptroller of the Currency assuming the discontinued agency's responsibilities,[128] nonetheless FSOC's decision to potentially subject an insurer to banking regulations is suspect.

Like the OTS, there is an argument that the Federal Reserve failed in its duty to prevent the crisis by failing to monitor investment banks such as the bankrupt Lehman Brothers. Indeed, as former Congressional Budget Office

119. CARNELL, MACEY, & MILLER, *supra* note 88, at 63.
120. Gerth, *supra* note 39.
121. Harrington, *supra* note 7, at 16.
122. *Id.*
123. Gerth, *supra* note 39.
124. *Id.*
125. *Id.*
126. *Id.*
127. Harrington, *supra* note 7, at 16.
128. Postal, *supra* note 77.

director Alice Rivlin acknowledged during a 2009 testimony before the Congressional Committee on Financial Services, "As regulator of bank holding companies, [the Federal Reserve] did not distinguish itself in the run up to the current crisis (nor did other regulators). It missed the threat posed by the deterioration of mortgage lending standards and the growth of complex derivatives."[129] In light of this, the Federal Reserve's decision to potentially apply bank-centric rules and standards to insurers begs the question as to why the federal government would be an adequate regulator of an insurer's activity when investment banking nearly imploded. Thus, allowing the Federal Reserve supervisory authority over insurers is an unwarranted position, as state-regulated insurance did not contribute to 2008's economic turmoil.

VI. REGULATORY OVERHAULS COULD PROMOTE SYSTEMIC RISK

While banks and the real estate market sustained heavy losses during 2008 and beyond, the insurance industry, on the other hand, escaped relatively unscathed. The insurance sector's durability is largely attributable to both existing regulations mandated by state insurance departments as well as the business practices employed by the industry. Indeed, by sufficiently diversifying investments, utilizing more conservative accounting standards, and maintaining high levels of liquidity, insurers and state regulators were able to prevent the insurance industry from becoming systemically risky. However, if a federal regulator decides replace these measures with those designed for banks or other financial institutions, the insurance industry may actually begin to contribute to systemic risk rather than help curb it.

A. State-Based Insurance Regulation Helps Prevent Systemic Risk

The existing state-based regulatory framework prevents insurers from becoming overly interdependent with other business sectors to the degree that an economy-wide collapse would occur if a large insurer failed, as was evidenced by the insurance industry staying afloat after the 2008 financial storm.[130] Even in the case of AIG, insurance regulators from New York and Pennsylvania concluded that, after conducting an extensive financial review of AIG's insurance subsidiaries, that those companies would be able to fulfill their obligations to policyholders without the help of government aid.[131] Indeed, because state insurance regulators require insurers to hold a larger degree of available capital in relation to their liabilities to policyholders than banks do, insurers are better insulated from economic trauma.[132]

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129. *Reducing Systemic Risk in the Financial Sector: Hearing before the H. Comm. of Fin. Serv.*, 111th Cong. 10 (2009) (testimony of Alice M. Rivlin, Brookings Institution and Georgetown University).

130. Burton, *supra* note 82, at *2.

131. Letter from Kermitt Brooks, Acting N.Y. Ins. Superintendent, and Joel Ario, Pa. Ins. Comm'r, to Editor of the New York Times (July 31, 2009) *available at* http://www.naic.org/Releases/2009_docs/response_letter_to_nytimes.pdf.

132. Harrington, *supra* note 7, at 19.

The Federal Reserve, however, is currently increasing the amount of mandatory capital a bank must retain irrespective of a bank's size, in turn pushing smaller banks out of certain markets because these smaller firms cannot meet the disproportionate capital requirements.[133] As a result, larger banks are only elevated to greater systemic significance.[134] The Fed's practice of imposing uniform floor capital requirements is the exact opposite of the practice of state insurance regulators, which have largely adopted NAIC model laws requiring risk-based-capital amounts customized to an individual insurer's size and the amount and type of risk that individual insurers assume.[135] However, if FSOC labels an insurer as "systemically significant," that insurer could be regulated as a bank, thereby substituting longstanding[136] regulations with banking requirements despite the lack of any indication that these existing risk-based-capital standards are inadequate.

Despite the Federal Reserve's measures designed to prevent insolvency, however, many analysts argue that federal regulation of financial institutions actually increase the probability of systemic risk. These expertsf theorize that financial institutions tend to practice less market discipline once they are federally regulated and insured.[137] In other words, once the federal government backs financial institutions, executives begin treating investments like "insured lottery tickets;" if trades are successful, the company keeps all of the profits, but even if they fail, the government takes the liability anyway.[138] Some analysts also argue that objective risk regulation rules (such as minimum capital reserves, for example) and the guarantee of government bailouts invariably cause regulated financial institutions to establish more positions in securities that require lower amounts of capital than on arbitrary average investments.[139] Thus, rather than different firms holding different well-capitalized risky positions, institutions governed by the same regulations will tend to invest in the same few securities that falsely appear to have decreased risk.[140] This suggests then that "systemically significant" institutions would be regarded as "too big to fail," thereby reducing market discipline while giving it

133. *See* Jason M. Breslow, *Small Banks Under Pressure From New Capital Requirements*, PBS (June 8, 2012), *available at* http://www.pbs.org/wgbh/pages/frontline/business-economy-financial-crisis/money-power-wall-street/small-banks-under-pressure-from-new-capital-requirements/; Danielle Douglas, *Small Banks Battle Regulators on Capital Requirements*, WASH. POST, Nov. 13, 2012, *available at* http://www.washingtonpost.com/business/economy/small-banks-battle-regulators-on-capital-requirements/2012/11/13/e5e52c14-2db0-11e2-9ac2-1c61452669c3_story.html.

134. *Id.*

135. KLEIN, *supra* note 19, at 142, 168.

136. *Id.* at 142 (noting that risk-based-capital standards have been enforced since 1992).

137. Philip Z. Maymin & Zakhar G. Maymin, *Any Regulation of Risk Increases Risk*, Financial Markets and Portfolio Management (forthcoming Apr. 20, 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1587043 (arguing that any form of risk regulation has an adverse effect on a financial institution's solvency).

138. *Id.* at 3.

139. *Id.* at 12.

140. *Id.*

an unfair competitive advantage.[141]

Furthermore, since the early 1990s, state insurance commissioners have imposed reserve requirements and investment restrictions designed to limit an insurer's financial risk.[142] In order for an insurer to have an adequate amount of reserves to meet its obligations to policyholders, state regulators mandate that insurers reasonably diversify investments while allocating them prudently.[143] These investment restrictions include limits on the proportional amount of different assets insurers may hold to encourage diversification while curbing exposure.[144] Thus, state regulation helps ensure that an insurer does not become systemically significant through investment diversification.

Lastly, the accounting technique insurers use, statutory accounting principles (SAP), also helps prevent an insurer from becoming a systemic risk. Mandated by the NAIC, all insurance companies maintain records and file annual and quarterly statements with insurance commissioners in accordance with SAP when reporting their surpluses so regulators may asses an insurer's solvency.[145] SAP differs from the generally accepted accounting principles (GAAP), which are used by all other financial industries, as SAP identifies an insurer's ability to satisfy its obligations at all times as if the insurer were in liquidation rather than in business.[146] Further, SAP uses amortized book or historical costs to value assets because of the difficulty of estimating the market values of some securities and liabilities.[147] Thus, SAP conservatively values most assets, including revenue not yet invoiced, as non-liquid assets, and, as such, these non-liquid assets are not included in an insurer's surplus.[148] GAAP, on the other hand, measures the earnings of a company on a going-concern basis, (in other words, assuming that the company will stay in business rather than go through liquidation) thereby calculating all potential revenue as part of the annual statement, including accounts receivable not yet invoiced.[149]

The NAIC requires that insurers use the more conservative SAP because the insurance industry is different from normal business transactions that are merely the sale of a good or service, rarely necessitating a refund to the other party more for the amount paid.[150] Instead, in the insurance industry, insurers will have to pay out policy claims that are larger than the premiums paid by a policyholder.[151] Additionally, insurers are long-term investors and there is

141. Harrington, *supra* note 7, at 29.

142. KLEIN, *supra* note 19, at 144-47, 169.

143. *Id.* at 144, 146.

144. *Id.* at 146-47.

145. *Id.* at 150.

146. *Id.* at 151.

147. KLEIN, *supra* note 19, at 151.

148. *Id.* at 151; Diane Perez, *Statutory Accounting vs. GAAP for Insurance Companies*, HOUS. CHRONICLE, *available at* http://smallbusiness.chron.com/statutory-accounting-vs-gaap-insurance-companies-38680.html.

149. KLEIN, *supra* note 19, at 151.

150. *Id.* at 150.

151. *Id.*

often uncertainty whether an insurer will ever need to pay a claim after it receives a premium.[152] Because of these long-term contingent payments, insurers' accounting technique focuses on matching assets and liabilities instead of managing those accounts separately.[153] Thus, due to the nature of the insurance industry, it is critical for an insurer to report conservative statements to ensure that it does not overextend its liabilities in order to indemnify claimants.

However, if designated to be "systemically significant," FSOC could require insurers to convert to a GAAP-based approach.[154] Therefore, if an insurer reports its assets using a GAAP approach, regulators will not be able to assess an insurer's solvency as accurately when claimants need indemnification because the insurer will be reporting assets not yet invoiced. As a letter from the House Services Committee to the Federal Reserve Board argues, changing insurers' accounting standards could potentially have a backfiring effect on Dodd-Frank's aim to curb financial instability as it would be "costly with no improvement in understanding the health of the insurance industry."[155]

B. Insurers' Current Business Model Helps Prevent Systemic Risk

Many figures within the insurance industry believe that the Federal Reserve's bank-centric regulatory framework would be unsuited to appropriately deal with insurance solvency and accounting issues.[156] Specifically, industry officials argue that there are pivotal dissimilarities between an insurer's capital structure and business model versus a bank's due to different pre-existing regulatory structures, underlying business purposes, and unique set of risks.[157] As a result of applying "rigid" banking standards to insurers without accordingly adjusting the regulatory framework, insurance industry representatives argue that insurers would be subjected to inaccurate capital requirements that would fail in properly assessing an insurer's financial soundness.[158] Banking capital regulations would only increase the threat of systemic risk to the U.S.'s economy because it will be increasingly difficult for these firms operating thrifts to serve as a financial resource to their subsidiaries.[159] Specifically, industry officials argue that blanket capital requirements would reduce the efficiency of risk pooling, thereby driving up

152. INT'L ASS'N OF INS. SUPERVISORS, INSURANCE AND FINANCIAL STABILITY 11 (Nov. 2011); SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 69.

153. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 69.

154. Elizabeth Festa, *ACLI concerned with US GAAP proposal,* LIFEHEALTHPRO (May 3, 2013), http://www.lifehealthpro.com/2013/05/03/acli-concerned-with-us-gaap-proposal.

155. Arthur D. Postal and Elizabeth Festa, *AIG's SIFI Designation Delayed,* PROP. CAS. 360 (Dec. 13, 2012), http://www.propertycasualty360.com/2012/12/13/aigs-sifi-designation-delayed; *see also* Festa, *supra* note 154.

156. Postal, *supra* note 77.

157. *Id.*

158. *Id.*

159. *Id.*

the cost of insurance, reducing the amount of risk an insurer can undertake, and, ultimately, causing greater industry reliance on state insolvency protection.[160]

The insurance industry is not alone in protesting a systemically significant designation for insurers, however. In bipartisan efforts, U.S. senators have emphasized to top federal banking regulators that although Dodd-Frank under the Collins Amendment instructs banking agencies to establish uniform minimum capital standards for federally-regulated financial institutions, nonetheless it was not Congress' intent to impose a banking-capital system on insurers.[161] Among them is Sen. Susan Collins (from whom the Collins Amendment gains its namesake), who explained in a November 2012 letter to Federal Reserve Chairman Ben Bernanke that it was not Congress's intent that federal regulators "supplant state-based regulation with a bank-centric capital regime."[162] Collins and her colleagues have argued that federal-banking agencies applying regulation to insurers must take into account preexisting regulatory standards that apply to insurers, along with the specific accounting and capital standards insurers have in place.[163] Legislators have also emphasized that insurers rely upon long-term assets to fund long-term liabilities, whereas banks use a variety of bonds, equity, and short-term debt to fund short-term liabilities.[164]

Insurers also try to decrease the amount of risk they have assumed through several risk-transferring tactics. These include hedging market positions or policyholder options with derivatives and securitizing insurance risks into capital markets or entering into insurance derivatives so as to transfer risk.[165] Insurers also diversify their risks by purchasing reinsurance ("insurance for insurers") that allows insurers to avoid concentrating risk.[166] Reinsurers spread coverage among themselves, thereby further limiting systemic risk.[167] Furthermore, the strong operating cash flow due to insurance being funded by upfront premiums provides insurers with significant

160. Press Release, Inst. of Int'l Fin., Inc., Leading Insurers Call for Careful Consideration of Unintended Consequences Emerging from IAIS Proposals on Systemic Risk (Dec. 17, 2012), *available at* http://www.iif.com/press/press+404.php.

161. Festa, *supra* note 6; Elizabeth Festa, *Proposed Basel III cap rules worry Congress*, LIFEHEALTHPRO (Feb. 14, 2013), http://www.lifehealthpro.com/2013/02/14/proposed-basel-iii-cap-rules-worry-congress?t=regulatory.

162. Elizabeth Festa, *Sen. Collins says Dodd-Frank amendment should lighten up on insurers*, LIFEHEALTHPRO (Nov. 28, 2012), http://www.lifehealthpro.com/2012/11/28/sen-collins-says-dodd-frank-amendment-should-light.

163. *Id.*; Festa, *supra* note 6.

164. Festa, *supra* note 6.

165. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 49-50, 53-54.

166. *Id.* at 8, 50-53.

167. THE GENEVA ASS'N, INSURANCE AND RESOLUTION IN LIGHT OF THE SYSTEMIC RISK DEBATE, 30 (2012) [hereinafter INSURANCE AND RESOLUTION], *available at* http://www.genevaassociation.org/PDF/BookandMonographs/GA2012-Insurance_and_Resolution_in_Light_of_the_Systemic_Risk_Debate.pdf.

liquidity.[168] The liquidity insurers enjoy also stems from asset bases made up largely of highly marketable securities.[169] On the other hand, banks, by accepting short-term, liquid demand deposits and granting long-term loans, expose themselves to major credit risk from lending activities and liquidity risk due to mismatching from borrowing short and lending long.[170]

Additionally, insurers are not a systemic risk because the nature of the business of insurance itself helps prevent insurers from becoming too systemically significant. For instance, even if a low-probability event occurs that brings large amounts of physical damage, such as a natural disaster, the economic impact would be broadly spread between property and casualty insurers through product line, geographic diversification, and reinsurance, thereby avoiding economic contagion.[171] Even if the same physical disaster brought massive loss of life, indemnification by life insurers to beneficiaries would not contribute to a financial collapse because shocks to the life insurance industry do not affect the country's payment systems, unlike the banking sector.[172]

The Geneva Association, the insurance industry's international trade body, tested the claim that insurers do not pose the same systemic risk as banks.[173] By comparing the 28 financial institutions that have been designated "globally systemically significant" with the 28 largest global insurers, the study found that the largest private insurer, by total assets, would only rank as the 22nd largest bank.[174] Further, the average bank writes 158 times the amount of CDSs than the average insurer, indicating that the impact of an insurers' distress on the buyers of CDS protection is far less than banks.[175] Systemically significant banks carry 219 times more derivatives than insurers, with the average bank owing 68 times more on derivatives than the average insurer, demonstrating banks' interconnectedness with the financial system.[176] Conversely, because banks are due 70 times more than average insurers on gross positive derivatives, insurers are much less dependent on derivative

168. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 3.

169. *Id.* at 20.

170. *Id.* at 6.

171. Harrington, *supra* note 7, at 19.

172. *Id.*; SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 41-43 (noting that even the losses of $73 billion associated with Hurricane Katrina – that were spread over several insurers and reinsurers – were less than Lehman Brothers' outstanding debt of $155 billion when it filed for bankruptcy).

173. Press Release, The Geneva Ass'n, Cross Industry Analysis: 28 G-SIBs vs. 28 Insurers: Comparison of Systemic Risk Indicators (Dec. 11, 2012) [hereinafter CROSS INDUSTRY ANALYSIS], *available at* http://www.genevaassociation.org/pdf/News/GA2012_Benchmark_Study.pdf.*; see also* Brooke Masters, *Insurers Argue against Systemic Importance Label*, FIN. TIMES, Dec. 12, 2012, at 16.

174. CROSS INDUSTRY ANALYSIS, *supra* note 173, at 5; *see also* INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 21-22 (noting that the top 25 largest insurers' assets total at $10.7 trillion whereas the top 25 largest banks' assets total at $44.3 trillion).

175. CROSS INDUSTRY ANALYSIS, *supra* note 173, at 6.

176. *Id.* at 8, 10.

counterparty performance than insurers.[177] Additionally, the average insurer relies on short-term funding for only 2.4% of its total assets whereas it accounts for 15.7% of an average bank's balance sheet, thus demonstrating how insurers are less likely to be forced into damaging fire sales due to their limited short-term funding activities.[178] Based on this data, the study concluded that because insurers match assets with liabilities, carry substantially lower positions in derivatives, and rely upon significantly smaller amounts of short-term funding, insurers pose less systemic risk than banks.[179]

The financial crisis' effects demonstrate how insurers' more conservative business model offered that industry greater resiliency than the banking sector. Losses in the insurance industry were only a sixth of those banks experienced, and the new capital raised was only a ninth.[180] At first glance, however these figures are somewhat misleading; AIG alone accounted for 58% of new capital in the insurance sector and 36% of credit losses — all of which were incurred due to non-insurance related activities.[181] Additionally, as of mid-2009, only three insurance companies had taken Troubled Asset Relief Program funds, whereas 592 banks had accessed the program.[182] Moreover, excluding those insurers with significant non-insurance related or quasi-banking operations (such as AIG), insurers received less than $10 billion globally in direct State support during the crisis while States gave over $1 trillion to banks.[183] Thus, insurers' emphasis on maintaining significant liquidity while designing their investments (such as highly marketable securities) to match liabilities allowed the industry to be largely unaffected by market downturn.[184]

VII. PROPOSALS: EXEMPTIONS FROM THE COLLINS AMENDMENT AND THE VOLCKER RULE

Although it seems unlikely that Congress will altogether exclude insurance companies from all forms federal supervision, there are some avenues that would nonetheless effectively bar the Federal Reserve from applying banking standards to insurers. The first approach would be passing introduced legislation into law that exempts insurers from bank-centric capital requirements as required by the Collins Amendment. Secondly, rather than regulating insurers affiliated with thrifts as banks, the more sensible course of action would be for federal regulators to focus on non-insurance-related transactions that exposed major firms to risk. The Volcker Rule strives to accomplish this, but regulators must still adjust the law's proposed regulations

177. *Id.* at 12-13.
178. *Id.* at 16-17.
179. *Id.* at 3.
180. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 12.
181. *Id.*
182. *Id.* at 15.
183. *Id.* at 3.
184. *Id.* at 20; *see also* INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 3 (noting that insurance underwriting risks are generally uncorrelated with the economic business cycle and financial market risks, thus disconnecting insurance liabilities from financial market losses).

to appropriately foster the traditional business of insurance. Not only will these two actions protect the insurance industry as well as the overall economy, but will also more accurately reflect policymakers' original intent that state-regulated insurance companies remain unaffected.

A. Insurers Should Be Excluded from The Collins Amendment's Capital Standards

The evidence of a lack of systemic risk posed by insurers has not gone unnoticed, however. Prodded by the insurance industry, the NAIC, and Congress to tailor capital rules for insurers, the Federal Reserve acknowledged that the structure of insurers are distinct from other financial firms along with the systemic risk that they pose.[185] Federal Reserve officials, including Chairman Bernanke, have stated that their office will aim to tailor capital requirements as much as possible to meet the insurance industry's specific needs.[186] However, as Board of Governors have cautioned, the Collins Amendment's requirement that bank style capital standards be applied to insurers significantly limits the Federal Reserve's ability to provide special treatment for insurers – despite Sen. Collins' insisting to the contrary.[187]

While industry lawyers and regulatory officials attempt to parse the scope of the Collins Amendment,[188] the Federal Reserve has, for the time being, temporarily exempted insurers from bank-centric capital and accounting requirements.[189] Although the insurance industry applauded this provisional action by the Federal Reserve,[190] both Republican and Democratic legislators from both chambers of Congress have nonetheless introduced bills that tailor the proposed capital rules to meet insurers' needs, thereby permanently removing insurers from banking capital standards.[191]

Legislation specifically exempting insurers from banking capital standards required under the Collins Amendment would help guarantee that insurers may continue to properly pool risks and keeping the cost of insurance

185. Elizabeth Festa, *Tarullo: Insurers really are different from banks*, LIFEHEALTHPRO (July 11, 2013), http://www.lifehealthpro.com/2013/07/11/tarullo-insurers-really-are-different-from-banks; Elizabeth Festa, *Fed takes on Dodd-Frank Conflicts*, LIFEHEALTHPRO (May 9, 2013), http://www.lifehealthpro.com/2013/05/09/fed-takes-on-dodd-frank-conflicts.

186. Festa, *Fed Takes on Dodd-Frank Conflicts*, *supra* note 176; Festa, *supra* note 11.

187. Festa, *Fed Takes on Dodd-Frank Conflicts*, *supra* note 185; Festa, *supra* note 10; Festa, *Tarullo: Insurers really are different from banks*, *supra* note 185; Festa, *supra* note 162.

188. *See* Festa, *Fed Takes on Dodd-Frank Conflict*, *supra* note 185 (discussing the perceived inconsistencies between sections 171 and 165 of Dodd-Frank).

189. Arthur D. Postal & Elizabeth Festa, *Reprieve for insurers from bank-centric capital rules*, LIFEHEALTHPRO (July 2, 2013), http://www.lifehealthpro.com/2013/07/02/reprieve-for-insurers-from-bank-centric-capital-ru.

190. *Id.*

191. Elizabeth Festa, *Insurers embrace bill to tailor proposed Fed capital rules,* LIFEHEALTHPRO (May 24, 2013), http://www.lifehealthpro.com/2013/05/24/insurers-embrace-bill-to-tailor-proposed-fed-capit; Arthur D. Postal, *Legislation Would Allow Fed to Tailor Capital Standards for Insurers,* PROP. CAS. 360 (July 26, 2013), http://www.propertycasualty360.com/2013/07/26/legislation-would-allow-fed-to-tailor-capital-stan.

low.[192] In addition, passing these bills and others like them is a middle ground between granting regulatory authority over insurers to the federal government while preserving the existing state-based system; federal agencies' (albeit misguided) concerns over ineffective state supervision will be assuaged while insurers will be able to sustain critical existing capital standards. Therefore, if the Federal Reserve chooses to regulate insurers, legislation exempting insurers from the Collins Amendment's capital requirement is essential to protect the insurance industry.

B. Non-Traditional Insurer Activities Requiring Intensified Regulation

In December of 2012, the Treasury Department announced that it had sold the last of AIG's common stock, consummating AIG's repayment of the $182 billion bailout plus an additional $22.7 billion positive return for the government.[193] However, rather than allowing insurers to return engaging in the same dangerous trades, John Gapper of the Financial Times warns, "it would be foolish to forget the lesson of AIG the moment the US gets its money back."[194] Indeed, instead of regulating large insurers as banks, the more sensible recourse for FSOC would be to regulate systemically significant non-insurance related *transactions* that caused the recession.

1. Insurers Do Not Contribute to Liquidity Shocks

Most authorities center their varying definitions of "insurance" on the concept that insurance is an arrangement for transferring risks to an insurer with the understanding that the insurer will indemnify the insured upon the occurrence of some specified contingency.[195] Thus the "core" or "traditional" functions of insurers are to provide protection to policyholders by accepting and pooling risks, managing them actively, and oftentimes transferring these risks to reinsurers.[196] Necessary to successfully accomplishing these core functions is prudent liquidity management activities.

Despite the shortage of liquidity in the banking system, insurers did not suffer systemic liquidity shock during the financial crisis.[197] This is in part due to the steady stream of premium cash flow but also due to insurers investing float (available cash reserves) in liquid assets.[198]

Insurers raise short-term funding by issuing commercial papers then

192. INST. OF INT'L FIN., INC., *supra* note 160; Festa, *supra* note 191.

193. Press Release, U.S. Dep't of the Treasury, *Treasury Sells Final Shares of AIG Common Stock, Positive Return on Overall AIG Commitment Reaches $22.7 Billion* (Dec. 11, 2012), http://www.treasury.gov/press-center/press-releases/Pages/tg1796.aspx.

194. John Gapper, Editorial, *Insurers Have to Learn the Lesson From AIG's Fall*, FIN. TIMES, Dec. 13, 2012, at 11.

195. *See* KEETON & WIDISS, *supra* note 19, at 3; KLEIN, *supra* note 19, at 229.

196. INSURANCE AND RESOLUTION, *supra* note 167, at 9; *see also* INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 6 ("The traditional business model of insurance builds on the underwriting of large diversified pools of mostly idiosyncratic and uncorrelated risks.").

197. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 56; INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 24.

198. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 56.

investing the proceeds from the loans in liquid assets offering a higher return, reaping the spread as profit.[199] Additionally, insurance firms lend the securities from their investment portfolios to short sellers.[200] An insurer-lender reinvests the collateral and earns the spread between the collateral's returns and the returns on the underlying securities.[201] Insurers engaging in short-term funding with commercial paper and securities lending are often able to safely provide improved returns for policy and shareholders.[202] However, when a firm invests commercial paper proceeds and securities lending capital in illiquid assets, the possibility of liquidity shocks and systemic risk increases when the counterparty calls its collateral and the insurer is unable to repay.[203]

Such was the case with AIG. The insurance giant invested more than 60% of the $76 billion in cash collateral it received into illiquid mortgage-backed securities.[204] However, during 2007-2008, when many assets declined in value and reduced the worth of reinvested collateral, borrowers terminated transactions in masses to improve liquidity and reduce exposure to lenders' credit risk.[205] As a result of securities lending coming to a halt, AIG was unable to liquidate its deposited collateral.[206] Had AIG reserved the collateral to repay counterparties rather than investing in illiquid assets, the firm would have prevented a liquidity shock.[207] Thus, where an insurance company deviates from its traditional practice of prudently managing collateral, its activities may become systemically risky.[208]

2. CDS Trading Restrictions and Improved Group Supervision

Some of AIG's other deviations from traditional industry practices also contributed to systemic risk. Because regulators prohibit insurers from trading many forms of derivatives such as CDSs, insurance groups circumvent these regulations by using an unregulated non-insurance subsidiary to engage in derivatives trading to generate additional revenue.[209] However, if the unregulated subsidiary writes excessive CDSs or builds other significant derivatives exposure that exceed the parent insurance group's liquid resources, sufficient amounts of counterparty margin calls may cause economic

199. *Id.* at 55; INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 12-13.

200. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 55; INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 12-13.

201. Harrington, *supra* note 7, at 10.

202. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 55; INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 12-13.

203. INSURANCE AND RESOLUTION, *supra* note 167, at 12.

204. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 56; INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 44.

205. Harrington, *supra* note 7, at 10; INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 44.

206. Harrington, *supra* note 7, at 11; SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 56; INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 44.

207. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 56.

208. *Id.* at 57; *see also* INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 12-13, 44.

209. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 40, 62; INSURANCE AND RESOLUTION, *supra* note 167, at 12; Harrington, *supra* note 7, at 9.

instability.[210]

It was by exploiting the lack of regulatory oversight for insurance conglomerate derivative speculation that AIGFP, AIG's largely unregulated non-insurance subsidiary, nearly caused its parent to implode.[211] Representing a third of AIG's total assets and five times its shareholders' equity, AIG's net CDS exposure amounted to more than double the net notional sold by all Depositors and Trust And Clearing Corporations.[212] As such, the CDSs sold by AIGFP were not supported by the amount of capital needed to indemnify CDS purchasers in case the housing bubble burst.[213]

As AIG demonstrated, the lesson for regulators is that systemic risk does not emanate from the traditional business of insurance. Rather, activities such as mismanagement of short-term funding and derivatives speculation caused economic instability in 2008. AIGFP found an opportunity to engage in these ill-fated trades by taking advantage of a gap in efficient regulatory oversight. Instead of imposing banking capital requirements on insurers, FSOC should instead identify and regulate activities that contribute to systemic risk while overhauling relevant regulatory frameworks.

C. The Volcker Rule

1. Legislative Background and Aims of The Volcker Rule

If AIG's story conveys anything, new comprehensive regulation limiting the kinds of transactions that banking-related subsidiaries of insurance conglomerates may engage in would help curb systemic risk. In 2010, Congress attempted to do just that by incorporating a measure into Dodd-Frank that sought to limit systemic risk by restricting banking firms from making certain trades.

First suggested by former Chairman of the Federal Reserve Bank Paul Volcker, the "Volcker Rule" prohibits banking entities and their affiliates from engaging in proprietary trading (business transactions unrelated to making profit for customers) and owning any interest in a hedge fund or a private equity fund.[214] Thus, insurance conglomerates owning bank subsidiaries such

210. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 40, 61; INSURANCE AND RESOLUTION, *supra* note 167, at 12.

211. *See* Gerth, *supra* note 39; *see also* Harrington, *supra* note 7, at 14-16 (identifying the OTS's lack of regulatory oversight over AIGFP); INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 40 (calling the OTS a "weak federal regulator"); SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 40 (noting that AIGFP relied on the absence of "effective group supervision").

212. SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 61.

213. *See* Harrington, *supra* note 7, at 9-10.

214. 12 U.S.C. § 1851(a)(1), (h)(4); *see also* Press Release, Office of the Press Sec'y, President Obama Calls for New Restrictions on Size and Scope of Financial Institutions to Rein in Excesses and Protect Taxpayers (Jan. 21, 2010), http://www.whitehouse.gov/the-press-office/president-obama-calls-new-restrictions-size-and-scope-financial-institutions-rein-e; Chatterjee, *supra* note 38, at 34; *see generally* CHADBORNE & PARKE, LLC, *Summary and Analysis of the Volcker Rule in the Dodd-Frank Act - Prohibiting Bank Proprietary Trading and Investing in Hedge Funds, Private Equity Funds and Other Private Funds - It Affects More Than*

as AIG would be prohibited to make any of the banned risky trades. Indeed, at the time of this writing, AIG had downgraded its thrift to a trust bank so as to avoid the Volcker Rule's ramifications.[215]

The Volcker Rule follows in the same legislative spirit as its Great Depression-era predecessor the Glass-Steagall Act,[216] which had required banks to sever their brokerage or investment transactions that had led to the stock market crash.[217] 1999's Gramm-Leach-Bliley Act,[218] however, repealed Glass-Steagall, thereby again allowing mergers between commercial and investment banks, brokerages, and insurers. While a full-on reimplementation of Glass-Steagall would be impractical in today's financial climate,[219] the Rule nonetheless aims to curb trades that integrate various financial sectors that in turn create systemic risk.[220]

Congress has also attempted to cure deficiencies in ineffective group supervision. The Volcker Rule requires that federal banking agencies (the Federal Reserve, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency)[221], the Securities and Exchange Commission, and the Commodity Futures Trading Commission consult and coordinate with each other when drafting and implementing regulations applicable to banking entities affected by the Rule.[222] Furthermore, the Rule gives the Federal Reserve regulatory authority over nonbank financial companies owning positions in thrifts, thereby consolidating the operations of large financial conglomerates under the jurisdiction of one regulator.[223] Indeed, it was the existence of "regulatory arbitrage" or unclear jurisdictional scope of regulatory agencies that allowed the operations of AIGFP to go undetected.[224] With integrated supervision of groups, a regulator is enabled to track both insurance and non-insurance balance sheets, therefore decreasing the probability of

Just Funds (July 29, 2010), http://www.chadbourne.com/files/Publication/ad549554-9229-4f77-ae1e-461f43f28338/Presentation/PublicationAttachment/3591ff9a-cc61-4c94-b0d9-48a89f09796f/Volker%20Rule%20ca-%20Gale.pdf.

215. Arthur D. Postal & Elizabeth Festa, *AIG downgrades its thrift*, LIFEHEALTHPRO, (July 30, 2013), http://www.lifehealthpro.com/2013/07/30/aig-downgrades-its-thrift.

216. 12 U.S.C. § 24 et. seq.

217. *See* Louis Uchitelle, *Glass-Steagall vs. the Volcker Rule*, N.Y. TIMES (Jan. 22, 2010), *available at* http://economix.blogs.nytimes.com/2010/01/22/glass-steagall-vs-the-volcker-rule/ (comparing the effects of the two laws).

218. 15 U.S.C. § 6801 et. seq.

219. *See* Chatterjee, *supra* note 38, at 39-41 (explaining why reinstating Glass-Steagall would be "problematic because it would force major U.S. financial institutions to dissect themselves and reduce their global competitiveness in order to comply").

220. 12 U.S.C. § 1851(b)(2)(B)(ii) (stating that the Volcker Rule's new measures are designed "to protect the safety and soundness of banking entities and nonbank financial companies").

221. Ben Protess, *S.E.C. Advances Volcker Rule,* N.Y. TIMES (Oct. 12, 2011) *available at http://dealbook.nytimes.com/2011/10/12/s-e-c-advances-volcker-rule/.*

222. 12 U.S.C. § 1851(b)(2)(B).

223. 12 U.S.C. § 1851(a)(2).

224. *See* Harrington, *supra* note 7, at 9-10, 14-16; SYSTEMIC RISK IN INSURANCE*, supra* note 70, at 40; INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, at 32.

unnoticed systemically risky derivative transactions and liquidity crunches.[225]

As part of its prohibition of allowing banks and their affiliates from engaging in proprietary trading or from sponsoring or investing in a hedge fund, nonbank affiliates of a thrift are subjected to the same capital requirements and quantitative limits on proprietary trading "as if the nonbank financial company supervised by the Board were a banking entity."[226] However, Congress recognized the unique nature of the business of insurance and appropriately provided an exemption from Volcker's prohibitions for regulated insurance companies. Specifically, Volcker allows insurers to trade securities both on behalf of customers and for the general account of an insurance company as long as insurers conduct themselves in compliance with state insurance company investment laws.[227] In other words, Congress intended that insurers affiliated with banks should continue to conduct ordinary investment activities after Volcker's implementation.[228]

By prohibiting proprietary trading and improving integrated regulatory authority over financial conglomerates, the Volcker Rule helps prevent future economic turmoil like the kind experienced in 2008. However, to appropriately facilitate the business of insurance, some facets of the law require modification or clarification.

2. Adjustments Needed to Accommodate for the Business of Insurance

Although the law provides exemptions for insurers, The Volcker Rule, as A.I.G. chief executive Robert H. Benmosche noted, still "doesn't really work for insurance companies."[229]

Mr. Benmosche was referring to how Volcker Rule may not allow insurers to engage in certain investments they routinely make.[230] Fundamental to the business of insurance is the fact that insurers' liabilities to policyholders are generally long-term, thereby requiring insurers to invest in long-term

225. *See* SYSTEMIC RISK IN INSURANCE, *supra* note 70, at 72; INT'L ASS'N OF INS. SUPERVISORS, *supra* note 152, 50-51.

226. 12 U.S.C. § 1851(a)(1)-(2).

227. *See,* 12 U.S.C. § 1851(d)(1)(D),(F); *see also* Letter from Kevin M. McCarty, President, Nat'l Assoc. of Ins. Comm'rs, & Therese M. Vaughan, Ph.D., Chief Executive Officer, Nat'l Assoc. of Ins. Comm'rs, to Robert E. Feldman, Exec.utive Secretary, FDIC, & Jennier J. Johnson, Secretary, Federal Reserve, Elizabeth M. Murphy, Secretary, SEC, & John G. Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency (Feb. 10, 2012), 1-2, *available at* http://naic.org/documents/committees_ex_grlc_120210_comment_volker_implementation.pdf.

228. Letter from Julie Spiezio, Senior Vice President, Ins. Regulation & Deputy General Counsel, ACLI, to Timothy F. Geithner, Secretary, U.S. Department of the Treasury, (Nov. 1, 2010), at 4, *available at* https://www.acli.com/Newsroom/News%20Releases/Documents/6c71435b5c7a45da834906ca219e6986ACLICommentstoFSOCRPIDocketNoFSOC20100002Nov12013.pdf.

229. Peter Eavis, *Why A.I.G. May Not Be Able to Avoid the Volcker Rule,* N.Y. TIMES (Sept. 12, 2012), *available at* http://dealbook.nytimes.com/2012/09/12/why-a-i-g-may-not-be-able-to-avoid-the-volcker-rule/.

230. *Id.*

assets.[231] Many of these assets include investments from the insurer's general account (an insurer's available assets meant to satisfy company creditors) in hedge and private equity funds that create diversification benefits and protections along with historically high rates of return.[232] Indeed, even as FSOC concluded in its 2011 study on the Volcker Rule, "The investment activity of insurers is central to the overall insurance business model and could be unduly disrupted if certain provisions of the Volcker Rule applied."[233] Investing in hedge and private equity funds nonetheless are generally prohibited under the Volcker Rule.[234]

However, the somewhat ambiguous or unclear scope of the law may be the driving force behind viewpoints like the one Mr. Benmosche expressed.[235] The law does provide an exemption for regulated insurers to continue trading securities from their general account in compliance with insurance company investment laws.[236] This exception is subject, however, to FSOC and banking authorities' joint approval that adhering to state investment laws do not threaten economic stability.[237] As state investment laws rigorously limit the amount of insurer's equity and investments and foster diversification among other safeguards,[238] these existing measures provide adequate protection from systematic risk. Indeed, because of these regulations, during 2009's financial turmoil only 1.13% of industry general account assets were invested in either hedge or private equity funds while over 50% of assets were invested in bonds.[239] Hence, it is likely then that Congress' intent in providing for insurer exemptions on general accounts was to retain the prudent state-based investment laws that proved effective during the wake of the 2008 financial collapse.

In addition to potential problems in implementing rules for general fund investments, insurers are also concerned that the Volcker Rule could impair market making, liquidity and depth in the securities markets.[240] "Market

231. Spiezio, *supra* note 228, at 3.

232. Spiezio, *supra* note 228, at 3-5 (providing distinctions between general and separate accounts).

233. FED. STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS 71 (2011) *available at* http://www.treasury.gov/initiatives/documents/volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

234. *See* 12 U.S.C. § 1851(a).

235. *See, e.g.*, McCarty & Vaughan, *supra* note 227, at 3 (requesting clarification from regulatory officials on scope of Volcker Rule's exemptions for insurers).

236. 12 U.S.C. § 1851(d)(1)(F).

237. *Id.*

238. Spiezio, *supra* note 228, at 3; *see also* Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation, Part II: Hearing on § 619 of the Dodd-Frank Act Before the H. Fin. Servs. Comm., 112th Cong. 2-3 (2012) (statement from ACLI), *available at* https://www.acli.com/Newsroom/News%20Releases/Documents/VolckerHearing_ACLIStatement4Record_121312.pdf (detailing state insurance laws and regulations for insurer investments).

239. Spiezio, *supra* note 228 at 3 n. 3.

240. ACLI, *supra* note 238, at 3.

making" is a firm practice of both buying and selling a security.[241] Market makers help provide liquidity for fixed income markets particularly during times of market stress where markets for a particular security may not exist.[242] These firms provide inventory to customers wishing to buy securities and buy from those wishing to sell while finding a profit in the spread or commission.[243] Insurance companies rely on market makers to buy and sell bonds to meet investment needs, manage credit risk, as well as achieving liquidity to fund benefit outflows.[244] Impeding insurers' ability to utilize market makers would reduce liquidity and ultimately cause higher premiums for customers, reduced product options, and wide-reaching negative effects on the overall economy.[245]

Recognizing the importance of market making in the business of insurance and other industries, the Volcker Rule permits "market-making-related activities" to the extent that these transactions "do not exceed the reasonably expected near term demands" of customers and to the extent that they do not pose a threat to affiliated banking entities or national financial stability.[246] Nonetheless, however, the criteria employed by the bill's proposed regulations to differentiate between market making and proprietary trading[247] may interfere with market making critical to the business of insurance as firms may be unable to conduct "bona fide" market making or will be reluctant to trade as they could be uncertain whether their practices fall within Volcker's exemption.[248]

The proposed regulations aim to account for the subtle distinctions of market-making and proprietary trading.[249] The regulations' benchmarks,

241. SEC, *Market Maker*, http://www.sec.gov/answers/mktmaker.htm (last modified Mar. 17, 2000).

242. Letter from Carl B. Wilkerson, Vice President & Chief Counsel, ACLI, to Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, John G. Walsh, Acting Comptroller of the Currency, Department of the Treasury, Martin J. Gruenberg, Acting Chairman, FDIC, & Mary L. Schapiro, Chair, SEC (February 13, 2012), 3, *available at* http://www.sec.gov/comments/s7-41-11/s74111-275.pdf.

243. *Id.*

244. *Id.* at 4.

245. ACLI, *supra* note 238, at 3; *see also* Wilkerson, *supra* note 242, at 4-5 (describing large-scale negative economic effects of reduction of market liquidity).

246. 12 U.S.C. § 1851(d)(1)(B), (2)(A).

247. Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (proposed Feb. 14, 2012) (to be codified at 17 C.F.R. pt. 75), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-935a.pdf ; *See* Proposed Regulations § _.4(b)(2).

248. Wilkerson, *supra* note 242, at 4; *see also* Eric J. Friedman, SKADDEN, ALPS, SLATE, MEAGHER & FLOM LLP & AFFILIATES, *Dodd-Frank Rulemaking: Volcker Rule and SIFI Proposals* 18 (Nov. 17, 2011), http://www.skadden.com/evites/NY/Dodd_Frank_Rule_Making_Volcker_Rule_and_SIFI_Proposals_111711.pdf.

249. Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (proposed Feb. 14, 2012) (to be codified at 17 C.F.R. pt. 75), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-935a.pdf (acknowledging and describing the difficulty in distinguishing between prohibited proprietary trading and market making in

however, fail to recognize certain realities that exist in trading markets, thereby possibly adversely affecting insurers and restraining liquidity. For example, one criterion requires that trades cannot exceed "reasonably expected near-term client, customer and counterparty demand."[250] Apart from the fact that there is no quantitative delineation of what "expected near-term demand" is or what is a "customer,"[251] this requirement may be difficult to meet as the timing of buying and selling securities is wholly customer-driven and are often unpredictable.[252] Additionally, implementation of this rule would have a chilling effect on market makers holding certain inventory on which long-term investors rely for portfolio management purposes.[253] Furthermore, because this criterion and others like it[254] regulate on a "trade-by-trade" approach, the proposed rules neglect to consider that insurers manage highly diversified fixed income portfolios and therefore focus on the risk and positioning of the entire portfolio rather than individual securities.[255] The better choice of action would be to incorporate a portfolio-based approach so as to facilitate the business of insurance, thereby keeping within Congress' original intent behind the market maker exemption.[256]

Finally, because an insurer under the Volcker Rule is considered to be a "covered banking entity" if it is affiliated with a bank subject to Volcker's purview,[257] an insurer is therefore required to comply with the enhanced reporting and recordkeeping requirements applicable to banks.[258] Imposing these intensified standards on insurers is unnecessary and duplicative, however, as state regulators already subject insurers to a multitude of reporting requirements designed to protect insurer solvency and policyholder interests.[259] Additionally, federal regulators are already capable of achieving effective group supervision through existing exchange agreements between themselves,

practice); *See* Prop. Reg. §§ _.4(b)(2)(i)–(vii).

250. Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (proposed Feb. 14, 2012) (to be codified at 17 C.F.R. pt. 75), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-935a.pdf ; *See* Prop. Reg. § _.4(b)(2)(iii).

251. FRIEDMAN, *supra* note 248, at 52-53.

252. Wilkerson, *supra* note 242, at 6.

253. *Id.*

254. Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Covered Funds, 77 Fed. Reg. 8332 (proposed Feb. 14, 2012) (to be codified at 17 C.F.R. pt. 75), *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-935a.pdf; *See* Prop. Reg. §§ _.4(b)(2)(i)–(vii).

255. Wilkerson, *supra* note 242, at 7.

256. *Id.*

257. Friedman, *supra* note 248, at 44 (explaining Prop. Reg. § _.2(e)).

258. *Id.* at 45 (explaining Prop. Reg. § _7).

259. *See* McCarty & Vaughan, *supra* note 227, at 3 (noting that state insurance commissions already highly regulate insurers by subjecting them to detailed statutory reporting requirements, periodic risk focused examinations, quarterly financial analyses, prior approval of affiliate transactions, and extensive regulatory oversight especially as it relates to more volatile investment vehicles).

state regulators, and the private sector.[260] Thus, requiring insurers to comply with new reporting requirements would result in a needless increase in regulatory burdens,[261] the necessary administrative cost of which may be borne by policyholders.

Although the Volcker Rule may, once implemented,[262] effectively curb abuses that were directly responsible for 2008's financial collapse, the administrative agencies implementing the Rule still must adjust regulations that would otherwise adversely affect insurers. Prohibiting insurance companies from investing in hedge and private equity funds, implementing a too narrow market making exception, and subjecting insurers to superfluous reporting and recordkeeping requirements would all have a negative effect on fostering the business of insurance. Moreover, failing to alter Volcker's regulations would be discordant with Congress' intent to leave the insurance industry untouched, as was evidenced by specific exemptions provided in law meant for insurers.[263]

VIII. CONCLUSION

Regulating insurers as banks is an unjustifiable position derived from a misunderstanding about the causes of 2008's financial collapse. It was not the state-regulated business of insurance that contributed to the recession but rather oversights made by an ill-equipped federal regulator in the wake of massive regulatory shake-ups that left the scope of agencies unclear. These regulatory overhauls, coupled with liberalized bank lending standards capitalized on by an all-too-confident Wall Street, made for the perfect financial storm. Moreover, designating insurers as "systemically significant" would be a misnomer; insurers are not a systemic risk. The nature of the insurance industry along with proactive regulation put in place by state regulators prevents insurers from becoming too systemically significant. These factors thus enable insurers to withstand financial shocks as evidenced by the insurance industry's resilience in 2008. Imposing rules meant for bank solvency on insurers would only detract from the Financial Stability Oversight Council's goal of deterring systemic risk. These standards would not be as an effective of a regulator as the current framework states have capably implemented. Indeed, with the bankruptcy of Lehman Brothers and other banks, it was oversights by the Federal Reserve that were a cause, rather than a deterrent, of the crisis.

Perhaps the more justifiable and prudent alternative would be to fix the problems that were directly responsible for the financial downfall; Congress must both restrict what kinds of transactions traders may engage in and implement more comprehensive group supervision while allowing insurers to

260. *Id.* at 227 at 4 n. 4.
261. *Id.* at 3-4; Friedman, *supra* note 248, at 5.
262. The Volcker Rule has not been implemented as of November of 2013.
263. *See* 12 U.S.C. § 1851(d)(1)(B), (d)(1)(F), (d)(2)(A).

retain their longstanding regulatory standards. Both the Volcker Rule and newly introduced legislation exempting insurers from the Collins Amendment are steps in the right direction. However, legislators must be cautious not to impose blanket capital requirements on insurers. Otherwise, 2008 may repeat itself.