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Chairman Crapo, Ranking Member Warner, and members of the Subcommittee, thank you very much for this opportunity to discuss the Financial Stability Oversight Council's ("FSOC") process for designating nonbank financial companies as systemically significant institutions. In my testimony today, I plan to make two central points regarding this process and its consequences for companies that are engaged primarily in the business of insurance.

First, I will emphasize that the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") constructed FSOC's designation process to be flexible and adaptive because systemic risk is itself complicated and evolving. Although this design choice inevitably reduces transparency, FSOC has done a reasonably good job of addressing this concern. For instance, FSOC's development of a quantitative screen in the first stage of its designation process helps assure the vast majority of nonbank financial institutions that they will not be deemed systemically significant. At the same time, FSOC's refusal to rely exclusively on quantitative metrics in its designation process or to define a simple, formulaic "off-

ramp" for designated firms preserves its ability to effectively evaluate and monitor the potential systemic importance of individual firms.

After addressing the transparency of FSOC's designation process, I will turn to the consequences of a systemic risk designation for nonbank financial companies that are principally engaged in insurance ("Insurance SIFIs"). Perhaps the most important such consequence is that Insurance SIFIs – in addition to Insurance Savings and Loan Holding Companies[1] – will be subject to consolidated capital rules to be crafted by the Board of Governors of the Federal Reserve System ("Fed"). I will suggest that these rules should focus on the potential ways in which the states' Risk-Based Capital ("RBC") regime fails to fully account for systemic risk concerns. In particular, the consolidated capital regime should use as its starting point firms' consolidated balance sheets, rely on market-based valuations of firms' assets, and generally avoid reliance on firms' internal models in setting capital or reserve requirements.

(1) Transparency in FSOC's Designation Process

One of the central goals of Dodd-Frank is to limit the risk that individual companies can pose to the general economy in times of financial market turbulence. As exemplified by the substantial role of American International Group ("AIG") in the 2008 Global Financial Crisis, the historical assumption that such systemic risk is cabined to banks and their holding companies is inaccurate in today's financial

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[1] Nothing in Dodd-Frank compels the Fed to use the same capital regime for Insurance SIFIs and Insurance Savings and Loan Holding Companies. However, many seem to anticipate that the Fed will design a single capital regime for both entities, and then apply a capital surcharge to Insurance SIFIs.

world. Instead, firms engaging in a wide variety of financial activities can, in certain circumstances, contribute to the fragility of the financial system in times of general market stress.

To address this reality, Dodd-Frank empowered FSOC to designate nonbank financial firms as entities that could pose a threat to U.S. financial stability. Rather than requiring FSOC to use specific activity-based or quantitative thresholds in executing this responsibility, Dodd-Frank instructed FSOC to consider ten broad factors. Tellingly, Dodd Frank also authorized FSOC to consider "any other risk-related factors that the Council deems appropriate."[2] Dodd-Frank thus tasked FSOC – a council of the nation's leading financial regulators – with employing a broad and evolving approach to identifying systemically significant nonbank financial institutions.

This flexible approach to identifying systemically significant nonbank financial institutions reflects a key lesson of the financial crisis: that systemic risk can arise in new and distinctive guises due to the massive complexity and interconnections that have evolved, and continue to evolve, within our financial system.[3] Just as the errant assumption that only banks could create systemic risk was substantially responsible for the 2008 global financial crisis, any specific quantitative or activity-based definition of systemically significant nonbank financial institutions in Dodd-Frank would undoubtedly have been under-inclusive. This, in turn, would have incentivized financial firms to take on risks that were not

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[2] Dodd-Frank § 113(a).

[3] See generally Daniel Schwarcz & Steven Schwarcz, Regulating Systemic Risk in Insurance, 81 U. Chi. L. Rev. 1569 (2014).

captured by the applicable statutory definition but where extreme losses could have been externalized on to the broader financial system and the general public.

As with all broad legal standards, the flexibility of the FSOC designation scheme as established in Dodd-Frank inevitably creates potential concerns regarding its transparency. Any legal standard that relies on expert decision-makers to apply a broad multifactor test will necessarily sacrifice predictability and transparency in favor of flexibility and adaptability. This is particularly true in a domain such as systemic risk, which is highly technical, constantly evolving, and not fully understood by the academic or regulatory communities.

To help address these inevitable transparency concerns, FSOC engaged in a prolonged process of rulemaking to more specifically describe its criteria for determining which nonbank financial firms might pose systemic risks to the financial system.[4] FSOC's Final Rule and Interpretive Guidance defined three potential "channels"[5] through which a nonbank financial firm might transmit systemic risk and established a six-part analytical framework[6] to guide its assessment of individual firms. At the same time, FSOC specifically declined commentators' requests to establish a simple formula that would link the transmission channels to the analytical framework or that would determine how the

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[4] See 77 Fed. Reg. 21,637 (Apr. 11, 2012). FSOC issued an advance notice of proposed rulemaking in 2010, a first notice of proposed rulemaking in early 2011, a second notice of proposed rulemaking in late 2011, and a Final Rule and Interpretive Guidance in 2012.

[5] These are (i) direct exposure of other firms to the systemic firm, (ii) abrupt liquidation of the systemic firm's assets, and (iii) the disruption of a critical function or service provided by the systemic firm.

[6] This framework focuses on (i) size, (ii) interconnectedness, (iii) substitutability, (iv) leverage, (v) liquidity risk and maturity mismatch, and (vi) existing regulatory scrutiny.

six-factor analytical framework would be weighted in a final determination. Such an approach, FSOC noted, would be inconsistent with the qualitative nature of many of Dodd-Frank's statutory considerations and with robust assessment of individual financial firms' unique risk profiles.

Nonetheless cognizant of continuing transparency concerns, FSOC did develop a formulaic quantitative test to screen out only a small subset of all nonbank financial firms for potential systemic risk designation. Under this screen (which occurs at "stage one" of FSOC's designation process), firms are generally identified for more searching quantitative and qualitative assessment by FSOC[7] if their total consolidated assets surpass $50 billion and they satisfy one of five additional quantitative standards.[8] The effect of this quantitative screen is to provide substantial certainty to the vast majority of nonbank financial institutions that they will not be designated as systemically significant institutions.[9] At the same time, this approach appropriately reflects the reality – illustrated by the crisis and embedded within Dodd-Frank – that the potential for a firm to pose a systemic risk to the larger financial system cannot currently "be reduced to a formula."[10]

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[7] The final rule established two post-screen stages of review. In the first (i.e. "stage two"), the Council considers a broad range of quantitative and qualitative information that is available through existing public and regulatory sources. As originally described in the final rule, firms being reviewed during this stage would not be notified of this fact. In the final evaluation stage (i.e. "stage three"), firms that FSOC continued to believe could pose a systemic risk would be subject to a more detailed review in which they would be invited to submit relevant materials.
[8] These quantitative metrics "represent the framework categories that are more readily quantified: size, interconnectedness, leverage, and liquidity risk and maturity mismatch." Id. at 21,642.
[9] FSOC did reserve its discretion to evaluate a financial firm as posing potential systemic risks even if it was screened out in Stage One.
[10] Id.

In recent months, FSOC has responded to continued concerns regarding the transparency of its process by adopting additional reforms suggested by various stakeholders. Among other things, these reforms will inform firms earlier in FSOC's process if they are being considered for designation and will allow those firms to submit relevant information to the Council at that point. It will also provide firms that have been designated as systemically significant with an enhanced opportunity to participate in the Council's annual reevaluation of that designation.

To be sure, none of this is to suggest that FSOC could not further improve the transparency of its operations. In particular, FSOC's public basis for designating nonbank financial firms as SIFIs could more clearly articulate the relative importance of the identified factors in explaining the Council's reasoning.[11] Additionally, FSOC could more clearly develop a process for allowing a SIFI to seek the Council's opinion regarding whether specific transactions or alterations to the firm's risk profile would allow it to shed its designation as a SIFI.

Nonetheless, in my view, FSOC has done a reasonable job of promoting the transparency of its designation process given the inherently multi-factored and complex nature of its responsibility. It has also rightly resisted calls to develop simple rules defining systemically risky nonbank financial firms or a formulaic "off-road" for systemic risk designation. The nature of systemic risk is too fluid, complex, and poorly understood to allow for such simple formulas. By using clear quantitative metrics only to narrow the field of potential systemically risky nonbank

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[11] Government Accountability Office, Financial Stability Oversight Council, Further Actions Could Improve the Nonbank Designation Process (Nov. 2014).

financial institutions, while promoting greater participation and transparency among stakeholders in the post-screen assessment process, FSOC has struck a reasonable balance between transparency, on the one hand, and flexibility and adaptability, on the other.

(2) Consolidated Capital Rules for Insurance SIFIs

Under Dodd-Frank, those nonbank financial firms that are deemed systemically significant by FSOC are subject to enhanced prudential rules and supervision by the Fed. Perhaps the most important element of this regime is the application of new risk-based capital standards on a consolidated basis, which Dodd-Frank directs the Fed to develop. The Insurance Capital Standards Clarification Act of 2014 authorized the Fed to tailor these capital standards to the distinctive risks posed by insurers, which are different than the risks posed by banks. But, at the present time, the Fed has not made clear how precisely it intends to use this authority.

In my view, the Fed should design capital standards for Insurance SIFIs that focus on the potential ways in which the policyholder-protection design of state RBC rules may fail to fully account for systemic risk concerns.[12] As I have emphasized on multiple occasions in prior congressional testimony,[13] the regulatory objectives of

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[12] In a Report of the NAIC and the Federal Reserve Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage (2002), a working group of insurance and banking regulators explained the core differences between risk-based capital rules in insurance and banking by noting that "Insurance company regulators place particular emphasis on consumer (policyholder) protection" while "banking regulators focus on depositor protection and the financial stability of regulated entities on a going concern basis."
[13] See, e.g, Daniel Schwarcz, Testimony before the Senate Subcommittee on Financial Institutions and Consumer Protection regarding "Finding the Right Capital Regulation for Insurers" (March 11, 2014);

any risk-based capital regime have important implications for how that regime should be constructed. For that reason, capital regimes focused on systemic risk can, and should, be designed differently than capital regimes focused on policyholder protection.

Given this perspective, I believe that the Fed should consider implementing a capital regime for insurance SIFIs that is consistent with three broad principles. First, that regime should use as its starting point the consolidated balance sheet of the firm.[14] The current state-based RBC regime focuses exclusively on the balance sheets of individual insurance entities. Although this regime generally works well to promote policyholder protection, it has important limitations when it comes to regulating systemic risk.[15] This is most obvious with respect to AIG's use of a non-insurance subsidiary to issue Credit Default Swaps prior to the 2008 crisis. But it was also importantly illustrated by AIG's use of a complex securities lending program to "transform insurance company assets into residential mortgage-backed securities and collateralized debt obligations, ultimately losing at least $21 billion and threatening the solvency of the life insurance companies."[16] More recently, the

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Daniel Schwarcz, Testimony before the House Housing and Insurance Subcommittee regarding "Legislative Proposals to Reform Domestic Insurance Policy" (May 20, 2014); Daniel Schwarcz, Testimony before the House Subcommittee on Insurance, Housing and Community Opportunity regarding "Insurance Oversight and Legislative Proposals" (Nov. 16, 2011).

[14] Consistent with the IAIS's proposed approach, this balance sheet could then be broken down into three components: insurance, banking, and non-insurance financial and material non-financial activities. See International Association of Insurance Commissioners, Basic Capital Requirements for Global Systemically Important Insurers (July, 2014).

[15] See generally Daniel Schwarcz, A Critical Take on State-Based Group Regulation of Insurers, 5 U. Cal. Irv. L. Rev. (forthcoming, 2015), available at http://ssrn.com/abstract=2593897.

[16] Robert L. McDonald & Anna L. Paulson, AIG in Hindsight (April, 2015), NBER Working Paper No. w21108, available at SSRN: http://ssrn.com/abstract=2596437.

entity-based focus of the RBC regime has allowed insurance companies to utilize complex transactions with "captive" affiliates that may create systemic risks.[17]

Second, the Fed should seriously consider designing its capital regime for insurance SIFIs to require valuation of assets at market rates. Market-based valuations are more relevant than accounting values when it comes to systemic risk regulation, because it is precisely in times of potential systemic risk transmission that liabilities previously perceived to be long-term can become short-term. To the extent this occurs, then systemic firms may find themselves compelled to sell their assets at prevailing market rates. Market valuation of assets is also more consistent with emerging international norms, thus tending to promote cross-jurisdictional comparability, which is important from a systemic risk perspective. Although market valuation does create potential concerns regarding artificial capital fluctuations that could possibly contribute to fire-sale dynamics, these issues could conceivably be dealt with by adjusting required capital levels in times of economic stress.

Third, the Fed should not allow firms to use their own internal models to determine adequate capital levels and it should also proceed with caution in accepting state Principles-Based Reserving (PBR) reforms that will allow insurers greater freedom to use internal models to set their reserves. A central lesson of the

[17] See generally Ralph S. J. Koijen & Motohiro Yogo, Shadow Insurance (February 18, 2015), Swiss Finance Institute Research Paper No. 14-64, available at http://ssrn.com/abstract=2320921; Federal Insurance Office, How to Modernize and Improve the System of Insurance Regulation in the United States (2014); New York State Department of Financial Services, Shining a Light on Shadow Insurance: A Little-Known Loophole That Puts Insurance Policyholders and Taxpayers at Greater Risk (June 2013).

2008 global financial crisis is that firms' internal models can often be overly optimistic, which should not be surprising given the incentives firms have to maintain lower capital levels and increased leverage. Moreover, in many cases it is simply not realistic to rely on regulators to police firms' internal models due to the complexity of these models and the imbalance of resources available to regulators and private firms.[18]

These principles are broadly consistent with elements of the group-wide, consolidated capital requirements for systemically significant insurers that are being developed by the International Association of Insurance Supervisors (IAIS). Moreover, the IAIS has made substantial progress in recent years in crafting and testing the technical features of this framework. Of course, the Fed should remain cognizant of this country's unique insurance regulatory scheme in determining how the IAIS's capital standards should apply to insurance SIFIs in the United States. But it should also seriously consider adopting elements of this scheme that would provide a more macro-prudential perspective than the state RBC regime, which focuses on policyholder-protection. For this reason, I believe that the Fed should continue to be an active participant in the IAIS's development of consolidated capital standards, and should draw on these developments in implementing a consolidated capital requirement for insurance SIFIs in the United States.

[18] Federal Insurance Office, How to Modernize and Improve the System of Insurance Regulation in the United States (2014).