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to the

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I am an associate professor of legal studies and business ethics at the Wharton School. I study financial regulation and, in particular, international financial regulation, a field of growing importance and one that has already transformed the way that banks and capital markets are regulated. It is a field of increasing importance to insurance as well.

1. Overview

In my testimony today on the covered agreement between the United States and the European Union, I would like to focus on three points.

First, the covered agreement grew out of an effort in the wake of the financial crisis to improve the regulation of financial companies, including insurance companies, given the repercussions of the failure of the large insurance company AIG during that crisis. For insurance, that effort has involved a number of different channels. The goals have been twofold. One has been to make sure that globally active insurance companies are sensibly regulated as whole enterprises, rather than as a series of operating subsidiaries in a variety of different jurisdictions. The second has been to insure that internationally active insurance companies have faced a level playing field when it comes to doing business at home or overseas.

The covered agreement complements efforts to reduce nontariff barriers through trade agreements and efforts to increase the quality of global insurance supervision through organizations like the International Association of Insurance Supervisors (IAIS). It offers the reduction of two barriers to trade and two regulatory agreements that will improve the supervision of insurance conglomerates in both the United States and Europe, serving objectives identified by regulators and trade negotiators in the wake of the financial crisis.

Second, the agreement deepens cooperation through the exchange of information, includes a deal on reinsurance that reduces trade barriers in both the United States and the European Union, and provides a sensible framework for the supervision of insurance conglomerates as groups. As a matter of content, it is likely to be good for insurance companies and consumers. In addition, it rationalizes the supervision of insurance companies by looking at the totality of their operations, just as banking supervisors do when it comes to banking financial conglomerates.

Third, the critics of the transparency of the process in concluding the covered agreement are misguided. The United States never hid the fact that it was engaging in negotiations with the European Union, and now that the result of those negotiations have been made public, the covered agreement is being appropriately reviewed by Congress and by stakeholders. That is the right way to contact transparent international processes: congressional approval to engage in international negotiations is given beforehand, and the results of those negotiations are reviewed after the fact. Requiring more and different consultations during the negotiations would be both inconsistent with the way negotiations work and entirely unnecessary process.

More generally, international regulatory cooperation is not easy, and must be paired with procedural protections, but the United States cannot ignore the efforts and interests of foreign

regulators. The global effort to create a single common set of accounting standards exemplifies the risks of failing to engage. The United States stayed out of that process, but the resulting International Financial Reporting Standards have now been adopted by essentially every jurisdiction in the world but one – and the Securities and Exchange Commission is now accepting IFRS for foreign filers. This country can take a leadership role in devising international regulatory standards, or it can let others develop the standards, and adopt them later. But it cannot ignore them.

2. The Context for the Covered Agreement between the US and EU

Before the financial crisis, insurance companies were thought to be relatively safe financial intermediaries. They were regulated, especially in the United States, more to ensure that they did not deceive consumers, rather than for the danger that they would collapse and create risks for the financial system. That perspective made sense in most contexts; insurance companies are less susceptible to bank runs or the sort of operational risks posed by rogue traders or flash crashes that may roil the financial and capital markets. State insurance commissioners have traditionally led the way in this oversight.

However, the financial crisis exemplified the ways that, as insurance companies have taken on more varied operations, their conduct can threaten the stability of the system. Most notably, this occurred in the case of the insurance giant American International Group, one of the largest companies in the country. As you all know, it collapsed in 2008. AIG provided all sorts of insurance to policyholders all over the world. But its diverse array of products proved to be its undoing; AIG was ruined by a combination of the entry into a new quasi-insurance market, and the dependence on a securities lending program that dried up just as the new business started to fare disastrously.

The new business was run out of AIG's London subsidiary, AIG Financial Products. AIG-FP wrote insufficiently hedged credit default swaps, bolstered by the strong balance sheet of the larger insurance firm. As the credit crisis worsened, AIG had to post more and more collateral to satisfy its counterparties that it would make good on the credit protection contracts it had written. Eventually the need to post ever more collateral rendered the company essentially insolvent, with a large proportion of its assets encumbered. Some accounts put the losses on this credit insurance at $30 billion.

To make matters worse, AIG's securities lending business collapsed at the same time and for largely the same reason: the collapse in mortgage backed-securities markets. Companies like AIG that hold a lot of securities against the insurance policies written by their operating subsidiaries often lend the securities out in exchange for cash collateral. When they do so, they typically take that cash collateral and invest it in something short term and relatively safe. But AIG invested in riskier assets, including assets backed by subprime residential mortgage loans. When the financial crisis began to deepen, and borrowers returned their securities, seeking the cash collateral, AIG found itself unable to liquidate these assets quickly, at the price the firm expected to receive. Estimates at the losses due to this securities lending have placed that deficit at around $21 billion.[1]

The result was that a famously careful American insurer that served different customers across the world was undone by one relatively small London subsidiary, which, it turned out, was not being carefully overseen by British insurance regulators, the New York insurance commissioners who oversaw the center of the firm's operations, or the Office of Thrift Supervision, which oversaw AIG to the extent that the conglomerate served as a holding

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[1] For a discussion, see Robert McDonald & Anna Paulson, *AIG in Hindsight*, 29 J. ECON. PERSP. 81 (Spring 2015).

company of a thrift subsidiary. Its overseers had also not realized that it had found its way into a runnable market through its securities lending business. The securities held by its insurance subsidiaries had been lent out through a process centralized through a noninsurance, securities lending–focused subsidiary.

Both disasters, which hit AIG at the same time, posed problems that the company's insurer supervisors were ill-equipped to solve or even recognize in part because they did not subject the firm to meaningful consolidated, or group level, supervision.[2] Instead the various subsidiaries of AIG were parceled out as the responsibility of various regulators, with little effort made to coordinate that supervision.

The AIG experience, and the financial crisis in general, changed the way that oversight over non-bank financial companies was allocated between the states and the federal government, particularly with regard to the effort to create international standards. Title V of the Dodd-Frank Wall Street Reform Act created the Federal Insurance Office ("FIO") within the Department of Treasury. That office has limited powers, especially domestically, where insurance supervision remains the province of the state insurance commissions. FIO has nonetheless been charged with a particularly important outward-facing role. It has unique international responsibilities: Congress instructed it "to coordinate Federal efforts and develop Federal policy on prudential aspects of international insurance matters, including representing the United States, as appropriate, in the International Association of Insurance Supervisors;" (IAIS) to "consult with the States (including State insurance regulators) regarding insurance matters of national

[2] For a further discussion of the AIG problem, see Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States, 5* UC IRVINE L. REV. 537 (2015).

importance and prudential insurance matters of international importance;" and to "advise the [Treasury] Secretary on … prudential international insurance policy issues."[3]

It also has been given the power, in association with the United States Trade Representative, to conclude agreements on insurance regulation with foreign counterparties. These so-called covered agreements are defined in Dodd-Frank as

> a written bilateral or multilateral agreement regarding prudential measures with respect to the business of insurance or reinsurance that is
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> > (A) entered into between the United States and one or more foreign governments, or regulatory entities; and
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> > (B) relates to the recognition of prudential measures with respect to the business of insurance or reinsurance that achieves a level of protection for insurance or reinsurance consumers that is substantially equivalent to the level of protection achieved under state insurance or reinsurance regulation.[4]

These covered agreements are meant to both strengthen insurance regulation and level the playing field between the United States and other countries, and are meant to serve as a bilateral backstop for regulatory cooperation in cases where multilateral regulation has not made progress. An analogy might be drawn to this country's approach to progress on reducing barriers to trade. When multilateral agreements like the Doha Round have foundered, the United States has increasingly looked to pursue its trade interests through regulation or bilateral trade and investment deals. In the case of post-crisis insurance supervision, the hope evinced in Dodd-Frank is that where multilateral efforts to either level the international playing field or to improve

[3] 31 U.S.C. § 313(c)
[4] 31 U.S.C. § 313(r)(2).

the supervision of systemically risky insurance companies has foundered, bilateral covered agreements might serve as a useful supplement.

The work of IAIS continues and, of course, trade negotiations, on both the bilateral and a multilateral basis, are part of the mix that will affect the playing field on which insurers from a variety of different jurisdictions can seek to market their products to consumers both at home and abroad.

In my view, the covered agreements occupies a place in the middle of these international efforts to solve some of the problems posed by the modern insurance market. On the one hand, trade negotiations are about reducing trade barriers and making it more possible for insurance companies to access foreign markets. Trade uses its national treatment principle to do so – that principle provides that members of the World Trade Organization "shall accord to the nationals of other Members treatment no less favourable than that it accords to its own nationals" for a variety of products and services.[5] The goal is to remove discriminatory regulation of foreign imports as much as possible.

The IAIS efforts are also designed to level the playing field when it comes to the supervision of insurance companies. Here, the effort is not so much to remove regulations as it is to improve them. International financial regulation through a network like IAIS in this way has a harmonizing purpose just like trade agreements, but IAIS seeks to bring regulatory standards in member countries up to a more intensive standard, with national treatment serving as both a justification (we must measure up to the other members of the network in our treatment of our

[5] GATT Article III.

insurers) and a caution (we must treat our insurers the same way we treat foreign insurers) for more intense oversight.[6]

In the wake of the financial crisis, IAIS, and the coordinator of financial oversight, the Financial Stability Board, under instruction from the G20, has taken new steps to create consistent global standards for supervisors designed to improve the safety and soundness of financial firms, including capital standards and group standards.

Efforts to create international insurance standards make sense as American firms increasingly enter foreign markets, and foreign firms enter the American one. Common standards level the playing field, and invite the sort of competition that can only benefit insurance consumers. And in a world where an insurance group can be destabilized by a faltering subsidiary in a single country, the value of coordinated supervision is obvious.

Nonetheless, international processes are almost by definition more difficult to follow than domestic ones. IAIS and the FSB have taken, often at the behest of American regulators, steps towards improving their transparency. They have websites, they issue consultative documents and accept comment upon them, and they hold increasingly open annual meetings. And the IAIS has usefully dropped the very high fee it required of those who hoped to attend its annual meeting. But transparency should not be viewed as requiring that any and every interested party be able to attend any meeting at any moment. No business works that way, and nor does any agency. Policymaking requires opportunities for deliberation, and the importance of a role for deliberation should not be gainsaid.

The covered agreement between the United States and the European Union occupies a middle ground once this context is taken into account. On one hand, the portion of the agreement

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[6] A further discussion of this point may be seen in David Zaring, *Finding Legal Principle in Global Financial Regulation*, 52 VA. J. INT'L L. 685, 707 (2012).

that deals with reinsurance reduces trade barriers in both the European Union and the United States. On the other hand, the group supervision agreement improves the quality and consistency of the supervision of insurance conglomerates by encouraging regulators to assess the solvency and capital adequacy of insurance companies at the group level, rather than solely at the operating subsidiary level.

Finally, I think it would be remiss not to observe that the agreement provides for an information exchange that is likely to deepen the contacts between regulators in the US and EU in a way that will be a great benefit the next time that a large insurance company runs into financial trouble.

3. The Content of the Covered Agreement

Once the context of the covered agreement is understood, its content makes a great deal of sense.

The reinsurance portion of the agreement reduces trade barriers in both the United States and the European Union in a way likely to benefit American consumers. I therefore view it as something like a trade deal, contained within the more narrow confines of a limited agreement on international insurance regulation. In particular, the requirement that foreign reinsurance firms post 100% collateral to do business in certain American jurisdictions makes little sense for well supervised European reinsurers. This problem has been apparent for years, and yet any reduction in the collateral requirements, which thereby would open up the US reinsurance market and introduce new competitors, to the benefit of insurance companies and ultimately consumers, has been slow.

The agreement would prevent US state insurance regulators from requiring EU reinsurers to post such high levels of collateral as a condition for US firms to be credited for their contracts

with EU reinsurers. These provisions do not limit the power of American regulators to apply requirements for entering into reinsurance agreements. The Treasury Department views this requirements as one that builds on the reinsurance collateral reform adopted unanimously by US state regulators in 2011 and implemented in many, but not all, states. I am inclined to agree.

In addition to improving the reinsurance market, the rationalization of reinsurance collateral requirements will likely help the United States as it pursues further nontariff barrier concessions from the European Union. The participation of the USTR in the negotiations over the covered agreement underscores the relevance of the reinsurance arrangements for the more general reduction in trade barriers on both sides of the Atlantic.

The United States also got something for American re-insurance companies as well. One of the covered agreement's objectives, as announced in its Article I, is "the elimination, under specified conditions, of local presence requirements." Specifically, the agreement relieves US reinsurers from the obligation to establish a local presence—i.e., a branch or subsidiary—in the EU. The local presence requirement in the EU was also a real burden on the ability of American reinsurers to access that market. The elimination of that burden will level the playing field for American and European reinsurance firms by making it easier for American reinsurers to access the European market without opening an office in every jurisdiction in which they do business.

The agreement also contains provisions on group supervision. Under the EU's "Solvency II" regime, European insurers are subject to group supervision, and foreign insurers seeking to do business in the EU are required to establish that they are supervised in a comparable way. Most worryingly for American firms, the EU reserved for itself the right to impose additional capital and other regulatory requirements on firms if its country of domicile was not determined by the EU to have a supervisory system that is "equivalent" to the Solvency II supervisory system.

The covered agreement provides that this requirement will not be imposed upon American insurers doing business in Europe, provided that they can establish that they are being adequately supervised as groups. The agreement was in this way designed to "establish[] that the [American] supervisory authority, and not the [European] supervisory authority, will exercise worldwide prudential insurance group supervision," as the agreement provides in Article I. It means that US insurance groups operating in the EU will be supervised at the worldwide group level by the relevant US insurance supervisors, rather than through a European process imposed on American insurers and based on Solvency II.

Group supervision is, in my view, the appropriate way to supervise any large financial conglomerate. Banks are supervised at the holding company level by the Federal Reserve, and the single point of entry resolution scheme also looks to manage firms in crisis in a consolidated way. Dodd Frank, in the way it treats non-bank subsidiaries of broker dealers and derivatives desks also looks to the group rather than the operating subsidiary in assessing systemic risk.

The group supervision component of the covered agreement brings this sort of focus to insurance conglomerates, and appropriately so. I have observed that some of the problems posed by the supervision of AIG were likely attributable to the fact that its American regulators were not sufficiently focused on its London financial products affiliate, as well as on its non-insurance securities lending affiliate. It makes sense to assess the riskiness of an insurance company with a view to the whole insurance company, and not by only looking at its operating subsidiaries on a state-by-state basis.

Moreover, it appears that the approach taken in group supervision of insurance conglomerates mimics the program that the National Association of Insurance Commissioners is already rolling out. State regulators used to regulating firms at the operating subsidiary level are

unaccustomed to group supervision, and may not have the incentives to cooperate in a way likely to make group supervision successful. They are, however, beginning to address the issue with their "windows" and "walls" approach to groups. The "walls" of the state regulatory process are designed to ring-fence individual regulated entities from various risks that may be associated with their affiliates or holding companies, and include rules requiring that insurers' transactions with affiliates be on terms that are "fair and reasonable" and subject to regulatory disapproval. The "windows" of U.S. insurance regulation are designed to allow regulators of individual operating entities to assess potential risks from affiliates that may impact the operating entity. The "windows" provide regulators with financial information from any entity controlling the insurer, financial statements of all affiliates, and the right to acquire information seek further information about large risks faced by the insurance group.[7] The covered agreement recognizes this approach, as well as the Own Risk and Solvency Assessment used by state regulators, which would be shared with European regulators.

Finally, the agreement provides for an information exchange that will amplify and improve contacts between regulators in the US and EU. Over four decades of cooperation among central bankers and securities regulators has contributed to the capacity for the coordinated response that we have seen, to the degree that we have seen it, in the response to the last crisis, by both. In the midst of that crisis, the Securities and Exchange Commission coordinated its shorting ban with its international counterparts at an International Organization of Securities Commissions (IOSCO) meeting, even though the coordination was done in the hallways rather than during the official session. By the same token, the coordination of the injections of capital through swap lines and other mechanisms by the world's central bankers was

[7] For an overview of these rules, see Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States, 5* UC IRVINE L. REV. 537 (2015).

facilitated by their already extant supervisory cooperation. In other words, cooperation on matters of enforcement and understandings along those lines can create or further the relationships that can facilitate an international response to the next crisis.[8] That precedent is why I view the agreement on information exchange as a worthy and useful aspect of the agreement.

4. Finding the Right Level of Transparency for the Covered Agreement

How can we ensure that the sorts of international processes represented by the covered agreement have the right amount of accountability and democratic legitimacy? At best, Congress will begin the process by authorizing, or in some cases blessing, efforts at international regulatory cooperation. Second, the regulators will engage in that cooperation. And finally, regulators must come engage in a domestic administrative process.

So far, this is the process that has been followed in the covered agreement. Congress gave Treasury and the USTR the power to negotiated covered agreements in Dodd-Frank. And American regulators participating in the process notified Congress and the industry before they began to negotiate an agreement with their European counterparts, and provided updates over the course of the negotiation.

Complaining about the transparency of the negotiations as they are happening is, in my view misplaced, provided there is a full and fair opportunity to review the product of those negotiations. This hearing is part of that review. Too many consultation or participation requirements limit the ability of negotiators to in fact negotiate.

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[8] For more on this, see David Zaring, International Institutional Performance in Crisis, 10 Chi. J. Int'l L. 475, 485 (2010).

Finally, the text of the final agreement was sent to all of the relevant committees as required by Dodd-Frank. There is much process required before the US can take action against any state that fails to bring its rules into line with the covered agreement:

- No later than 42 months following execution of the Agreement, the US must begin evaluating potential preemption determinations with respect to any state insurance measure that results in less favorable treatment of an EU insurer or reinsurer than a US insurer or reinsurer in a manner inconsistent with the agreement. The US has agreed to consider the states with the biggest reinsurance market first, and to finish within five years following execution of the agreement.
- If it makes a preemption determination, Treasury must notify and consult with the state insurance regulator, take comment on the proposed determination, and give the state some time before finalizing preemption.
- A state has the right to challenge that preemption determination in court.

Covered agreements are meant to strengthen insurance regulation and level the playing field between the United Stated and European Union. There has been talk in the past about pre-conclusion publication requirements, or elaborate rounds of comment, sometimes involving congressional committees, before beginning the process of negotiating the agreement. But requiring draft agreements, or the American negotiating position, to be published in the Federal Register simply slows the process of implementing these agreements. It also suggests that the United States might not be able to live up to its bargains, which makes these agreements – which were blessed by Congress in Dodd-Frank – all the more difficult to conclude. It is also, for that matter, no way to conduct an international negotiation – you don't reveal your hand before you head to the bargaining table.

5. The Risks Of Non-Participation: The International Accounting Standards Saga

In my testimony, I have emphasized that international regulatory cooperation provides opportunities for American regulators to improve the stability of the financial system at home, and abroad, and therefore better meet their domestic regulatory mandates. I'd like to conclude with a cautionary tale about what can happen if American regulators reject an international process.

The accounting story is particularly instructive. It is a cautionary tale for Americans because American regulators, by essentially abandoning an already ongoing harmonization effort in the 1990s, lost their ability to affect the effort, and now have had to begin the process of conforming to it.

International accounting standards--the idea that companies listed on stock exchanges from Stockholm to Shanghai might report their results in the same way--have always been an attractive regulatory goal. In the 1980s, capital market regulators agreed to endorse an effort by professional accounting organizations to try for global harmonization of accounting rules. But the effort proved controversial, as American regulators comfortable with the unique American approach to financial statements withdrew their support for the enterprise in the early 1990s.

That exit, however, did not stop the process of devising common accounting standards. Instead, the international efforts moved to Europe; the creation of international accounting standards after the SEC's rejection of the prospect of them, has been managed by the International Accounting Standards Board (IASB), a public-private arrangement based in London created in 2001. The IASB has devised a set of accounting standards, the International Financial Reporting Standards (IFRS), which has enjoyed quick adoption in European and other countries. IFRS was essentially created without American participation.

And therefore, perhaps unsurprisingly, IFRS is rather different from American accounting rules. It is a principles--rather than rules--based accounting system, in that it is less technical than traditional American accounting, and relies more on the gestalt of a company's returns to assess its accuracy. The United States had--and, for the moment, still has--a unique rules-based and reputedly challenging set of accounting standards that differ greatly from those of any other nation, the Generally Accepted Accounting Principles (GAAP).

But, faced with a cascade of adoptions of IFRS, those GAAP principles have a very tenuous future, despite the SEC's doubling down on their necessity in the 1990s. As foreign jurisdictions have gained more and more of the business of floating stocks and bonds and raising capital, American capital market regulators have given up hope that they might do so in ways consistent with the complicated GAAP. The SEC has permitted foreign companies that list on American stock markets to use IFRS to file their American annual and quarterly reports. And the SEC will surely accede to IFRS eventually for all filers.

Accounting is technical, and acronyms like GAAP and IFRS daunt almost as much as they reveal what, exactly, the distinction between rules-based and principles-based accounting really amounts to. But the import of the triumph of IFRS can be gleaned by abstracting away from it, and from the details of accounting. The commitment to an international effort in accounting has worked a sea change in the way that companies report their results, and the sea change has come without much American involvement--even though it will, in the near future, affect American companies as much as anyone else.

Thus, this story of accounting standards illustrates what happens when international efforts are not pursued, even though safeguards on cooperation are important. Its propensity towards momentum is not a universal law, to be sure, but regulators ignore cross-border efforts

at their peril, because those efforts can set the standards for even the most independent and recalcitrant jurisdictions, if the circumstances are right.

Thank you.