IN THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF COLUMBIA

METLIFE, INC.,

Plaintiff,

v.

FINANCIAL STABILITY OVERSIGHT COUNCIL,

Defendant.

Civil Action No. 15-45 (RMC)

BRIEF OF SCHOLARS OF INSURANCE REGULATION AS *AMICI CURIAE* IN SUPPORT OF DEFENDANT FINANCIAL STABILITY OVERSIGHT COUNCIL

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INTRODUCTION

MetLife challenges the Financial Stability Oversight Council's determination that material financial distress at the company could pose a threat to U.S. financial stability. One central element of MetLife's challenge is its claim that FSOC failed to adequately consider the strength of the state insurance regulatory system. This amicus brief of scholars with expertise in insurance regulation argues that FSOC's designation of MetLife fairly accounts for state insurance regulation's focus on protecting policyholders rather than mitigating systemic risk. Advancing these two regulatory goals often requires very different types of prudential safeguards and supervisory scrutiny. In fact, many of the central features of U.S. state insurance regulation are inadequate in their capacity to prevent, anticipate, or respond to systemic risks. This problem is structural and cannot be remedied by state reforms. Individual states and the states collectively lack the inherent jurisdiction and ability to properly monitor and regulate systemic financial risk.

This brief develops these points in three parts. *First*, it emphasizes that state insurance regulation focuses predominantly on individual insurance entities rather than on the financial conglomerates that own or control these companies. This "micro-prudential" perspective is limited in its capacity to address the risk that a group enterprise such as MetLife could pose to U.S. financial stability. *Second*, the brief explains that state insurance regulators would face substantial coordination challenges in attempting to halt a run at a company of MetLife's size and scope. Relatedly, the state insurance guaranty fund system could well be inadequate to deter a run at such a massive company because it provides only limited coverage and is funded predominantly by statutorily capped, *ex post* assessments on surviving insurers. *Third*, the brief argues that state insurance regulators do not have either the appropriate political accountability or the line of sight into the entire financial regulatory system to effectively anticipate and manage firms of systemic significance, such as MetLife.

BACKGROUND

Historically, U.S. financial regulation has been structured around the assumption that banks pose unique systemic risks to the broader financial system and general economy. But the financial crisis of 2008 vividly illustrated that excessive risk-taking by nonbank financial institutions can also have systemic consequences. Indeed, the federal government's $182-billion rescue of American International Group—a financial group predominantly engaged in the business of insurance—remains the largest U.S. rescue of a private company in history.

Recognizing that systemic risks[1] are not restricted to deposit-taking banks, The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), tasks FSOC with identifying nonbank financial firms whose "material financial distress . . . could pose a threat to the financial stability of the United States." *Id.* § 113.[2] Dodd-Frank subjects such institutions to supervision by the Board of Governors of the Federal Reserve System as well as enhanced prudential standards. *Id.* Under Dodd-Frank, FSOC must consider eleven broad factors in assessing whether individual nonbank financial firms should be designated under § 113. One of these factors is the "degree to which the company is already regulated by one or more primary financial regulatory agencies." *Id.* § 113; *see also* FSOC's Final Rule and Interpretive Guidance, 77 Fed. Reg. 21,638 (Apr. 11, 2012) (establishing existing regulatory scrutiny as one of

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[1] This brief describes an institution as raising potential "systemic risks" or being "systemically important" if material financial distress at that institution could pose a threat to the financial stability of the United States. Of course, this does not mean that there are not other ways in which an institution or market might prove to be systemically significant.

[2] Section 113 also established a second determination standard, whereby the Council could designate a nonbank firm for supervision by the Fed and enhanced prudential standards if "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States." This determination standard is not at issue here because FSOC did not rely on it to designate MetLife.

six elements of FSOC's analytical framework for assessing the potential systemic risks posed by individual firms).

In this case, MetLife challenges FSOC's December, 2014 designation of the company under § 113 as a nonbank financial company subject to supervision by the Fed and enhanced prudential standards.[3] *Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc*. ("Public Basis") (Dec. 18, 2014).[4] One key element of MetLife's argument is that FSOC failed to give due weight to the fact that its individual insurance company subsidiaries are already subject to state insurance regulation. *See*, *e.g.*, Compl. at ¶ 4, *Metlife Inc. v. Financial Stability Oversight Council*, No. 15 Civ. 45 (D.D.C. Jan. 13, 2015). In addition, MetLife repeatedly emphasizes that various state insurance regulators have criticized FSOC's designation of the company under § 113. *See*, *e.g.*, *id.* (noting that the non-voting state insurance commissioner on FSOC accused the Council of failing to understand basic elements of the state insurance regulatory system). This amicus brief argues that FSOC's public basis for designating MetLife

[3] Although the Fed has already begun its supervision of MetLife, it is still devising elements of the prudential standards that will apply to the company on a consolidated basis. *See The State of the Ins. Indus. and Ins. Regulation: Hearing before the S. Comm. on Banking, Hous., and Urban Affairs*, 114th Cong. (April 28, 2015) (statement of Mark Van Der Weide, Deputy Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve). This delay is largely attributable to legal uncertainty regarding the scope of the Fed's discretion to devise capital standards specific to the insurance business for insurance-focused firms that are designated under § 113 or otherwise subject to the Fed's oversight because they own a depository institution. In 2014, Congress resolved this uncertainty with legislation providing the Fed with discretion to tailor the capital standards applicable to insurance focused firms so that they appropriately reflect the distinct risks posed by such firms. *See* Insurance Capital Standards Clarification Act of 2014, Pub. L. No. 113-279 (2014).

[4] This brief cites portions of the administrative record containing the nonpublic basis for the FSOC's final determination regarding MetLife, which was provided to undersigned scholars with expertise in insurance regulation by the FSOC on May 13, 2015, with redactions that had been made by MetLife.

under § 113 of Dodd-Frank accurately reflects the fact that state insurance regulation is focused predominantly on protecting policyholders rather than mitigating systemic risk.[5]

INTEREST OF *AMICI CURIAE*

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Patricia A. McCoy is a professor of insurance law at Boston College Law School. Previously, she was the Director of the Insurance Law Center at the University of Connecticut School of Law and the Assistant Director of Mortgage Markets at the Consumer Financial Protection Bureau in Washington, D.C. Professor McCoy has testified multiple times before

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[5] Amicus Daniel Schwarcz has testified on this point repeatedly to U.S. congressional committees since the 2010 passage of Dodd-Frank. *See Examining Ins. Capital Rules and FSOC Process: Hearing before Subcomm. on Sec., Ins., & Inv. of the S. Comm. on Banking, Hous., & Urban Affairs*, 114th Cong. (April 30, 2015) (statement of Daniel Schwarcz); *Finding the Right Capital Regulation for Insurers: Hearing before the Subcomm. on Fin. Inst. & Consumer Prot. of the S. Comm. on Banking, Hous., & Urban Affairs*, 113th Cong. (March 11, 2014) (statement of Daniel Schwarcz); *Legislative Proposals to Reform Domestic Ins. Policy: Hearing before the Subcomm. on Hous. & Ins. of the H. Comm. on Fin. Servs.*, 113th Cong. (May 20, 2014) (statement of Daniel Schwarcz); *Ins. Oversight and Legislative Proposals: Hearing before the Subcomm. on Ins., Hous. & Cmty. Opportunity of the H. Comm. on Fin. Servs.*, 112 Cong. (Nov. 16, 2011) (statement of Daniel Schwarcz). This point is also made in the *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. The Report explained the core differences between risk-based capital rules in insurance and banking by noting that "[i]nsurance 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."

Congress on the 2008 financial crisis and has written extensively on the AIG rescue and the need for federal systemic-risk regulation of consolidated insurance groups.

Joseph M. Belth is a professor emeritus of insurance in the Kelley School of Business at Indiana University, Bloomington. He has written extensively about insurance regulatory issues and has received many awards, including a George Polk Award for *The Insurance Forum*, a monthly periodical on insurance matters.

Steven L. Schwarcz is the Stanley A. Star Professor of Law & Business at Duke University School of Law. He is widely regarded as a leading legal expert on systemic risk and its regulation, having testified on that subject before committees of the U.S. Senate and House of Representatives. He has authored numerous articles on systemic risk generally as well as the regulation of systemic risk in insurance.

Peter N. Swisher is a Professor of Law at University of Richmond Law School. He is co-author of *Principles of Insurance Law* (4th ed. 2011) and has written numerous articles on insurance regulation and coverage issues. He is past Chair of the Association of American Law Schools Insurance Law Section and has testified as an expert witness in over two dozen state and federal insurance law disputes.

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ARGUMENT

A. State insurance regulation focuses predominantly on individual legal entities, while regulation aimed at preventing systemic risk must also scrutinize firms on a consolidated basis.

Regulation designed to anticipate and mitigate systemic risk requires effective regulation of both individual financial companies and the larger financial conglomerates that own and control these companies. *See* Basel Committee, *Principles for the Supervision of Financial Conglomerates* 3 (2011) (discussing the importance of group-level supervision in addition to entity supervision for the regulation of large financial conglomerates). In large part for this reason, banking regulation—where systemic risk is a core regulatory concern—explicitly extends to both individual banks and their holding companies. *See* Bank Holding Company Act of 1956, 12 U.S.C. § 1841, *et seq*. (2012); *see also* Viral V. Acharya, *A Theory of Systemic Risk and Design of Prudential Bank Regulation*, 5 J. Fin. Stab. 224, 224-25 (2009) (noting that systemic risk concerns are at the heart of banking regulation). Effective systemic risk regulation requires group-level scrutiny because the risk that a financial conglomerate poses to the broader financial system is a function of its overall risk taking and interconnectedness to the financial system. For this reason, FSOC's Final Rule and Interpretive Guidance provides that the Council will evaluate the existing regulatory scrutiny faced by a nonbank financial firm in light of the "[e]xistence and effectiveness of consolidated supervision, and a determination of whether and how nonregulated entities and groups within a nonbank financial company are supervised on a group-wide basis." *See* FSOC Final Rule, 77 Fed. Reg. 21660 (Apr. 11, 2012) (codified at 12 C.F.R. Pt. 1310).

In sharp contrast to the group-level regulatory scrutiny of financial conglomerates that systemic-risk regulation demands, state insurance regulation focuses almost exclusively on individual insurance companies and not their holding companies. Indeed, every core element of state insurance regulation—including risk-based capital rules, reserve requirements, licensing requirements, investment restrictions, and financial monitoring—is applied solely to individual operating insurers. *See* Kenneth Abraham & Daniel Schwarcz, *Insurance Law and Regulation* 173 (6th ed. 2015). By contrast, state insurance regulators do not impose any quantitative restrictions on consolidated financial conglomerates such as MetLife. *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.

Even if it wanted to, no state has the legal or practical ability to conduct umbrella oversight of insurance groups for systemic risk.[6] From a legal standpoint, state insurance regulators lack meaningful authority over insurance holding companies or their non-insurance subsidiaries. In an attempt to rectify this situation, the National Association of Insurance Commissioners adopted substantial revisions to its Model Insurance Holding Company System Regulatory Act in 2010. These revisions implemented a "windows and walls" system for group regulation, which attempts to insulate individual insurance companies from potential financial risks associated with their parents and affiliates ("walls"), while simultaneously allowing regulators

[6] The extent to which insurance activities—whether traditional or non-traditional—historically have raised systemic risks is a hotly contested issue in the academic literature. However, the regulation of systemic risk in this arena must reject a methodology that is driven entirely by historical precedents, instead seeking to "proactively anticipate new potential sources of systemic risk based on *structural* vulnerabilities of the insurance industry and *structural* interconnections between the insurance industry and the rest of the financial system." Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. Chi. L. Rev. 1569, 1574-75 (2014).

to remain attuned to these risks ("windows")[7] But the jurisdictional constraints of state insurance commissioners severely hamper the effectiveness of this approach: under the model act, state insurance regulators still have no authority whatsoever over non-insurer affiliates, and they have virtually no authority over insurers' holding companies.[8]

More to the point, the "windows and walls" approach suffers from an inward-looking focus that makes it unsuited for systemic risk oversight. The sole purpose of "windows and walls"

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[7] State insurance departments seek to create "windows" into insurance group activities by requesting from licensed insurers information on the business activities of their parent companies and non-insurer affiliates. Similarly, they have set up "walls" by requiring review of specific transactions between insurers and their affiliates to stop holding companies from inappropriately siphoning cash out of their insurance subsidiaries and to protect the ability of those subsidiaries to pay policyholder claims. However, this approach has not been universally adopted. As of April 15, 2015, six states had not fully or substantially adopted the 2010 revisions to the Model Act that instituted "windows and walls." An even larger number of states had failed to promulgate the latest revisions to the implementing regulation to the Model Act. *See* NAIC, Implementation of 2010 Revisions to Model #440, Insurance Holding Company System Regulatory Act [status as of April 1, 2015], www.naic.org/documents/committees_e_related_smi_dashboard.pdf; Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance*, 5 U. Cal. Irv. L. Rev. (forthcoming 2015), and citations therein.

[8] In general, state commissioners can only compel insurance subsidiaries to submit reports, not parent companies or non-insurance affiliates. The one exception is that, under the Model Holding Company Act, states can indeed demand that parent companies file an enterprise risk report. *See* NAIC, Model #440, Insurance Holding Company System Regulatory Act § 4L. But even in the case of this limited exception, state insurance regulators have no enforcement authority over the parent itself. Instead, their sole enforcement authority for a parent's noncompliance with this single requirement comes under § 11F, which permits regulators to disapprove dividends or distributions or to place an order of supervision on the insurance subsidiary. For these reasons, insurance subsidiaries must rely on the kindness of their parent companies and affiliates to obtain information about transactions and exposures through the group. Since much of this data collection is voluntary, it comes as no surprise that insurance regulators do not systemically collect consolidated group-wide data on insurance firms. *See* McCoy, *supra*, and citations therein. More generally, state insurance commissioners lack authority to sanction insurance group parent companies or non-insurer affiliates for any activities that jeopardize their insurance affiliates or threaten systemic harm to outside financial firms. Instead, state regulators can only hope to achieve such enforcement indirectly by imposing sanctions on the insurance subsidiaries that they do regulate. Needless to say, these jurisdictional impediments are magnified when an insurance subsidiary is domiciled in one state and its holding company is incorporated in another state. *See* McCoy, *supra*.

is to keep insurance subsidiaries solvent and able to pay claims. That system does not attempt to safeguard the larger financial system by policing excessive risks to the global system generated by insurance groups. *See generally* Schwarcz, *A Critical Take*, *supra*; Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance*, 5 U. Cal. Irv. L. Rev. (forthcoming 2015), *available at* http://ssrn.com/abstract=2548065.

Similarly, nothing in "windows and walls" permits state insurance commissioners to see the connections and monitor the exposures of counterparties *outside* of an insurance group.[9] The alarming data gaps that came to light during the 2008 Bear Stearns, Lehman Brothers, and AIG crises demonstrated that regulators must have a direct line of sight into both sides of material inter-firm exposures for systemic oversight to be effective. But state insurance departments lack access to information about other firms' exposures to insurance groups (particularly exposures by investment banks, commercial banks, and hedge funds). And even if state regulators did have that access, they lack the expertise, budget, or staff to monitor those interconnections successfully. Only the federal government has that manpower and line of sight.[10] The patchwork nature of state regulation also makes it unmanageable for foreign nations to negotiate agreements to contain global systemic risk with all 50 states. *See* McCoy, *supra.* For these reasons, if systemic risk

[9] For instance, supervisory colleges, while valuable, largely act as periodic check-ins among the regulators of the individual insurance companies within the insurance group, rather than as a sustained attempt to understand how the consolidated financial company fits within the larger financial system. *See* Federal Insurance Office, *How to Modernize and Improve the System of Insurance Regulation in the United States* 42 (2013) ("Supervisory colleges are necessary but not sufficient, and do not completely substitute for a consolidated regulator.").

[10] The federal government's unique capacities with respect to systemic risk regulation do not necessarily mean that all group-level regulation of insurers should be conducted by the federal government. *See* Schwarcz, *A Critical Take*, *supra*, at 21-22 (describing ways in which state-based insurance regulation could more effectively conduct group-level regulatory oversight of all insurance groups, both those posing systemic risks and those not posing risks).

regulation of insurance groups were confined to the states, there would be no effective systemic risk oversight of insurance groups at all.

In light of these limitations in states' group-level regulation, it is hardly surprising that domestic and international bodies have repeatedly expressed concern about the capacity of states to regulate large financial conglomerates that may pose systemic risks, such as MetLife. For instance, a peer review of the U.S. state-based system of insurance regulation by the Financial Stability Board concluded "that while the state-based regulatory system was effective in assuring policyholder protection and the soundness of individual insurance companies, it lacked a systemic focus and the capacity to exercise group-wide oversight." Financial Stability Board, *Peer Review of the United States* 32 (2013); *see also* International Monetary Fund, *United States: Publication of Financial Sector Assessment Program Documentation—Detailed Assessment of Observance of IAIS Insurance Core Principles* (2010) (noting that international regulatory regimes have increasingly "been supplementing their strong solo company focus with financial and other requirements and more supervisory focus applied at the group level and U.S. supervisors should do the same"); Federal Insurance Office, *How to Modernize and Improve the System of Insurance Regulation in the United States* 40 (2013) ("Experience with recent insurer insolvencies, moreover, illustrates that a comprehensive understanding of an insurance group could have resulted in a safer and more stable system."); *see also International Association of Insurance Supervisors (IAIS) Core Principles* 23 (describing as a core principle of insurance regulation that "[t]he supervisor supervises insurers on a legal entity and group-wide basis."). Of course, most directly relevant here is FSOC's Public Basis for designating MetLife under § 113, which similarly emphasized the lack of consolidated supervision of MetLife by state insurance regulators. *See* Public Basis, *supra*, at 26-29.

These concerns are not simply theoretical: state insurance regulators' lack of adequate group regulation was partially responsible for AIG's risk taking leading up to the financial crisis.

See How to Modernize, *supra* at 40 (noting that the "inability of [state regulators' solo entity focus] to account for consolidated supervision was evident during the financial crisis, particularly in the case of AIG"). AIG's near-failure in 2008 was attributable to two business lines at the company, both of which exploited the entity-centric nature of state insurance regulation. The first involved the sale of Credit Default Swaps—which essentially "insured" the risk that mortgage-related securities would default—by the company's Financial Products division. Because this subsidiary was not a regulated insurance entity, it was not subject to the state insurance regulatory regime. Although the Office of Thrift Supervision technically supervised AIG Financial Products, the OTS's pre-crisis regulatory oversight is generally understood to have been woefully deficient, in part because regulated firms had the option to shop for the OTS as their regulator. *See*, *e.g.*, Permanent Subcomm. on Investigations of the S. Comm. on Gov't Sec. and Homeland Affairs, *Wall Street and the Fin. Crisis: Anatomy of a Financial Collapse: Majority and Minority Staff Report*, 112th Congress 208-239 (2011), *available at* http://1.usa.gov/1FxrNzt (describing OTS's ineffective regulation generally). This was particularly true with respect to non-banking products, for which the agency lacked expertise. *See* U.S. Gov't Accountability Office, GAO-97-154, Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration (2007) (describing the OTS's relative lack of expertise in supervising financial activities that did not involve activities traditionally engaged in by thrifts, such as the Credit Default Swaps); Financial Crisis Inquiry Commission, *Causes of the Recent Financial and Economic Crisis* (Sept. 2, 2010) (statement of Chairman Ben S. Bernanke) (noting that OTS's supervision of AIG's derivatives activities in its financial products unit was extremely limited in practice). For these reasons, Dodd-Frank eliminated the OTS as well as the federal regulatory architecture that allowed firms to select their consolidated regulator.

The second cause of AIG's near failure was the company's ill-fated securities lending program, which also exploited state insurance regulators' lack of consolidated regulation. AIG used securities lending 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." Robert L. McDonald & Anna L. Paulson, *AIG in Hindsight* (NBER Working Paper No. w21108, 2015), *available at* http://ssrn.com/abstract=2596437. Yet "prior to mid-2007, state regulators had not identified losses in the securities lending program and the lead life insurance regulator had reviewed the program without major concerns." U.S. Gov't Accountability Office, GAO-11-616, Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc. 13 (2011). While most of the securities lent were owned by AIG's insurance subsidiaries, state insurance regulators failed to diagnose or respond to these risks in large part because AIG's securities lending program was operated by non-insurer affiliates of AIG and was not specific to any of its individual life insurance entities. As a result, no individual insurance regulator took primary responsibility for carefully scrutinizing that program. State insurance regulators' focus on individual insurance entities also caused them to miss the key fact that the risks associated with AIG's securities lending program were the exact same risks being taken by the company's financial products subsidiary. *See generally* Schwarcz, *A Critical Take*, *supra*. In the end, fully $43.7 billion of AIG's 2008 federal rescue was used to pay off AIG's securities lending counterparties. *See* Scott E. Harrington, *The Financial Crisis, Systemic Risk, and Future of Insurance Regulation* 15 (2009), *available at* http://www.naic.org/documents/topics_white_paper_namic.pdf.

Since the financial crisis, the entity-based focus of state insurance regulation has facilitated the development of another potential source of systemic risk, which some have labeled "shadow insurance." *See* 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); Ralph S. J. Koijen & Motohiro Yogo, *Shadow Insurance* (Swiss Finance Institute Research Paper No. 14-64, 2015), *available at* http://ssrn.com/abstract=2320921. In a shadow insurance transaction, an insurer purchases reinsurance from an affiliated company that is subject to limited regulatory scrutiny because it is treated as a captive of the parent company.[11] Because the captive-reinsurer is subject to such limited regulatory scrutiny, state regulators only allow the insurer to avoid holding assets to pay the reinsured claims if the captive-reinsurer's obligations are fully supported by collateral. But in shadow insurance transactions, this collateral ultimately consists of an obligation of the two companies' parent company or yet another affiliate. The ultimate result is that shadow insurance transactions do not actually transfer risk outside of the consolidated entity, thus allowing financial conglomerates to reduce the capital they hold and avoid other state regulatory requirements they view as excessively burdensome without substantially reducing their aggregate risk exposure. *See* Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. Chi. L. Rev. 1569, 1624-25 (2014).[12]

Both the near failure of AIG and the recent rise of shadow insurance illustrate that state insurance regulation is limited in its capacity to regulate massive financial conglomerates such as MetLife. Indeed, the Public Basis for designating MetLife under § 113 of Dodd-Frank highlighted both the company's securities lending operations and its use of shadow insurance.

[11] Because captive insurers only provide coverage to their owners and affiliates, they are much more lightly regulated than ordinary insurers.

[12] The mechanics of shadow insurance transactions are explained in more depth in the nonpublic basis for FSOC's final determination regarding MetLife. *See* Financial Stability Oversight Council, *Explanation of the Basis of the Financial Stability Oversight Council's Final Determination that Material Financial Distress at MetLife Could Pose a Threat to U.S. Financial Stability and that MetLife Should be Supervised by the Board of Governors of the Federal Reserve System and Be Subject to Prudential Standards* 61-67 (2014).

Public Basis, *supra*, at 10-12. Moreover, the Public Basis discusses several other practices by MetLife that seem to necessitate effective group supervision. Primary among these is the company's use of funding agreement-backed notes and commercial paper to help fund the company's operations. *See id.* at 9-10. As in the case of both securities lending and shadow insurance, this arrangement appears to exploit complex internal corporate structures in a way that creates risk to the entire financial conglomerate. The enterprise-wide nature of this type of risk taking requires supervision by a regulator that embraces an enterprise-wide perspective. The state insurance regulatory system does not reliably adopt this holistic focus.

B. The state insurance regulatory regime is not well designed to stop a large-scale run on a massive financial conglomerate such as MetLife.

FSOC's Public Basis for designating MetLife under § 113 of Dodd-Frank also concluded that MetLife could experience a "run" if policyholders of its various insurers believed that the larger company could not be relied upon to meet its long-term obligations. Although many insurance policies only permit policyholders to demand payment on the occurrence of a contractually specified event, various life insurance and annuity products allow policyholders to withdraw funds, cash out their policies, or take out a loan backed by their policy. *See Regulating Systemic Risk in Insurance*, *supra*, at 1619-23.[13] In the case of MetLife, for instance, policyholders could demand approximately $49 billion from the general accounts of the company's insurers with little or no penalty, and approximately $206 billion of separate account liabilities could be withdrawn or transferred with some penalty. *See* Public Basis, *supra*, at 22-23.

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[13] The Article *Regulating Systemic Risk in Insurance*, *supra*, argues in favor of a more comprehensive system for regulating systemic risk in insurance than that which Dodd-Frank establishes. However, this conclusion does not undercut FSOC's designation of MetLife in this case or the broader idea that systemically important financial conglomerates predominantly engaged in insurance should be subject to enhanced supervision and prudential rules, as Dodd-Frank contemplates.

These features of many life insurance and annuity products mean that policyholders who become concerned about their carrier's solvency may well demand withdrawals, cash surrender values, or policy loans, producing a run on liabilities analogous to a classic bank run. There is indeed historical precedent for a run on a life insurance company: for instance, in 1991 policyholders withdrew over $3 billion from Executive Life in the year prior to its failure, forcing the company to liquidate a substantial percentage of its portfolio. *See Regulating Systemic Risk in Insurance*, *supra*, at 1619-23. Although Executive Life's failure was not large enough to trigger systemic consequences, a forced liquidation at a company the size of MetLife could well be. Indeed, MetLife has $909 billion in total consolidated assets, compared to Executive Life's approximately $13.2 billion in assets (in 1989 dollars)[14] immediately prior to its failure. *See* Richard L. Fogel, *Insurance Regulation: Failures of Four Large Life Insurers* (1992).

MetLife disputes that it is subject to the risk of an unmanageable run in part by noting that state insurance regulators could impose a stay on policyholder withdrawals and have done so successfully in the past. *See* Complaint, *supra*, at 29-30. MetLife also suggests that state guaranty fund protections would limit the risk of such runs. *See id.* State insurance regulators have indeed issued moratoriums on cash surrenders and partial withdrawals at life insurance companies that they have placed into receivership.[15] But the purpose of such stays has generally been to prevent some policyholders from unfairly benefiting at the expense of other policyholders. State insurance regulators have never stopped a run at a massive financial conglomerate such as MetLife in the

[14] That amounts to $25.72 billion in 2015 dollars.

[15] There is reason to believe that the threat of a run on a life insurer has increased in recent years and will continue to do so, because of changing product designs and increasing policy ownership by sophisticated investors and corporations. See *Regulating Systemic Risk in Insurance*, *supra*, at 1621.

midst of a larger financial crisis. And there is good reason to believe that state insurance regulators could face substantial difficulties in attempting to halt a run in these circumstances.

First, halting a run on a massive financial conglomerate like MetLife in the midst of financial turmoil would require each of the state or foreign regulators overseeing each of the company's operating life insurers to issue stays in a coordinated and nearly simultaneous fashion.[16] If some state or foreign regulators took measures to stay withdrawals at some of MetLife's insurers while others did not, then the predictable result would be to substantially aggravate runs on MetLife entities that were not subject to the stay. Indeed, mere rumors of a moratorium on withdrawals from one of MetLife's subsidiaries in the midst of broader financial instability could trigger a run at the firm's other insurers. The problem, of course, is that state insurance regulators frequently are not able to coordinate effectively among themselves. Foreign insurance regulators labor under even greater handicaps in coordinating with numerous different state regulators. Yet such coordination problems are quite likely to occur in the event of material financial distress at MetLife. For instance, some regulators might favor issuing a stay on policyholder withdrawals at the company, while others might believe that placing a moratorium on withdrawals was not necessary or could backfire by triggering runs at other companies. The inevitable delay that would accompany debates among states and foreign counterparts regarding exercising this option could well exacerbate the run and, in a period of general financial market turmoil, potentially cause it to spread to other insurers.

[16] MetLife's latest annual report illustrates the magnitude and global reach of those coordination challenges. Exhibit 21.1 to MetLife's Annual Report (10-K) for the year ended December 31, 2014 lists 390 subsidiaries owned in whole or in part by MetLife, Inc. At least eight of those subsidiaries are life insurers domiciled in the U.S. (specifically, in California, Delaware, Massachusetts, Missouri, and New York). Another fifteen appear to be life insurers domiciled abroad, including in Australia, China, Cyprus, Egypt, Greece, Hong Kong, Japan, Malaysia, Pakistan, Russia, South Korea, the United Kingdom, and Vietnam.

Second, while the state guaranty fund system has historically helped to limit the risk and magnitude of runs on life insurers, it is not designed to handle the failure of a massive financial conglomerate such as MetLife in the context of broader financial instability.[17] State insurance guaranty funds are financed principally through assessments on surviving insurers that are imposed only after one of their competitors has failed. These assessments are limited to 2% of insurers' recent average annual premiums, and can be further limited if they would endanger an insurer's capacity to meet its obligations to its own policyholders. *See NAIC Life and Health Insurance Guaranty Association Model Act* Section 9. Moreover, state insurance guaranty funds do not extend coverage to large commercial policyholders, who are generally the most likely to trigger a run. *See id.* These design features mean that state insurance guaranty funds provide much more reliable protections in the event of ordinary insolvencies than they would in the event of a massive financial conglomerate's failure. Such a failure could well require assessments that would exceed the capacity of existing carriers and potentially jeopardize those carriers' own financial health. Understanding these limitations, policyholders of a massive financial conglomerate like MetLife would be comparatively likely to withdraw their savings if they lost faith in the company's long-term capacity to pay its claims. Meanwhile, if state insurance regulators intervened to attempt to halt a run at MetLife, this could trigger runs at other life insurers, as these policyholders would

[17] In the case of all insurer insolvencies, state guaranty funds limit payouts to amounts that are often well below the face value of insurance policies and are subject to a per-claimant limit. See Insurance Law and Regulation, supra at 122-23. These caps resemble the caps on federal deposit insurance coverage (which were $100,000 per depositor per bank in September 2008 and are $250,000 today). Despite this generous amount of deposit insurance coverage, Washington Mutual and Wachovia Bank suffered devastating runs on the uninsured portions of their deposits in 2008, which led to their demise. See Kathleen C. Engel & Patricia A. McCoy, *The Subprime Virus* 110-11 (2011). As this suggests, any unpaid life insurance policy liabilities over the state guaranty fund limits could similarly be vulnerable to runs.

understand that the claims-paying ability of the guaranty fund system might already be exhausted.

C. The localized political and economic accountability of state insurance regulators is inconsistent with effective systemic risk regulation, which is fundamentally an issue of national and global scope.

Historically, insurance regulation has been the principal responsibility of the individual states rather than the federal government. Lodging insurance regulation at the state level is sensible to the extent that such regulation primarily addresses matters of local importance. But since 1944, the federal government has frequently intervened in the regulation of insurance markets on matters of national importance, as specifically contemplated by the McCarran-Ferguson Act.[18] Consistent with this understanding, § 113 of Dodd-Frank subjects nonbank financial companies that FSOC deems to be systemically important to consolidated federal regulation, irrespective of whether they are comprised of individual entities that are subject to state insurance regulation.

Empowering a federal agency to regulate nonbank financial firms that are systemically important makes eminent sense, because the localized political and economic accountability of state insurance regulators is incompatible with effective systemic risk regulation. State insurance departments are politically accountable only to the constituents in their jurisdictions. The commissioners who run these departments are either elected by the state's voters or are

[18] The McCarran Ferguson Act does not in any way limit the power of the federal government to regulate insurance markets, nor was it intended to do so. Instead, the primary goal of the Act was to make it clear that federal laws of general applicability should not be interpreted to interfere with state insurance regulation. See Kenneth Abraham & Daniel Schwarcz, *Insurance Law and Regulation* 110 (6th ed. 2015). By contrast, federal laws that do "specifically relate to the business of insurance" are perfectly valid under the Act. Examples of such federal laws include the Patient Protection and Affordable Care Act, 42 U.S.C. § 18001, *et seq*., the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001, *et seq*., and, of most relevance here, Dodd-Frank itself.

appointed by the state's governor, and their budgets are set by state legislatures. State insurance departments therefore face limited incentives to devote their attention to regulatory activities whose potential benefits extend beyond their state borders. By definition, the benefits of reducing systemic risk are almost entirely felt outside of the boundaries of any individual state. For this reason, consistent with the Dodd-Frank Act, systemic risk regulation should generally be lodged at the national rather than state level. *See Regulating Systemic Risk in Insurance*, *supra*, at 1627-34.

By the same token, state supervisors have incentives to shift the cost of any financial harm by insurers that they regulate to the federal government and U.S. taxpayers. That is exactly what happened in 2008, when the federal government was forced to shoulder hundreds of billions of dollars in losses resulting from systemic risk generated by the insurance sector. While the rescue of AIG and the sizable TARP payments to The Hartford and Lincoln National are the most notable examples, MetLife also tapped tens of billions of dollars in federal government largesse in 2008 and its aftermath.[19]

Even properly motivated state regulators lack the perspective and expertise to manage systemic risk effectively. As described by FSOC's Public Basis, MetLife's potential to pose

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[19] During that period, MetLife's ownership of MetLife Bank subjected it to Federal Reserve oversight as a financial holding company while providing MetLife with access to Federal Reserve discount window loans. In 2008 and 2009, MetLife's bank received 19 Term Auction Facility loans totaling $18.9 billion from the Federal Reserve. In 2009, MetLife also obtained $397 million through the Temporary Liquidity Guarantee Program offered by the Federal Deposit Insurance Corporation. MetLife borrowed another $1.6 billion through the Federal Reserve's Commercial Paper Funding Facility. Public Basis, *supra*, at 14–15. In addition, MetLife applied for TARP funds but later changed its mind and announced that it had elected not to participate in TARP. *See* Arthur D. Postal, *Some Insurers Qualify for TARP, but 'Nothing is Imminent,'* Lifehealth Pro (Apr. 20, 2009), http://bit.ly/1edvwpC; MetLife, MetLife Issues Statement on U.S. Treasury's Supervisory Capital Assessment Program (Press Release, May 7, 2009). Later, in 2013, MetLife divested its bank and shed its status as a financial holding company. *See* MetLife, MetLife Sheds Bank Holding Company Status With Approvals from the Federal Reserve and FDIC (Press Release, Feb. 14, 2013). Some criticized that move as an effort to escape consolidated federal oversight once the company no longer needed federal support.

systemic risks if it experienced material financial distress arises in large part because of the company's interconnections with the larger financial system. More generally, regulation designed to address systemic risk requires regulators to pay close attention to the interactions and linkages between the financial institutions and markets that constitute the financial system. Yet state insurance regulators have limited expertise or oversight over any part of the financial system other than insurance. Virtually all securities regulation at the state level is focused on fraudulent sales to consumers or on relatively small offerings, and state banking regulation focuses predominantly on the regulation of smaller, community banks. State insurance regulators' limited exposure to the national (and international) financial system and the non-insurance players in it limits their capacity to regulate systemic risk effectively. *See Regulating Systemic Risk in Insurance*, *supra*, at 1627-34.[20]

State insurance regulators' insistence that they can and do effectively regulate even institutions that could pose systemic risks is deaf to these concerns and consistent with their historical resistance to virtually every potential form of federal involvement in insurance regulation. Indeed, the threat of federal preemption has been the primary driver of state insurance regulatory reform over the last century. *See* Kenneth J. Meier, *The Political Economy of Regulation: The Case of Insurance* (1988); Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 UCLA L. Rev. 394, 457-58 (2014). But state insurance regulators' insistence that they can and do adequately regulate insurance-focused firms that could pose a systemic risk, such as MetLife, does not reflect a consensus among those with a

[20] By contrast, FSOC is specifically designed to bring together the nation's leading financial regulators from across all sectors of the financial system. It is thus designed to allow the Council to appreciate the interconnections and potential stress points across all facets of that system.

deep understanding of insurance markets and regulation. Indeed, as described above, both the international insurance regulatory community and the Federal Insurance Office have expressed sustained concerns regarding the capacity of state insurance departments, standing alone, to regulate systemically risky firms.

CONCLUSION

As experts on the state-based system of insurance regulation, amici are firmly convinced that FSOC's public basis for designating MetLife as subject to supervision by the Fed and enhanced prudential standards under § 113 of Dodd-Frank wisely reflects the limitations of state insurance regulation. Although state insurance regulators may protect policyholders reasonably well, they do not have the necessary authority, expertise, resources, or perspective to address on their own the types of concerns that systemically important institutions, such as MetLife, raise in today's financial landscape. For these reasons, we conclude that FSOC's determination that material financial distress at MetLife could pose a threat to U.S. financial stability appropriately accounts for the strengths and weaknesses of the state insurance regulatory system as it applies to MetLife's individual insurance firms.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that on May 22, 2015, I electronically filed the foregoing Brief of *Amici Curiae* Scholars of Insurance Regulation in Support of Defendant with the Clerk of the Court of the U.S. District Court for the District of Columbia by using the Court's CM/ECF system. All participants are registered CM/ECF users, and will be served by the CM/ECF system.

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