ORAL ARGUMENT NOT YET SCHEDULED

No. 16-5086

In the United States Court of Appeals for the District of Columbia Circuit

METLIFE, INC.,
Plaintiff-Appellee,

v.

FINANCIAL STABILITY OVERSIGHT COUNCIL,
Defendant-Appellant.

On Appeal from the United States District Court
for the District of Columbia

BRIEF OF *AMICI CURIAE* SCHOLARS OF INSURANCE AND FINANCIAL REGULATION IN SUPPORT OF APPELLANT AND REVERSAL

DEEPAK GUPTA
NEIL K. SAWHNEY
GUPTA WESSLER PLLC
1735 20th Street, NW
Washington, DC 20009
(202) 888-1741
deepak@guptawessler.com

June 23, 2016

Counsel for Amici Curiae Scholars of Insurance and Financial Regulation

COMBINED CERTIFICATES

Certificate as to Parties, Rulings, and Related Cases

A. Parties and Amici. All parties, intervenors, and *amici* appearing before the district court and this Court are listed in the Brief for Appellant, apart from *amici* current and former Members of Congress, and former Secretaries of the Treasury and former Chairmen of the Federal Reserve Board.

B. Rulings under Review. References to the rulings under review appear in the Brief for Appellant.

C. Related Cases. This case has not been before this Court before. *Amici* are unaware of any related cases pending in this or any other court.

Certificate of *Amicus Curiae* Under Circuit Rule 29(d)

Amicus are scholars with expertise in insurance and financial regulation. This *amicus* brief is necessary to present the Court with evidence that the Financial Stability Oversight Council's designation of MetLife fairly and adequately considered the strength of the state insurance regulatory system. No other *amicus* brief contains this material.

/s/ Deepak Gupta
DEEPAK GUPTA
GUPTA WESSLER PLLC
1735 20th Street, NW
Washington, DC 20009
(202) 888-1741

TABLE OF CONTENTS

Combined certificates i

Table of authorities iii

Glossary vii

Identity and interest of *amici curiae* 1

Introduction and summary of the argument 3

Argument 5

I. The district court's misinterpretation of the Council's guidance and atextual demand that the Council consider costs effectively end the Council's ability to designate firms that could pose a threat to U.S. financial stability 5

A. The requirement that the Council quantify the risk of financial distress—and then compare that risk to the costs—imposes an unachievable burden. 5

B. By reading the guidance to require an assessment of MetLife's "likelihood of failure," the court disregarded the broader context of the Council's designation scheme. 11

II. The bulk of MetLife's operations are now subject only to state insurance regulation, which is structurally incapable of addressing systemic risks to the broader financial system 14

A. Although regulation aimed at preventing systemic risk must scrutinize firms on a *consolidated* basis, state insurance regulation focuses predominantly on *individual* entities. 15

B. The state insurance regulatory regime is not designed to stop a large-scale run on a massive financial conglomerate like MetLife. 24

C. Localized political and economic accountability prevents state insurance regulators from effectively regulating systemic risks. 28

Conclusion 31

TABLE OF AUTHORITIES*

Cases

F.C.C. v. Fox Television Stations, Inc.,
556 U.S. 502 (2009) 8

Investment Company Institute v. Commodity Futures Trading Commission,
720 F.3d 370 (D.C. Cir. 2013) 8

Webster v. Doe,
486 U.S. 592 (1988) 6

Statutes

12 U.S.C. § 5322(a)(1) 12

12 U.S.C. § 5323(a)(2)(K) 6

Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841 *et seq.* 16

Regulatory Materials

12 C.F.R. § 217.1 9

* Financial Stability Oversight Council Final Rule and Interpretive Guidance, 77 Fed. Reg. 21,637 (Apr. 11, 2012) (codified at 12 C.F.R. § 1310) 11, 16

Legislative Materials

S. Rep. No. 111–176 (2010) 12

Staff of the Senate Committee on Government Security and Homeland Affairs, Permanent Subcommittee on Investigations, 112th Cong., *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse: Majority and Minority Staff Report* (2011) 21

Other Authorities

Kenneth Abraham & Daniel Schwarcz, *Insurance Law and Regulation* (6th Ed. 2015) 18, 31

* Authorities upon which we chiefly rely are marked with asterisks.

Basel Committee, *Principles for the Supervision of Financial Conglomerates* (2012) 17

Ben S. Bernanke, *The Courage to Act* (2015) 7

Causes of the Recent Financial and Economic Crisis, Hearing Before the Financial Crisis Inquiry Commission (Sept. 2, 2010) 24

John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications,* 124 Yale L.J. 882 (2015) 7

George W. Downs & David M. Rocke, *Conflict, Agency, and Gambling for Resurrection: The Principal-Agent Problem Goes to War*, 38 Am. J. Pol. Sci. 362 (1994) 14

Kathleen C. Engel & Patricia A. McCoy, *The Subprime Virus* (2011) 24

Federal Insurance Office, *How to Modernize and Improve the System of Insurance Regulation in the United States* (2013) 21, 22

Financial Crisis Inquiry Commission, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (2011) 7

Financial Stability Board, *Peer Review of the United States* (2013) 21

* Financial Stability Oversight Council, Department of the Treasury, Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc. (2014) .... *passim*

Richard L. Fogel, *Insurance Regulation: Failures of Four Large Life Insurers* (1992) 29

Government Accountability Office, GAO-07-154, *Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration* (2007) 23

Government Accountability Office, GAO-11-616, *Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc*. (2011) 25

Scott E. Harrington, *The Financial Crisis, Systemic Risk, and Future of Insurance Regulation* (National Association of Mutual Insurance Companies Paper, Sept. 2009) 25

Henry T. C. Hu, *Financial Innovation and Governance Mechanisms: The Evolution of Decoupling and Transparency*, 70 Bus. Law. 347 (2015) 9

International Association of Insurance Supervisors, *Insurance Core Principles* 22

International Monetary Fund, *United States: Publication of Financial Sector Assessment Program Documentation—Detailed Assessment of Observance of IAIS Insurance Core Principles* (2010) 21

Ralph S. J. Koijen & Motohiro Yogo, *Shadow Insurance* (Swiss Finance Institute Research Paper No. 14-64, 2015) 26

* Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance*, 5 U. Cal. Irvine L. Rev. (forthcoming 2016) 19, 20, 33

Robert L. McDonald & Anna L. Paulson, *AIG in Hindsight* (NBER Working Paper No. 21108, 2015) 24

Kenneth J. Meier, *The Political Economy of Regulation: The Case of Insurance* (1988) 34

N.Y. 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) 26

NAIC Life and Health Insurance Guaranty Association Model Act § 9 31

NAIC, Model #440, Insurance Holding Company System Regulatory Act § 4L 19

* Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States*, 5 U. Cal. Irv. L. Rev. 537 (2015) 18, 20, 25

Daniel Schwarcz, *The Risks of Shadow Insurance*, 50 Ga. L. Rev. 163 (2015) 27

Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. Chi. L. Rev. 1569 (2014) 10, 28, 33, 34

William K. Sjostrom, Jr., *The AIG Bailout*, 66 Wash & Lee L. Rev 943 (2009) 11

Cass Sunstein, *Cost Benefit Analysis and Arbitrariness Review* (Harvard Public Law Working Paper No. 16-12) 9

GLOSSARY

AIG	American International Group

IDENTITY AND INTEREST OF *AMICI CURIAE*

Amici are professors who teach, write, and research in the area of insurance and financial regulation. They have a strong interest in promoting the effective and efficient regulation of insurance-focused, non-bank financial companies such as MetLife. Amici are:[1]

Aviva Abramovsky, Kaufman Professor of Entrepreneurship and Innovation and Associate Dean, Syracuse University College of Law.

Hazel Beh, Professor of Law, University of Hawaii William S. Richardson School of Law.

Joseph M. Belth, Professor Emeritus of Insurance, Kelley School of Business at Indiana University, Bloomington.

Peter C. Carstensen, Emeritus Professor of Law, University of Wisconsin Law School.

John Crawford, Associate Professor of Law, UC Hastings College of Law.

Max N. Helveston, Associate Professor of Law, DePaul University College of Law.

Donald T. Hornstein, Aubrey L. Brooks Professor of Law, University of North Carolina School of Law.

John Patrick Hunt, Professor, University of California Davis Law School.

[1] The institutional affiliations of amici are given only for purposes of identification.

Peter Kochenburger, Deputy Director, Insurance Law Center and Associate Clinical Professor of Law, University of Connecticut School of Law.

Joseph Lavitt, Lecturer, University of California, Berkeley, School of Law.

Kyle D. Logue, Wade H. and Dores M. McCree Collegiate Professor of Law, University of Michigan Law School.

Patricia A. McCoy, Professor of insurance and banking law, Boston College Law School.

Daniel Schwarcz, Julius E. Davis Professor of Law, University of Minnesota Law School.

Steven L. Schwarcz, Stanley A. Star Professor of Law & Business, Duke University School of Law.

Jeffrey W. Stempel, Doris S. & Theodore B. Lee Professor of Law, William S. Boyd School of Law, University of Nevada Las Vegas.

Robert F. Weber, Associate Professor, Georgia State University College of Law.

Jennifer Wriggins, Sumner T. Bernstein Professor of Law, University of Maine.

David Zaring, Associate Professor of Legal Studies and Business Ethics, The Wharton School.

INTRODUCTION AND SUMMARY OF THE ARGUMENT

By a vote of 9-1, a council of the nation's expert financial regulators concluded that material financial distress at MetLife could pose a threat to the stability of the U.S. economy. As a result of this determination, MetLife became subject to a federal oversight scheme that Congress specifically designed—in the wake of the 2008 financial crisis—to limit and manage such systemic risks. In designing this system, Congress was well aware that excessive risk-taking by non-bank financial institutions could have devastating consequences. Indeed, the federal government's $182-billion rescue of AIG—a financial entity predominantly engaged in the business of insurance—remains the largest U.S. rescue of a private company in history.

Disregarding the federal regulators' considered judgment, the district court set aside the Financial Stability Oversight Council's designation of MetLife. The ultimate result of the court's decision is that MetLife is less regulated today than it was in the midst of the crisis—when it received approximately $19 billion in federal financial support and applied for a bailout under the Troubled Asset Relief Program.

As experts on insurance and financial regulation, *amici* are firmly convinced that the Council's designation of MetLife should stand. Notably, the district court did *not* conclude that the Council had contravened the Dodd-Frank Act or

exceeded its statutory authority. Rather, in setting aside the Council's designation as arbitrary and capricious and releasing MetLife from federal oversight, the district court imposed on the Council an extratextual—and impossible—quantitative requirement that misunderstands the nature of the Council's responsibilities and capacities. And the court further erred by misinterpreting the Council's reference to "vulnerability" in its interpretive guidance to create a requirement that the Council consider the likelihood of a firm's financial failure—even though such a requirement is manifestly inconsistent with the Dodd-Frank Act's scheme for non-bank financial companies.

Additionally, this amicus brief argues that the Council's basis for designation wisely reflects the limitations of state insurance regulation. If the district court's decision is left to stand, nearly all of MetLife's operations will be completely free from federal regulation, leaving state insurance regulation as the only safeguard. But, unlike the federal regulatory scheme that the Dodd-Frank Act imposes on designated firms, state insurance regulation focuses exclusively on protecting individual policyholders. It is therefore ill equipped to address the systemic risks that the Council determined MetLife poses to the larger financial system.

The mismatch between state insurance regulation and systemic risk regulation is perhaps most aptly illustrated by the fact that presently there is *no* single consolidated regulator of MetLife's entire enterprise. Nor is MetLife

currently subject to any quantitative regulatory restrictions that apply across its numerous individual subsidiaries. That is because state insurance regulation applies almost exclusively to the operating insurance companies within MetLife, each one of which may be principally regulated by a different state. Such a patchwork regulatory system does little to address the systemic risks that MetLife could pose to U.S. financial stability.

ARGUMENT

I. The district court's misinterpretation of the Council's guidance and atextual demand that the Council consider costs effectively end the Council's ability to designate firms that could pose a threat to U.S. financial stability.

A. The requirement that the Council quantify the risk of financial distress—and then compare that risk to the costs—imposes an unachievable burden.

The district court twice faulted the Council for not considering additional quantitative factors beyond those contained in its final determination. First, the court concluded that the Council did not adhere to its own guidance because it failed to quantify the "impairment of financial intermediation" or "financial market functioning" that would result from material financial distress at MetLife. Only by quantifying these risks, the court reasoned, could the Council determine whether they would be "sufficiently severe to inflict significant damage on the broader economy." Op. at 24-28. Second, the court held that the Council erred by failing to consider the costs of designation, a requirement that the court located in Dodd-

Frank's instruction that the Council consider "any other risk-related factors that [it] deems appropriate,"[2] 12 U.S.C. § 5323(a)(2)(K). Op. at 5, 28-33.

Both conclusions were deeply flawed. The district court's insistence on these quantitative analyses paralyzes the Council's ability to carry out its statutory mandate—and jeopardizes the nation's financial system in the process. Nor is this error limited to MetLife's designation: If this Court were to embrace the district court's holding, it could threaten all future designation decisions by the Council. It is entirely possible that one or more of those cases could threaten the financial system. Courts should tread carefully when such grave harm is at risk.

But the court did exactly the opposite, demanding that the Council quantify an inherently unquantifiable risk. Simply put, there is no plausible way for the Council (or anyone else) to meaningfully quantify the likelihood that material financial distress at MetLife (or any other single firm) could impair market functioning. This would not only depend on the behavior of MetLife's policyholders, counterparties, and regulators, but also—to a much larger extent—on these responses' secondary effects on other actors in the broader financial system. And that, in turn, would be influenced by these actors' ever-changing

---

[2] Although this brief does not focus on statutory interpretation, the court's failure to consider Dodd-Frank's use of the term "deems" is notable, given that the word "exudes deference" and, in context, indicates that the broader clause expands, rather than contracts, the Council's authority. *Webster v. Doe*, 486 U.S. 592, 600 (1988); *see* FSOC Br. 51-53.

perceptions of the financial system's health, not to mention the actions of lawmakers and regulators. Quantifying these factors would thus require one arbitrary assumption after another. *See* John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications,* 124 Yale L.J. 882, 997-98 (2015).

Revisiting regulators' understanding of Lehman Brothers during the 2008 financial crisis illustrates the downstream risks of the district court's newly fashioned requirement. Although regulators had varying views regarding whether Lehman Brothers could or should be bailed out, hardly anyone predicted that allowing the firm to fail would trigger the sequence of events that followed its bankruptcy filing. *See* Ben S. Bernanke, *The Courage to Act* (2015). Yet Lehman Brothers' failure was perhaps the financial crisis's single most dramatic accelerant, directly causing a series of unexpected knock-on events, including the freezing of the commercial-paper market and runs on money-market mutual funds. *See* Fin. Crisis Inquiry Comm'n, *Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* 324-44 (2011). The nation's leading financial regulators, in other words, could not anticipate the impact of Lehman Brothers' failure on the financial system *immediately before it occurred*—in spite of their knowledge of Lehman Brothers' balance sheet at that time, as well as the state of the broader economy and financial system.

In light of that reality, the district court's ruling places the nation's financial system at risk by faulting the Council for failing to quantify—as a result of *hypothetical, future* losses incurred by MetLife's counterparties under unknown financial and economic conditions—"*what* the losses would be, *which* financial institutions would have to actively manage their balance sheets, or *how* the market would destabilize." Op. at 25-26. As this Court has observed, "the law does not require agencies to measure the immeasurable." *Inv. Co. Inst. v. Commodity Futures Trading Comm'n*, 720 F.3d 370, 379 (D.C. Cir. 2013). "It is one thing to set aside agency action under the Administrative Procedure Act because of failure to adduce empirical data that can be readily obtained. It is something else to insist upon obtaining the unobtainable." *F.C.C. v. Fox Television Stations, Inc.*, 556 U.S. 502, 519 (2009) (citations omitted). Even enthusiasts of cost-benefit analysis recognize that it has limits: "[T]he failure to specify unquantifiable benefits might be the height of reasonableness; under imaginable assumptions, specification, rather than the opposite, would be arbitrary." Cass Sunstein, *Cost Benefit Analysis and Arbitrariness Review* 22-23 (Harvard Public Law Working Paper No. 16-12), http://bit.ly/22D3ojB.

Precisely because quantifying the risks posed by individual companies to the broader financial system is impossible, financial regulations geared towards promoting safety and soundness generally do not require agencies to engage in

such quantitative analysis. For example, bank-holding companies are subject to supervision by the Federal Reserve, which promulgates capital standards for these entities. 12 C.F.R. § 217.1. Although the Fed changes these capital rules as new challenges emerge, courts have never required it to quantify the benefits of such revisions in terms of crises avoided. *See* Henry T. C. Hu, *Financial Innovation and Governance Mechanisms: The Evolution of Decoupling and Transparency*, 70 Bus. Law. 347, 404 (2015).

Instead of attempting to quantify the impossible, the Council reasonably evaluated the *structural* factors that indicate whether instability at MetLife could threaten broader financial stability. *See* Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. Chi. L. Rev. 1569, 1575 (2014) ("[T]he need for regulation of systemic risk in insurance must be determined in part by attempting 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. Although that analysis must be deeply informed by available empirical evidence, it should not assume . . . that the future will resemble the past or present."). To that end, the Council's Public Basis emphasized that MetLife engages heavily in a variety of activities and strategies—including funding agreements, securities lending, guaranteed investment contracts, captive reinsurance, and variable annuities—that,

due to their basic structure, could expose MetLife to runs, and produce or exacerbate financial panics. *See* Fin. Stability Oversight Council, Dep't of the Treasury, Public Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc. (2014) ("Public Basis").

Consider one example of how the district court misunderstood the Council's structural focus in designating MetLife as a threat to the financial system. The court criticized the Council for not explaining why or how losses incurred by holders of MetLife's $30.6 billion in funding-agreement-backed securities could be sufficiently severe to impact the broader economy. Op. at 25. But the court failed to understand that, because these securities are of varying maturities and often short-term, they as a class have the potential to create an asset-liability mismatch problem—one that could produce runs at MetLife if purchasers of these securities lose confidence in the company. While the likelihood of such a run occurring is difficult to predict, it is not hypothetical: AIG, for instance, suffered such a run in both its securities-lending and derivatives operations. *See* William K. Sjostrom, Jr., *The AIG Bailout*, 66 Wash. & Lee L. Rev. 943, 959-63 (2009). Nevertheless, the hypothetical *effects* of a MetLife run on the broader financial system—in the context of preexisting financial market turmoil—are impossible to quantify in any rigorous way. To then fault the Council for failing to engage in such a quantitative exercise,

as the district court did, dooms the entire Council designation process and undermines Congress's intent that the Council act to avoid future financial crises.

B. By reading the guidance to require an assessment of MetLife's "likelihood of failure," the court disregarded the broader context of the Council's designation scheme.

The district court also concluded that the Council flouted its final rule and guidance by failing to consider the *likelihood* that MetLife would experience financial distress in the first place. Op. at 19–24. As with the risk-quantification requirement discussed above, the court did not locate this supposed requirement in the final rule or in any statement in the accompanying guidance. Instead, it seized on the Council's characterization of three of the six categories of consideration contained in its final rule—leverage, liquidity risk, and maturity mismatch—as seeking "to assess the *vulnerability* of a nonbank financial company to financial distress." 77 Fed. Reg. 21,637, 21,641 (Apr. 11, 2012) (codified at 12 C.F.R. § 1310) (emphasis added). Taking a single word from the Council's guidance, which merely sought to describe the general thrust of these three categories, the court elevated "vulnerability" into an independent requirement that the Council consider the likelihood of a company's failure before designation.

Even assuming that the Council was bound to consider how "vulnerabl[e]" MetLife was in the designation process—which the Council persuasively argues is not the case, *see* FSOC Br. 28-30—the court incorrectly defined that term to

require an assessment of the likelihood that MetLife would experience financial distress. In context, this understanding of "vulnerability" is untenable; it is inconsistent with Dodd-Frank's basic scheme for designating non-bank financial companies for enhanced supervision. That regime is preventative in nature and is meant to reduce the likelihood that systemically risky firms will fail in the first place. *See* 12 U.S.C. § 5322(a)(1) ("The purposes of the Council" include "*respond[ing]* to emerging threats to the stability of the United States financial system."); S. Rep. No. 111–176, at 2 (2010) (describing the Council as "a new framework" intended "*to prevent* a recurrence or mitigate the impact of financial crises that could cripple financial markets") (emphases added).

To accomplish the law's preventative goal, the Council must designate systemically significant firms for supervision *before* they are at a heightened risk of failure. This is because firms are only subject to the Federal Reserve's enhanced regulation after the Council completes its inherently lengthy designation process, and then affirmatively decides upon designation. If, as the district court suggested, the Council should not designate firms for enhanced regulation until they are *already* at an elevated risk of failure, then there would predictably be a lag between when a firm first started facing elevated risk and when it was ultimately subject to the full panoply of the Fed's regulatory oversight.

Yet a central lesson of effective financial regulation is that regulators must address problems at firms swiftly and proactively. That is because a financial firm's incentives to take aggressive risks generally increase as its financial health decreases. *See* George W. Downs & David M. Rocke, *Conflict, Agency, and Gambling for Resurrection: The Principal-Agent Problem Goes to War*, 38 Am. J. Pol. Sci. 362, 375 (1994). Such risk-taking would presumably accelerate if a firm at risk of failure learned that the Council was considering it for designation, because designation would result in enhanced regulation limiting the firm's future options for taking on excess risk in a gamble to reverse its fortunes. By contrast, allowing the Council to designate firms that pose systemic risk *before* any concerns arise about a firm's financial health preserves the Federal Reserve's ability to act nimbly to prevent a systemically significant company from taking on increased risks in response to a deterioration in its financial health.

Given that effective financial regulation in this context must operate proactively, the most reasonable interpretation of "vulnerability" in the guidance is as a reference to vulnerability to the *types* of risks that could cause larger financial distress. Indeed, this interpretation is much more consistent with the three underlying categories that the Council was characterizing—leverage, liquidity risk, and maturity mismatch—than that embraced by the district court. To take just one example, banks inherently have substantial maturity mismatch, because their

liabilities consist largely of on-demand deposits, but many of their assets are illiquid. But this does not mean that all banks are at substantial risk of failure; instead, it means that all banks are at *some risk* of a certain type of failure—a bank run—that is particularly likely to have spillover effects on the financial system. It is for this reason that we regulate banks to prevent systemic risks. The same should be true for non-bank firms, like MetLife, that are similarly structurally vulnerable to destabilizing risks.

II. The bulk of MetLife's operations are now subject only to state insurance regulation, which is structurally incapable of addressing systemic risks to the broader financial system.

Before the 2008 financial crisis, MetLife was regulated by the Federal Reserve because it owned a bank and was thus classified as a bank-holding company. MetLife took advantage of this status to access over $20 billion of financial assistance from the federal government during the crisis. But in 2013, MetLife sold its banking operations. *See* Press Release, MetLife, MetLife Sheds Bank Holding Company Status With Approvals from the Federal Reserve and FDIC (Feb. 14, 2013). Doing so allowed it to avoid the Federal Reserve's regulation—a goal no doubt related to the fact that it was one of only four companies to fail the Fed's 2012 stress test. *See* Arthur D. Postal, *MetLife Fails Federal Reserve Stress Test*, Lifehealth Pro, Mar. 14, 2012, http://bit.ly/28QdOuK. Although selling its banking operations substantially reduced MetLife's regulatory

oversight, it likely had a minimal impact on the company's overall risk profile: MetLife's banking business reflected only a sliver of its total operations and did not meaningfully contribute to the broader company's problems during the crisis. *See* Fin. Stability Oversight Council, Dep't of the Treasury, Explanation of the Basis of the Financial Stability Oversight Council's Final Determination 70-74 (2014).

After the district court's ruling, MetLife will continue to avoid regulation by the Federal Reserve, with only its individual insurance subsidiaries subject to state insurance regulation. Yet state insurance regulation focuses exclusively on protecting policyholders rather than mitigating the systemic risks the Council deemed the company to pose to the larger financial system. Unlike federal regulation under the Dodd-Frank Act, in other words, state insurance regulation is effectively incapable of preventing a repeat of the 2008 financial crisis.

A. Although regulation aimed at preventing systemic risk must scrutinize firms on a *consolidated* basis, state insurance regulation focuses predominantly on *individual* entities.

Regulation designed to anticipate and mitigate systemic risk, like that envisioned by Dodd-Frank, requires effective regulation of both individual financial companies and the larger financial conglomerates that own and control these companies. *See generally* Basel Committee, *Principles for the Supervision of Financial Conglomerates* (2012) (discussing the importance of group-level supervision for large financial conglomerates). Thus, banking regulation—where systemic risk is a core

regulatory concern—expressly extends to both individual banks and their holding companies. *See* Bank Holding Company Act of 1956, 12 U.S.C. §§ 1841 *et seq.* So too for massive nonbank financial firms like MetLife: Effective systemic-risk regulation requires group-level scrutiny because the risk that a financial conglomerate poses to the broader economy is a function of its overall risk taking and interconnections to the financial system. Thus, the final rule and guidance provide that the Council will evaluate 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 . . . within a nonbank financial company are *supervised on a group-wide basis*." *See* 77 Fed. Reg. at 21,660 (emphasis added).

In sharp contrast to the group-level regulatory scrutiny that systemic-risk regulation demands, state insurance regulation focuses almost exclusively on *individual* insurance companies—not their holding companies or non-insurer affiliates. 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). Indeed, state regulators do not impose *any* quantitative restrictions at the holding-company level on consolidated financial conglomerates like MetLife.

See Daniel Schwarcz, *A Critical Take on Group Regulation of Insurers in the United States*, 5 U. Cal. Irvine L. Rev. 537 (2015).

Moreover, no state has the legal or practical ability to conduct umbrella oversight of insurance groups for systemic risk, even if it wanted to do so. From a legal standpoint, state insurance regulators lack meaningful authority over insurance-holding companies or their non-insurance subsidiaries. Attempting to rectify this situation, the National Association of Insurance Commissioners adopted substantial revisions to its Model Insurance Holding Company System Regulatory Act in 2010, which implemented a "windows and walls" system for group regulation. The "walls" attempt to insulate individual insurance companies from potential financial risks associated with their parents and affiliates by, for instance, limiting transactions with affiliates and the distribution of dividends. Meanwhile, the "windows" of this scheme ostensibly allow regulators to remain attuned to the risks that could arise from an insurance entity's affiliates. Yet state insurance commissioners' jurisdictional constraints 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.[3]

---

[3] In general, state commissioners can compel only insurance subsidiaries to submit reports, not parent companies or non-insurance affiliates. The one exception is that states may demand that parent companies file an enterprise risk

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" is to keep insurance subsidiaries solvent and thus able to pay claims. That approach does not attempt to police excessive risks generated by insurance groups to the global system. *See generally* Schwarcz, *A Critical Take*, *supra*; McCoy, *supra*, at 55.

And state insurance commissioners still lack the tools to see the connections and monitor the exposures of counterparties *outside* of an insurance group. The alarming data gaps that came to light during the Bear Stearns, Lehman Brothers, and AIG crises in 2008 showed that, for systemic oversight to be effective, regulators must have a direct line of sight into both sides of material inter-firm exposures. But state insurance regulators lack access to information about other firms'—especially investment banks, commercial banks, and hedge funds—exposures to insurance groups. And even if they 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. Thus, state regulators'

---

report. *See* NAIC, Model #440, Insurance Holding Company System Regulatory Act § 4L. But even under this limited exception, state insurance regulators have no enforcement authority over the parent company. *See* Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance*, 5 U. Cal. Irvine L. Rev. (forthcoming 2016), available at http://bit.ly/28PE5UY.

oversight of MetLife's operating insurers cannot translate into effective systemic risk oversight of MetLife writ large. *See* McCoy, *supra*, at 58-59.

It therefore is no surprise that domestic and international bodies have repeatedly expressed concern about the capacity of states to regulate large financial conglomerates that may pose systemic risks. For instance, in a peer review of the U.S. state-based insurance-regulation system, 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." Fin. Stability Bd., *Peer Review of the United States* 32 (2013); *see also* Int'l Monetary Fund, *United States: Publication of Financial Sector Assessment Program Documentation—Detailed Assessment of Observance of IAIS Insurance Core Principles* 18 (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"); Fed. Ins. 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."); International Association of Insurance Supervisors, *Insurance 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 relevant here is the Council's *own* explanation for designating MetLife, which similarly emphasized state regulators' inability to conduct consolidated supervision of MetLife. *See* Public Basis, *supra*, at 26-29.

And these concerns are not merely theoretical: the states' lack of adequate group regulation was partially responsible for AIG's risk-taking, which led 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 U.S. Office of Thrift Supervision technically supervised AIG Financial Products, the office'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 Office as their regulator. *See*, *e.g.*, Staff of the S. Comm. on Gov't Security and Homeland Affairs, Permanent Subcomm. on Investigations, 112th Cong., *Wall Street and the*

Financial Crisis: Anatomy of a Financial Collapse: Majority and Minority Staff Report 208–39 (2011), available at http://1.usa.gov/1FxrNzt. This was particularly true with respect to non-banking products, for which the agency lacked expertise. *See* Gov't Accountability Office, GAO-07-154, *Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration* (2007) (describing the Office's relative lack of expertise in supervising financial activities like credit default swaps); *Causes of the Recent Financial and Economic Crisis,* Hearing Before the Fin. Crisis Inquiry Comm'n (Sept. 2, 2010) (statement of Chairman Ben S. Bernanke) (noting that the Office's supervision of AIG's derivatives activities in its financial-products unit was extremely limited in practice). Dodd-Frank therefore eliminated the Office, as well as the federal regulatory architecture that allowed firms to select their consolidated regulator. *See* Kathleen C. Engel & Patricia A. McCoy, *The Subprime Virus* 186–87, 221–23, 246–47 (2011).

The second cause of AIG's near-failure was the company's ill-fated securities-lending program, which likewise 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* 1 (NBER Working Paper No. 21108, 2015), http://bit.ly/28T7Zgn. 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." Gov't Accountability Office, GAO-11-616, *Financial Crisis: Review of Federal Reserve System Financial Assistance to American International Group, Inc*. 13 (2011). Even though most of the securities lent were owned by AIG's insurance subsidiaries, state insurance regulators failed to diagnose or respond to these risks because *non-insurer* affiliates operated AIG's securities-lending program, which was not specific to any of its individual life-insurance entities. Thus, no individual insurance regulator took primary responsibility for carefully scrutinizing that program. State regulators' focus on individual insurance entities also led them to miss a critical connection: 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 bailout 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 (Nat'l Ass'n of Mutual Ins. Cos. Paper, Sept. 2009), http://bit.ly/1vMFNxG.

What's more, since the financial crisis, state insurance regulation's entity-oriented focus has facilitated the development of another potential source of systemic risk, which some have labeled "shadow insurance." *See* N.Y. State Dep't of

Fin. Servs., *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 Fin. Inst. Research Paper No. 14-64, 2015), http://bit.ly/28QniS2. In a shadow-insurance transaction, an insurer purchases reinsurance from an affiliated company subject to more limited regulatory scrutiny. State regulators generally allow the insurer to treat this claim from its affiliate as reliable only if it is supported by a third-party guarantee. But in many cases, such guarantees are themselves backed by a different affiliate of the insurer. The ultimate result is that many 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, *The Risks of Shadow Insurance*, 50 Ga. L. Rev. 163, 175-76 (2015).

Both the 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 Council's public basis for designating MetLife highlighted both the company's securities-lending operations and its use of shadow insurance. Public Basis, *supra*, at 10-11 & 11-12. And it discussed several other practices by MetLife that warrant effective group supervision—most notably,

the company's use of funding agreements to back notes and commercial paper that fund the company's operations. *See id.* at 9-10. As with securities lending and shadow insurance, this arrangement appears to exploit complex internal corporate structures in a way that creates risk to the entire 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 cannot reliably adopt this holistic focus.

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

The Council 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. Public Basis, *supra*, at 22-23. 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. In the case of MetLife, policyholders could demand approximately $49 billion from the general accounts of the company's insurers with little or no penalty, and could withdraw or transfer approximately $206 billion of separate account liabilities with some penalty. *See* Public Basis, *supra*, at 22-23.

These features mean that policyholders who become concerned about their carrier's solvency may well demand withdrawals, cash-surrender values, or policy loans, thus producing a run on liabilities analogous to a classic bank run. And there is historical precedent for such a run on a life insurance company: in 1991, for instance, policyholders withdrew over $3 billion from Executive Life in the year before 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—which had $909 billion in total consolidated assets, compared to Executive Life's approximately $25.72 billion in assets (in 2015 dollars) immediately before its failure—could well be. *See* Richard L. Fogel, *Insurance Regulation: Failures of Four Large Life Insurers* (1992); Public Basis, *supra*, at 7.

Disputing the risk of an unmanageable run, MetLife suggests that state insurance regulators could, as they have done in the past, impose a stay on policyholder withdrawals. *See* MetLife Compl., at 29-30. MetLife also suggests that state guaranty fund protections would limit the risk of such runs. *See id.* To be sure, state insurance regulators have indeed issued moratoriums on cash surrenders and partial withdrawals at life insurance companies that they have placed into receivership. But the purpose of these 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 like MetLife in the midst of a larger financial crisis. And there is good reason to believe that state regulators could face substantial difficulties in attempting to halt a run under those 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. If only some state or foreign regulators took measures to stay withdrawals while others did not, then the predictable result would be to significantly aggravate runs on the MetLife entities that were not subject to any stays. 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 unable to coordinate effectively among themselves. And foreign insurance regulators labor under even greater handicaps in coordinating with numerous different state regulators. In the event of material financial distress at MetLife, such coordination problems are likely to be even greater: some regulators might favor issuing a stay on policyholder withdrawals at the company, while others might

believe that placing a moratorium on withdrawals is not necessary or could backfire by triggering runs at other companies. The inevitable delay that would accompany debates among states and foreign counterparts over exercising these options could well exacerbate the run and, in a period of broad financial market turmoil, potentially cause it to spread to other insurers.

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 like MetLife in the context of broader financial instability.[4] 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* § 9, http://bit.ly/28R2s82. Additionally, 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

[4] 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.

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, potentially jeopardizing those carriers' own financial health. Understanding these limitations, policyholders of a massive financial conglomerate like MetLife would be comparatively more likely to withdraw their savings if they lost faith in the company's long-term capacity to pay its claims. Meanwhile, if state regulators intervened to attempt to halt a run at MetLife, this could trigger runs at other life insurers, as policyholders would realize that the claims-paying ability of the guaranty fund system might already be exhausted. State insurance regulators' efforts to stem the bleeding could, in essence, make a financial crisis worse.

C. Localized political and economic accountability prevents state insurance regulators from effectively regulating systemic risks.

Historically, insurance regulation has been the principal responsibility of the individual states, not 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. Consistent with this understanding, Dodd-Frank subjects nonbank financial companies that the Council 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 systematically important, nonbank financial firms makes eminent sense, because the state insurance regulators' localized political and economic accountability 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 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. And, by definition, the benefits of reducing systemic risk are almost entirely felt outside of the boundaries of any individual state. For this reason, and consistent with the Dodd-Frank Act, systemic risk regulation is properly 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 bailed out insurance companies to the tune of hundreds of billions of dollars. While the bailout of AIG and the sizable Troubled Asset Relief Program payments to The

Hartford and Lincoln National are the most notable examples, *see* McCoy, *supra*, at 27-28, MetLife itself tapped tens of billions of dollars in federal government largesse in 2008 and its aftermath.

And even properly motivated state regulators lack the perspective and expertise to manage systemic risk effectively. As the Council explained, MetLife's potential to pose systemic risks if it experienced material financial distress arises in large part because of the company's interconnections with the larger financial system. Public Basis, *supra*, at 15. Regulation designed to address systemic risk thus 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. State insurance regulators' limited exposure to the national (and international) financial system and its non-insurance players therefore limits their capacity to regulate systemic risk effectively. *See Regulating Systemic Risk in Insurance*, *supra*, at 1627-34.[5]

In light of these hurdles, state insurance regulators' claims that they can effectively regulate even massive financial institutions that potentially pose systemic risks, like MetLife, find little support. Yet these claims are consistent with state insurance regulators' historical resistance to virtually every proposed form of

[5] By contrast, the Council is specifically designed to bring together the nation's leading financial regulators from across all sectors of the financial system.

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). Nevertheless, state regulators' insistence that they can and do adequately regulate insurance-focused firms that could pose a systemic risk does not reflect a consensus among those with a deep understanding of insurance markets and regulation. Rather, 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.

As evidenced by the near failure and subsequent bailout of AIG, state insurance regulators simply do not have the necessary authority, expertise, resources, or perspective to address on their own the types of concerns that systemically important institutions, like MetLife, raise in today's financial landscape. This Court should not allow that flawed regulatory system to be this country's only safeguard against a future financial crisis.

CONCLUSION

For the reasons set forth above, the district court's judgment should be reversed.

Respectfully submitted,

/s/ Deepak Gupta
DEEPAK GUPTA
NEIL K. SAWHNEY
GUPTA WESSLER PLLC
1735 20th Street, NW
Washington, DC 20009
(202) 888-1741

June 23, 2016

Counsel for Amici Curiae Scholars of Insurance and Financial Regulation

CERTIFICATE OF COMPLIANCE WITH RULE 32(a)(7)

I hereby certify that my word processing program, Microsoft Word, counted 6,972 words in the foregoing brief, exclusive of the portions excluded by Rule 32(a)(7)(B)(iii).

/s/ Deepak Gupta
Deepak Gupta

CERTIFICATE OF SERVICE

I hereby certify that on June 23, 2016, I electronically filed the foregoing Brief of *Amici Curiae* Scholars of Insurance and Financial Regulation in Support of Appellant with the Clerk of the Court of the U.S. Court of Appeals for the D.C. Circuit by using the Appellate CM/ECF system. All participants are registered CM/ECF users, and will be served by the Appellate CM/ECF system.

/s/ Deepak Gupta
Deepak Gupta