



STATEMENT OF

THE AMERICAN COUNCIL OF LIFE INSURERS

BEFORE THE

SENATE BANKING COMMITTEE

ON

FSOC ACCOUNTABILITY: NONBANK DESIGNATIONS

March 25, 2015

Statement Made by

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Chairman Shelby and Ranking Member Brown, my name is Gary Hughes, and I am Executive Vice President and General Counsel of the American Council of Life Insurers (“ACLI”). ACLI is the principal trade association for U.S. life insurance companies with approximately 300 member companies operating in the United States and abroad. ACLI member companies offer life insurance, annuities, reinsurance, long-term care and disability income insurance, and represent more than 90 percent of industry assets and premiums.

ACLI appreciates the opportunity to address the procedures governing the designation of nonbank financial companies by the Financial Stability Oversight Council (FSOC). ACLI has a particular interest in the subject matter of this hearing; three of the four nonbank financial companies that have been designated by FSOC for supervision by the Federal Reserve Board are insurance companies, and all of those companies, Prudential, MetLife, and AIG, are members of ACLI. Many ACLI member companies also are actively engaged in asset management, which is a business under active review by FSOC.

Last year, ACLI along with several other national trade associations submitted a petition to FSOC recommending changes to the procedures for designating nonbank financial companies as being subject to supervision by the Federal Reserve Board. In response, FSOC made some needed improvements to the process. Nonetheless, additional reforms to the procedures and standards applied by FSOC in its designations are necessary to promote transparency and ensure a fair process.

My testimony addresses five key points: (1) the additional procedural safeguards that should be adopted by FSOC in connection with designations; (2) FSOC’s flawed application of the “material financial distress” standard for designations; (3) FSOC’s failure to give sufficient weight to the views of state insurance authorities in connection with designations; (4) FSOC’s failure to

give consideration to the consequences of designation; and (5) FSOC's failure to consider an "activities-based" approach for insurance. My testimony concludes with recommendations to address these matters.

1. The designation and de-designation processes lack sufficient procedural safeguards and the public explanations accompanying designations give the public and other nonbank financial companies insufficient insight into why particular companies have been designated.

FSOC has established a three-stage process for determining whether a nonbank financial company should be subject to supervision by the Federal Reserve Board. In response to concerns raised by ACLI and other national trade associations, FSOC has made some improvements to the process. Nonetheless, additional reforms are needed.

A company should have access to the entire record.

A company that advances to the third and final stage of review has no way of knowing what materials FSOC believes are relevant, whether and in what form the materials it submits are provided to voting members of FSOC, or what materials, in addition to those submitted by the company, FSOC staff and voting members reviewed and relied upon. In other words, a company is not provided with the evidentiary record upon which the voting members will make a proposed or final determination. A company should have access to the entire record that is the basis for an FSOC determination.

FSOC should have separate staff assigned to enforcement and adjudicative functions.

Council staff who identify and analyze a company's suitability for designation and author the notice of proposed determination and final determination should not also advise Council members in deciding whether to adopt the notice of proposed determination and final determination. Dividing Council staff between enforcement and adjudicative functions would protect the

independence of both functions. Separation of powers principles and basic fairness require no less. In addition, communications between Council members and enforcement staff should be memorialized as part of the agency record and provided to companies under consideration for designation.

Special weight should be given to the views of the Council member with insurance expertise and to the primary financial regulatory agency for a company.

FSOC must vote, by two-thirds of the voting members then serving including the affirmative vote of the Chairperson, to issue a final determination. The requirement for a supermajority vote is intended to ensure that designation is reserved for companies that pose the most obvious risk to the financial stability of the United States. Yet, the members of FSOC vote as individuals rather than as representatives of their agencies. Thus, the vote is based upon their own assessment of risks in the financial system rather than the assessment of their respective agencies. Moreover, the voting process gives equal weight to views of all members, regardless of a member's experience in regulating the type of company being considered for designation. In the case of an insurance company, special weight should be given to the views of the Council member with insurance experience, and to the state insurance regulator for the company.

The explanation of a designation should provide greater insight into the basis for designation, and a designation should be based upon evidence and data.

When FSOC votes to designate a company, it provides the company with an explanation of the basis for the determination and releases a public version of that document. These documents provide little insight into the basis for a designation, typically offering only conclusory statements unsupported by data or other concrete evidence and analysis. For example, in the documents released by FSOC in connection with the Prudential and MetLife determinations, FSOC concluded that material financial distress at Prudential and MetLife would be transmitted to other financial

firms and harm the financial system. In drawing this conclusion, FSOC relied on extensive speculation about the behavior of policyholders and the reactions of competing insurers and assumed that state regulatory responses would be inadequate, even though history and empirical evidence were to the contrary. When the only explanation for a designation disregards historical experience, empirical research, and fundamental and proven principles of economic behavior and risk analysis, the industry can at best only speculate about the kind of evidence that would satisfy FSOC that designation is neither necessary nor appropriate.

A company should have more than 30 days to seek judicial review of a final decision in a federal court, and during judicial review, the company should not be subject to supervision by the Federal Reserve Board.

Upon receipt of a final designation, a company may seek judicial review before a federal court. Even this safeguard, however, is subject to limitations. A company has only 30 days in which to file a complaint, and loses the right to do so beyond that date. Moreover, filing the complaint carries no automatic stay of supervision by the Federal Reserve Board. Thus, while a company is challenging the legitimacy of a designation, it simultaneously must establish a comprehensive infrastructure (e.g., systems, procedures, and controls) to comply with Board supervision.

Companies should be able to petition for a review of a designation based upon a change in operations or regulations, and a company should be provided with an analysis of the factors that would permit it to be de-designated.

FSOC is required to review the designation of a company on an annual basis. A company also should have the opportunity to obtain a review based upon a change in its operations, such as the divestiture of certain business lines, or a change in regulation. Moreover, during a review, FSOC should be required to provide a company with an analysis of the factors that would lead FSOC to de-designate a company. This would lead a company to know precisely what changes in its

operations or activities are needed to eliminate any potential for the company to pose a threat to the financial stability of the United States.

FSOC's determinations should be independent of international regulatory actions.

Finally, the lack of transparency in FSOC's designation process and the thinly-reasoned explanations in its designation decisions support the concern voiced by some that FSOC's designations have been preordained by actions of an international regulatory entity, the Financial Stability Board (FSB). The member of FSOC with insurance expertise, Roy Woodall, expressed this concern in his dissent to the Prudential designation. The U.S. Department of Treasury and the Federal Reserve Board are both important participants in the FSB, which in 2013, issued an initial list of insurance companies that the organization considered to be "global systemically important insurers." AIG, Prudential, and MetLife were all on the FSB's list. Those companies' designations as SIFIs should have been based on the statutory requirements of the Dodd-Frank Act, which differ meaningfully from the standards FSB has said it applies. Yet, there is ground for concern that leading participants in FSOC were committed to designating as systemic under Dodd-Frank those companies that they had already agreed to designate as systemic through the FSB process. FSOC should not be outsourcing to foreign regulators important decisions about which U.S. companies are to be subject to heightened regulation.

2. FSOC's flawed application of the material financial distress standard for designation distorts the purpose of designations by failing to account for the vulnerability of prospective designees and departs from the requirements of the Dodd-Frank Act and its own regulatory guidance.

The Dodd-Frank Act authorizes FSOC to designate a nonbank financial company for supervision by the Federal Reserve Board if either (1) material financial distress at the company, or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the

company could threaten the financial stability of the United States. Each of the designations made by FSOC has been based on the first standard, the material financial distress standard. Moreover, in each case, FSOC *assumed* the existence of material financial distress at the company, and then concluded that such distress could be transmitted to the broader financial system.

This interpretation of the material financial distress standard departs from the authorizing statute and FSOC's own regulatory guidance, and distorts the purpose of designation. The Dodd-Frank Act expressly directs FSOC, when considering a company for designation, to consider 11 factors, a number of which implicate the company's vulnerability to material financial distress. And FSOC's own interpretive guidance recognizes that a company's vulnerability to financial distress is a critical part of the designation inquiry.¹ The statute, FSOC's guidance, and well-established principles of reasoned regulation make clear that FSOC should not evaluate a company's systemic effects by assuming that the designated company is failing, but instead should separately assess the company's vulnerability to material financial distress. Making this a part of the designation process also provides guidance and the right incentives for companies that may be considered for designation in the future, because it incentivizes them to change aspects of their business that FSOC regards as vulnerabilities.

Roy Woodall addressed FSOC's flawed application of the material financial distress standard in his dissents in both the Prudential and MetLife cases. In the Prudential case, he noted that:

...the Notice's analysis under the [material financial distress standard] is dependent upon its misplaced assumption of the simultaneous failure of all of Prudential's

¹ See *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21,637 (Apr. 11, 2012).

insurance subsidiaries and a massive and unprecedented, lightning, bank-style run by a significant number of its cash value policyholders and separate account holders, which apparently is the only circumstance in which the Basis concludes that Prudential could pose a threat to financial stability. I believe that, absent a catastrophic mortality event (which would affect the entire sector and also the whole economy), such a corporate cataclysm could not and would not occur.

Similarly, in his dissent in the MetLife case, Mr. Woodall highlighted the lack of evidence to support one of FSOC's principal bases for assuming "material financial distress" at MetLife:

I do not, however, agree with the analysis under the Asset Liquidation Transmission Channel of the Notice of Final Determination, which is one of the principal bases for the finding under the [material financial distress standard]. I do not believe that the analysis' conclusions are supported by substantial evidence in the record, or by logical inferences from the record. The analysis relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity products, and, importantly, State insurance regulation and the framework of the McCarran-Ferguson Act.

One consequence of FSOC's interpretation of the material financial distress standard is that FSOC focuses too narrowly on a company's size. When it passed the designation provisions in the Dodd-Frank Act, Congress never intended a unilateral focus on size. Rather, size is just one of 11 factors that Congress directed FSOC to consider when it designates a company.

Another consequence of FSOC's reliance on the material financial distress standard is that it is difficult for a company, or the public, to understand the basis for a designation. The documents accompanying designations address how the company's failure might impact financial stability, but do not address what hypothetically caused the company to fail in the first place. Thus, a designated company has little, if any, insight into what activities are, in FSOC's view, associated with systemic risk.

Under a material financial distress standard that actually meets the statutory requirements of

the Dodd-Frank Act, FSOC would need to employ the 11 statutory factors to first determine whether the company is vulnerable to material financial distress based upon its company-specific risk profile and, if it is, then determine whether the company's failure could threaten the financial stability of the United States. In other words, FSOC should not be able to designate a company on an assumption that it is failing, but instead should only designate a company when a company's specific risk profile – including its leverage, liquidity, risk and maturity alignment, and existing regulatory scrutiny – reasonably support the expectations that the company is vulnerable to financial distress, and then that its distress could threaten the financial stability of the United States. The purpose of designations should be to regulate nonbanking firms that are engaged in risky activities that realistically “could” cause the failure of the firm, not to regulate firms that are not likely to fail.

3. FSOC does not give sufficient weight to the views of primary financial regulatory agencies.

In drafting the Dodd-Frank Act, Congress recognized that many nonbank financial companies are subject to supervision and regulation by other financial regulators. Insurance companies, for example, are subject to comprehensive regulation and supervision by state insurance authorities. Thus, Congress directed FSOC to consult with other primary regulators when making a designation determination, and required FSOC to consider “the degree” to which a company is already regulated by another financial regulator. Congress also gave the Federal Reserve Board authority to exempt certain classes or categories of nonbank financial companies from supervision by the Board, and directed the Board to take actions that avoid imposing “duplicative” regulatory requirements on designated nonbank companies.

FSOC's designation of insurance companies shows little deference to these requirements. In the case of MetLife, for example, FSOC discounted state insurance regulation even after the

Superintendent of the New York State Department of Financial Services (NYDFS), Benjamin Lawskey, told FSOC that: (1) MetLife does not engage in non-traditional non-insurance activities that create any appreciable systemic risk; (2) MetLife is already closely and carefully regulated by NYDFS and other regulators; and (3) in the event that MetLife or one or more of its insurance subsidiaries were to fail, NYDFS and other regulators would be able to ensure an orderly resolution.² Similarly, in his dissent in the Prudential case, the Council member with insurance experience noted that the scenarios used in the analysis of Prudential were “antithetical” to the insurance regulatory environment and the state insurance company resolution and guaranty fund systems.

This lack of deference to an insurer’s primary financial regulator is particularly troubling given the fact that insurance, unlike every other segment of the financial service industry, does not have any of its primary regulators as voting members of FSOC. Moreover, none of the primary regulators of the three insurers that have been designated were “at the table” when FSOC designation decisions were made.

4. FSOC has failed to consider the consequences of designation.

FSOC has an obligation to consider the consequences of its actions. Administrative law requires that an agency consider the effects of its actions, and the failure to do so can cause a court to void the action. SEC Chair Mary Jo White acknowledged publicly in June that a principle of good policymaking is to know “. . . what is on the other side if I make that decision. . .” and to understand what a decision “. . . actually accomplish[es] in terms of the issue you’re trying to solve

² Letter to Honorable Jacob Lew, Secretary of the Treasury, from Benjamin M. Lawskey, Superintendent, New York State Department of Financial Services, July 30, 2014.

for.”³ In its determinations to date, however, FSOC has failed to consider the consequences of its designations.

This failure is particularly relevant to designations involving insurance companies. The insurance industry is highly competitive, and the additional regulation imposed upon a designated company can place that company at a significant competitive disadvantage relative to its non-designated competitors. Capital standards are the most obvious example. Congress recently clarified that the Board has the ability to base capital standards for designated insurance companies on insurance risk, rather than banking risk. We appreciate very much this Committee’s role in effecting that important clarification. At this point, we are waiting on a proposal from the Federal Reserve Board that makes use of this revised statutory provision. Should the Federal Reserve Board impose capital requirements on designated insurers that are materially different from those imposed by the states, designated insurers may find it difficult to compete against non-designated competitors.

Additionally, FSOC’s failure to consider the consequences of designations on insurance companies is at odds with FSOC’s “duty” under the Dodd-Frank Act to monitor regulatory developments, including “insurance issues,” and to make recommendations that would enhance the “integrity, efficiency, competitiveness, and stability” of U.S. financial markets.⁴

5. FSOC has failed to consider an “activities-based” approach to insurance.

The Dodd-Frank Act gives FSOC two principal powers to address systemic risk. One power is the authority to designate nonbank financial companies for supervision by the Federal Reserve Board. The other power is an “activities-based” authority to recommend more stringent regulation of specific financial activities and practices that could pose systemic risks. FSOC has not been

³ SEC Chair: Asset Managers Not Overreacting to FSOC.” *Politico Pro*. June 22, 2014. <https://www.politicopro.com/financialservices/whiteboard/?wbid=33914>.

⁴ §112(a)(2)(D) of the Dodd-Frank Act.

consistent in its exercise of these powers. In the case of the insurance industry, FSOC has actively used its power to designate. In the case of the asset management industry, FSOC has undertaken an analysis of the industry so it can consider the application of more stringent regulation for certain activities or practices of asset managers, and it has not designated any asset management firm to date.

FSOC held a public conference on the asset management industry in order to hear directly from the asset management industry and other stakeholders, including academics and public interest groups, on the industry and its activities. Furthermore, following its meeting on July 31, 2014, FSOC issued a “readout” stating that FSOC had directed its staff “to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry.”

In contrast, FSOC has not held any public forum at which stakeholders could discuss the insurance industry and its activities. Instead, FSOC has used its power to designate three insurance companies for supervision by the Federal Reserve Board.

ACLI supports the more reasoned approach that FSOC has taken in connection with the asset management industry and believes that FSOC should be required to use its power to recommend regulation of the specific activities of a potential designee *before* making a designation decision with respect to that company.

FSOC’s power to recommend more stringent regulation of specific activities and practices has distinctive public policy advantages over its power to designate individual companies for supervision by the Federal Reserve Board. FSOC’s power to recommend brings real focus to the specific activities that may involve potential systemic risk and avoids the competitive harm that an individual company may face following designation. As noted above, in certain markets, such as

insurance, designated companies can be placed at a competitive disadvantage to non-designated companies because of different regulatory requirements. Finally, the power to recommend avoids the “too-big-to-fail” stigma that some have associated with designations.

FSOC’s recommendations for more stringent regulation of certain activities and practices must be made to “primary financial regulatory agencies.” These agencies are defined in the Dodd-Frank Act to include the SEC for securities firms, the CFTC for commodity firms, and state insurance commissioners for insurance companies. A recommendation made by FSOC is not binding on such agencies, but the Dodd-Frank Act includes a “name and shame” provision that encourages the adoption of a recommendation. That provision requires an agency to notify FSOC within 90 days if it does not intend to follow the recommendation, and FSOC is required to report to Congress on the status of each recommendation.

Recommended Reforms

To address the concerns highlighted in this statement, ACLI recommends the following reforms:

Institute additional procedural safeguards during the designation process.

We recommend the following changes to the designation process: (1) companies that receive a notice of proposed determination should be given access to the entire record upon which FSOC makes the determination to issue the notice; (2) the same FSOC staff should not serve as factfinder, prosecutor and adjudicator; (3) in the case of an insurance company, the views of the Council member with insurance expertise and the primary financial regulatory agency for the company should be given greater weight; (4) a company should be given more than 30 days to initiate judicial review of a final determination; and (5) supervision of the company by the Federal Reserve Board should be stayed during judicial review.

Establish additional procedures for de-designation

In addition to the mandatory annual review of a determination, FSOC should be required to conduct a review upon the request of a designated company if there has been a change in the operations of the company or a change in regulation affecting the company. In connection with such a review, FSOC should also provide a company with an analysis of the factors that would lead FSOC to de-designate the company. This would permit a company to know precisely what changes in its risk profile are needed to eliminate any potential for the company to pose a risk to the financial stability of the United States. Finally, during the de-designation review, the views of the Council member with insurance expertise and the primary financial regulatory agency for the company should be given special weight.

Require FSOC to pursue an “activities-based” approach before using its power to designate a company for supervision by the Federal Reserve Board.

FSOC should use its authority under the Dodd-Frank Act to recommend specific activities and practices for more stringent regulation before designating individual nonbank financial companies within an industry for supervision by the Federal Reserve Board. More stringent regulation of the activities or practices of an entire class or category of financial firms can have a greater impact on financial stability than the designation of an individual firm.

Require FSOC to consider “vulnerability” in its designation decisions.

The statute, FSOC’s own regulatory guidance, and common sense dictate that a company should not be designated systemic without an evaluation of whether the company, as currently structured and operated, is indeed vulnerable to material financial distress. Steps should be taken to ensure that FSOC makes this factor an element of its decision making process in the future.

Promulgate the regulations required by Section 170 of the Dodd-Frank Act.

Section 170 of Dodd-Frank directs the Federal Reserve Board, in consultation with FSOC, to issue regulations exempting certain classes or categories of companies from supervision by the Federal Reserve Board.⁵ However, to date no such regulations have been issued pursuant to this authority. This requirement represents yet another tool Congress created to delineate between those entities that pose systemic risk and those that do not. How such regulations might affect insurance companies, if at all, is unknown. But presumably the regulations will shed additional light on what metrics, standards or criteria operate to categorize a company as non-systemic. The primary goal here should be to clearly inform companies of how to conduct their business and structure their operations in such a way as to be non-systemic. Only if that primary goal cannot be met should the focus turn to regulating systemic enterprises.

Conclusion

Mr. Chairman, we believe the best interests of the U.S. financial system and the stated objectives of the Dodd-Frank Act can be realized most effectively by an FSOC designation process that operates in a more transparent and fair manner. The overarching purpose of the Dodd-Frank Act is to minimize systemic risk in the U.S. financial markets. Providing companies with the choice and the ability to work constructively with FSOC to structure their activities in such a way as to avoid being designated as systemic in the first instance advances that purpose and reflects sound regulatory policy – as would affording companies a viable opportunity for de-designation. The reforms we are recommending are intended to achieve these objectives, and we pledge to work with this Committee and others in Congress toward that end.

⁵ §170 of the Dodd-Frank Act.