

Sheila C. Bair

March 10, 2014

Chairman Sherrod Brown
Senate Committee on Banking, Housing and Urban Affairs
Subcommittee on Financial Institutions and Consumer Protection
534 Dirksen Senate Office Building
Washington, DC 20510

Re: Subcommittee Hearing: "Finding the Right Capital Regulation for Insurers"

Dear Chairman Brown and Members of the Subcommittee:

Thank you for the opportunity to present my views on the appropriate capital framework for insurance companies under the Dodd-Frank Act. I understand the insurance industry has expressed concerns about the potential treatment of insurance companies by the Federal Reserve in its establishment of consolidated capital standards for bank holding companies and nonbank financial institutions designated for heightened supervision. I agree that the Federal Reserve can and should craft a capital framework appropriate to insurance products, and should have the discretion to defer to state insurance regulators in establishing capital standards for the insurance activities which they regulate. However, I also believe that the Federal Reserve already has ample authority to do so without undermining important safeguards.

I am concerned however, that S. 1369 may unintentionally go beyond legitimate concerns about protecting the integrity of state regulation of insurance. As drafted, S. 1369 would provide a wholesale carve-out from common sense protections contained in the Section 171 of Dodd-Frank, also known as the Collins' amendment, for insurance conglomerates, including their banking and derivatives activities. This would give insurance giants a significant competitive advantage over banking organizations engaged in the same activities, and leave the door open to the kinds of highly leveraged risk-taking which contributed to the 2008 crisis. We should not forget that in 2008 AIG was also an insurance company, which took excessive risks in its non-state regulated affiliates.

A better approach would afford the Federal Reserve the opportunity to use the public notice and comment process to issue a proposal and then assess the extent to which the Federal Reserve has appropriately addressed the risks posed by these companies. To the extent Congress acts, it should only do so in a way that retains the essential protections of Section 171 of the Dodd-Frank Act: namely by clarifying the Federal Reserve's discretion to credit effective and applicable insurance capital regimes established by state insurance regulators over regulated insurance companies. Congress should not establish a wholesale carve out from Section 171's common sense capital floors.

The Collins Amendment (Section 171 of the Dodd-Frank Act) is a vital safeguard against capital arbitrage and excessive leverage. It helps protect markets, ensure a level playing field and avoid many of the regulatory mistakes that contributed to the recent financial crisis.

In the years leading up to the financial crisis, federal (and international regulators) established a series of complex, model-driven capital rules for the world's largest, most complex firms. Not only did these complex capital regimes create a host of perverse incentives that encouraged institutions to use risky-synthetic products (like synthetic CDOs) over "real" traditional alternatives (like whole mortgages), they created regulatory advantages for large firms relative to small firm competitors, fueling size, complexity and ultimately too big to fail. Section 171 helps address that risk by requiring that the largest, most complex bank holding companies and systemic institutions meet the same basic "generally applicable" capital standards that apply to other bank holding companies.

This "generally applicable" standard is not set in stone. If, at any point, regulators want to change how they create and measure that standard, they can, but they must make sure that the largest and most systemic firms can meet the same basic capital floor that applies to the smaller, less systemic ones and they must make sure that any new standards are not weaker than those standards in effect when Dodd-Frank was enacted. As discussed below, this is not a high hurdle. This floor is a common sense protection so that regulators do not again create affirmative incentives for firms to become big, levered and risky or to escape leverage constraints by moving risky activities into more lightly regulated venues.

Section 171 only applies to (1) institutions that own banks or thrifts (so called bank (or thrift) holding companies); and (2) potentially systemic institutions whose failure could pose a threat to financial stability.

To the extent insurance companies are subject to this safeguard, it is only because they are also bank/thrift holding companies or so large that they pose a potentially systemic threat. Any company can avoid complying with these basic leverage constraints by not engaging in the business of banking (i.e., not owning a bank) or not being large and potentially systemic (like AIG).

Fairness (and effective regulation) would treat all institutions engaging in the same activity the same way. If an insurance company chooses to become a bank/thrift holding company, it is reasonable that, as a bank/thrift holding company, it follow the same rules. Carving out "insurance bank holding companies" from "bank holding company" requirements would create a competitive advantage for these firms (1) when they engage in the business of banking; and (2) when traditional bank holding companies engage in the business of insurance. This dynamic also facilitates a race to the bottom that ultimately hurts their customers (who should be protected by the holding company capital buffer), the markets, and potentially taxpayers (who could suffer from the failure and cleanup).

Section 171 standards are basic, minimum, capital floors. They are not onerous and they continue to permit high leverage.

As interpreted by the Federal Reserve, Section 171 establishes the generally applicable “adequately capitalized” standards for banks as the floor. These standards are far from onerous. A 4% leverage limit for on balance sheet assets still permits debt to equity ratios of 25 to 1. Though banks are also subject to a “risk-based” capital floor, the federal banking regulators are free to craft risk weights to appropriately address insurance products, so long as the same minimum rules apply to institutions large and small. Though minimal, these Section 171 floors are still quite robust compared to the excessive levels of leverage used prior to the crisis, where large investment banks and others took on debt to equity ratios of 40 and even 50 to 1. Moreover, aggregate capital levels reported by industry trade associations such as the ACLI suggest capital ratios significantly in excess of these minimums. Thus it is hard to understand why these constraints are raising such alarm.

Capital is important for any financial institution. It protects an institution’s customers – be they depositors or policy holders – by absorbing unexpected losses from bad investment or lending decisions. It protects the public by reducing the risk of destabilizing failures. And it protects government safety net programs like deposit insurance and state guarantee funds which must step in to protect the public when institutions fail. The relevant standard applicable under Section 171 is the basic standard that applies to even small community banks. This floor exists so that regulators do not again provide artificial capital advantages to large and complex bank holding companies or systemic firms, unintentionally fueling risk that create market asymmetries and imbalances. Though, the existing risk-based standards might be considered “bank-centric,” they could be tailored for state regulated insurance subsidiaries under the Federal Reserve’s existing authority.

Section 171 does not change state insurance capital requirements.

Banks and insurance companies are different and they continue to be treated differently under the law. Nothing in Section 171 changes the state regulation or state capital requirements of regulated insurance companies. States continue to set capital for regulated insurance company subsidiaries, just as bank agencies set capital requirements for individual bank subsidiaries. If a company lacks sufficient capital at the individual insurance company level, state rules apply. The key issue here is meeting the minimum consolidated (group) capital requirement when there is a bank/thrift holding company or a systemic institution that also has an insurance business.

The Federal Reserve has not yet even published its specific rules on this topic, making legislation premature, at best.

To its credit, the Federal Reserve understands the concerns and has stated, that in crafting specific rules, it does not believe a “one size fits all approach” is appropriate. As Federal Reserve Chairman Janet Yellen stated on Feb. 27, before the full Committee:

“We are looking very carefully to design an appropriate set of rules for companies with important involvement in insurance to recognize that there are very significant differences between the business models of insurance companies and the banks that supervise and we are taking the time that is necessary to understand those differences and to attempt to craft a set of capital and liquidity requirements that will be appropriate to the business models of insurance companies.”

Given this ongoing regulatory process, Congress should wait to review and assess the Federal Reserve’s rules. Though I understand the Federal Reserve has stated that it is also constrained by Section 171, absent a rule, the nature and potential impact of any constraint remains theoretical.¹ Though it is true that Section 171 applies to a bank/thrift holding company and a systemically important institution, even if it is predominantly engaged in insurance, the Federal banking agencies have broad authority to establish risk weights that credit the state-regulated insurance activities while still capturing the other, banking and potentially risky unregulated activities as they would with a bank holding company.

If Congress ultimately decides to legislate, I strongly urge it to do so only in the most-narrow way: providing Federal Reserve with discretion to give credit for the effective and applicable capital standards of state insurance regulators.

This narrow approach would provide the clarity and flexibility needed without undermining the essential safeguard for holding companies and unregulated affiliates. It would also help ensure that there is a “cop on the beat” (i.e., the relevant state insurance regulator) who is accountable for his/her capital regime and for the protection of state insurance policyholders. To the extent a firm is also engaged in non-insurance activities, or other AIG like synthetic risk-taking, it should not be carved out from this common sense capital floor just because it also has a large insurance business. It should apply equally to all firms engaging in the same activity.

Unfortunately S. 1369 is too broad and would undermine the protections afforded by Section 171 and create a host of artificial advantages for these firms that could reduce their safety and soundness and set the stage for more AIG-type failures.

S. 1369 goes well beyond clarifying the Federal Reserve’s authority and would instead provide a wholesale carve out, not just for state regulated insurance subsidiaries, but for all activities if the consolidated entity is “primarily engaged in the business of insurance.” Given the broad definitions, I fear that even AIG, in 2008, might have been carved out under this broad approach because it had a large insurance business.

¹ I agree with many commenters that the Federal Reserve has significant authority to address reasonable issues. See e.g., Letter from 30 Members of Congress to Ben Bernanke, Chairman of the Board of Governors of the Federal Reserve System, December 11, 2012; Letter from A. Patrick Doyle, Arnold & Porter LLP et. al, to Scott Alvarez, General Counsel, Federal Reserve Board, Mar. 20, 2013 at 5; and Letter from H. Rodgin Cohen, Sullivan & Cromwell to MetLife, May 20, 2013;

Moreover, even today – with AIG being designated by the FSOC for heightened prudential standards – they might be carved out from Section 171 if they meet the broad “primarily engaged” test. Though Section 165 of the Dodd-Frank Act could be used to recapture the systemic firms, eliminating the capital floor leaves open the possibility that regulators could again impose lower/weaker standards at large, systemic firms as they did before the financial crisis. If stronger protections and higher capital are needed for large, potentially systemic financial institutions (and I believe they are), why remove the floor that helps provide basic protections and a level playing field?

While I understand there maybe disagreements about whether individual insurance companies are potentially systemic, once a firm is designated, there is no reason why they should have lower capital standards than bank holding companies – or even community banks – under the basic “generally applicable” standards simply because they are “primarily” insurance. Permitting the Federal Reserve to credit effective capital standards established for state regulated insurance subsidiaries is one thing: a wholesale carve out from these minimum standards for all activities, is another, particularly in light of the lessons learned from AIG in 2008.

Insurance companies are not risk-free

Though insurance companies are different than banks, it is important to remember that they put their money in many of the same assets: government and corporate bonds, mortgage-backed securities, and real estate loans. Indeed, according to the American Council of Life Insurers’ data, life insurers have over a trillion dollars in real estate exposure, including \$600 trillion in mortgage-backed securities and \$354 billion in commercial and residential mortgages. Though their run-risk may be different from banks, it is real. While banks hold short-term deposits, most are backed by the FDIC, and are quite stable, as we saw during the crisis. Even if we concede these differences, insurance policy holders can “run,” just differently. A life insurance policy is not indentured servitude. Policyholders can cash out whole life and annuity products, and halt premium payments on term products. Indeed, one of the biggest life insurance failures – \$15 billion Executive Life – suffered debilitating policy surrenders contributing to its failure in 1991.

I question the argument that insurance organizations should have weaker bank/thrift holding company protections because their insurance policy holders can’t easily cash out if they make bad investments. This holding company capital is there to absorb unexpected losses, capture risks in their unregulated entities, and protect customers and the markets from their potential failure. All these risks exist in a bank/thrift holding company or a systemically important financial institution, even if that firm also happens to have a large insurance business. Moreover, given the long-term nature of life insurers’ obligations to their policy holders, they are exposed to substantial risk based on market fluctuations and turns in the economic cycle. Thus, it could be easily argued that they need more, not less, capital than banks based on the long tail of their liability structure.

A more valid argument is that state regulated insurance companies are already subject to oversight by state regulators who are experts in the risk of insurance. Therefore, these institutions do not need another layer of federal standards. This argument would be more compelling if the Federal Reserve had already written rules and if they needed a narrow clarification of authority.

To go beyond a narrow clarification would undermine federal capital standards for all their businesses, including their unregulated U.S. affiliates, their overseas activities and their banking business. We should remember it was not AIG's state-regulated insurance business that got it into trouble; it was its derivatives business in London.

Conclusion

During the years leading up to the crisis, there was a substantial amount of regulatory arbitrage between bank holding companies and nonbank institutions (investment banks, GSEs, AIG), as well as between large and small banking institutions, with complex, mega institutions being able to operate with thinner capital cushions than the average community bank. The Collins Amendment/Section 171 was designed to strengthen the integrity of capital standards by imposing a generally applicable floor that would constrain destabilizing leverage for all systemic institutions, regardless of business model, so that they would have to hold at least as much capital as that generally required of smaller banks.

Though I understand the desire to proactively address an issue that could become a problem, there are substantial downside risks for consumers and the markets. As it moves forward, I hope the Committee will go slow and consider the risks and tradeoffs before changing this important safeguard. To its credit, Congress has thus far chosen not to reopen Dodd-Frank, and instead has afforded regulators the opportunity to implement its provisions through an open rulemaking process before considering changes. I believe that legislation is unnecessary and that the Federal Reserve has ample discretion under current law to craft appropriate capital rules for insurance companies that are systemic or that are bank/thrift holding companies. If the Congress ultimately decides to legislate, I strongly urge it to do so only in the most-narrow way: providing Federal Reserve with discretion to give credit for the effective and applicable capital standards of state insurance regulators.

In considering legislation in this area, the key question for Congress to consider is whether systemic institutions, as well as those with access to the federal safety net through their ownership of a federally insured bank, are sufficiently capitalized. If a company lacks sufficient capital to meet the Fed's basic (and still undefined) standards – Congress should then examine whether requiring additional capital of that institution is an undesirable policy result. Millions of Americans rely on these companies to safeguard their assets, and fulfill their legal obligations to them. It would be a terrible mistake to eliminate an important safeguard only to later learn that firms are, or became, more risky than had been previously assumed.

Respectfully,

A handwritten signature in blue ink that reads "Sheila C. Bair". The signature is written in a cursive style and is contained within a thin black rectangular border.

Sheila C. Bair