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# Source of Weakness

## Worrisome Trends in Solvency Regulation of Insurance Groups in a Post-Crisis World

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### Abstract

The regulation of insurer financial strength in the United States historically has focused on a fundamental principle: that the premiums and capital of any insurer are meant to pay the claims of that insurer's policyholders and not to be drawn on to rescue a failing affiliate within the same group. This is a *customer-centric* approach, based on the individual insurance contract that is issued by a separately capitalized insurer for a specific period of time, in which the premiums charged are regulated based on that issuer's solvency position and the risk assumed under that contract.

Since the financial crisis, however, international financial bodies, including the EU, have been pressing U.S. policy makers to adopt the EU's very different approach toward insurance regulation for globally and systemically important insurers, and potentially for all insurers, borrowing from the banking industry the notion of "group capital" regulation. This latter approach ignores the legal separateness of the different entities belonging to the same group and makes all parts of a banking group financially responsible for each other, through the so-called "source of strength" doctrine for holding companies and "cross-guarantee" requirements for bank subsidiaries. In effect, group capital regulation is *creditor-centric*, and potentially ignores the specifics of individual insurance contracts.

The U.S. Congress also has expanded the scope of the Federal Reserve's authority to apply one particular aspect of group capital regulation (the "source of strength" doctrine), but only to systemically important insurance groups. So far, the only two insurance groups to receive this designation are AIG and Prudential, although there has been much speculation that Metropolitan Life will be added to the list at some point.

The FSOC's designation process raises questions of how U.S. regulators will now respond to the heavy international pressure being exerted to have the United States converge its solvency regulation of insurers with the European approach. This essay urges U.S. policy makers to slow this train down and give serious thought to several key issues.

The author greatly appreciates the excellent comments on an earlier draft from his Brookings colleague Doug Elliott. All views expressed here are the author's own and not those of the Brookings Institution, its trustees, officers, or employees. Litan has authored numerous books and articles about financial regulation, including regulation of insurers. In addition, during the course of his career, he has consulted for insurance groups and individual insurers on insurance-related matters.

## Abstract, continued

First, if the history of international bank capital standards established by the Basel Committee is any guide – as it should be – the rules applied to a limited number of institutions (Basel initially applied only to internationally-active banks) tend to become a template for a much larger number (the Basel approach has since been applied to a larger group of banking organizations). In the insurance arena in particular, the International Association of Insurance Supervisors (IAIS) is currently working on a global solvency standard initially meant to apply by the end of this year only to Globally Systemically Important Insurers (GSIIs), but plans appear to be in place to use that template for a much larger group of insurers, including those in the United States. That is why the current pressure on the United States to adopt European-style group capital regulation for what initially may be a limited number of insurance groups is so significant: over time, it could become the default rule for all insurers and insurance groups in this country.

Second, this essay also explains why there are good reasons for not applying a group capital approach to the overwhelming majority of insurers that cannot reasonably be said to present systemic risk to our financial system, and conceivably to insurance groups that have been so designated: they primarily stem from that fact that the businesses of banking and insurance, and specifically the nature of their liabilities, are very different.

Third, there is a key difference between the way in which other aspects of the insurance are regulated in the United States and in Europe, as well as in a fundamental difference in regulatory philosophy: while Europe tends to put primary emphasis on preserving insurers and protecting their creditors, the U.S. historically has focused its primary attention on protecting insurance policyholders, while allowing financially troubled insurers to fail – potentially even systemically important ones under the new resolution procedures of the Dodd-Frank Act.[1]

All this means that while group capital regulation may be appropriate for banks, it clearly is not generally appropriate for insurance. U.S. policy makers should keep these distinctions in mind before embracing any European-style insurance solvency regulation for all but U.S.-designated systemically important insurers or groups, either at the behest of financial regulators in the E.U. or international insurance supervisors (IAIS).


1 See e.g., Sec. 203(e) of the Dodd-Frank Act, which seeks to preserve and apply state law to any insurance company subject to liquidation or rehabilitation under the Act.

## Introduction and Executive Summary

The financial crisis of 2007-08 changed a lot of things for the U.S. economy and the financial industry in particular. U.S. policy makers responded with much tougher regulation not only of the banking industry, but of the entire financial sector, largely because the crisis originated and affected more than just the banking industry. Financial policymakers in other countries, mostly other developed countries in the EU that were deeply affected by the crisis, also mounted vigorous policy responses.

Because finance is a global activity, and many financial institutions have a global or at least multinational presence, policymakers in developed economies also seem to have intensified their efforts at harmonizing regulatory approaches, if not specific rules. The best example is the Basel III capital standard for banks, quickly agreed to by Basel member countries after the crisis (in contrast to the long-drawn out negotiations pre-crisis over the Basel II standards). Similarly, financial regulators from the G-20 countries met shortly after the crisis began, with a view toward harmonizing principles for improving regulation and supervision of the financial industry.

This essay will examine one important, but lesser-noticed, aspect of this twin move toward improved post-crisis regulation/supervision and harmonization: whether, and if so, how to harmonize solvency regulation and supervision of *multi-unit* insurance companies (those with multiple insurance subsidiaries) and their holding companies, or what some (and I will) call "insurance groups," and what the reach of any such harmonized rules should be.

In addressing this issue, it is critical to keep in mind that the regulation of insurer financial strength in the United States historically has focused on a fundamental principle under which the premiums and capital or any insurer are meant to pay only the claims of that insurer's policyholders based on the insurer's contract with the customer. To do otherwise – namely to allow state regulators to treat an insurer's capital as the capital of its affiliates or parents – would give regulators in various jurisdictions a license, if not an invitation, to suppress insurance rates below their actuarially appropriate levels, undermining the role of actuarial analysis that underpins the business of insurance. Such a result, while temporarily appealing, ultimately would weaken all insurers in these states, reducing competition among insurers, and ultimately harming insurance consumers.

Why the focus on insurance, and insurance groups, in particular? A large part of the answer to both questions can be summarized in three letters – AIG – or the initials of the now infamous (though recently resurrected) American International Group.

AIG was once one of the world's largest insurers, active in two of three major lines of insurance, life and property-casualty, in the United States and elsewhere around the world. Until the financial crisis, it was also thought to be one of the most financially sound of all insurance groups. The company's debt consistently received the highest ratings (AAA) the major ratings agencies could assign.

AIG, the parent company, also had a non-insurance subsidiary, AIG Financial Products, separate from the company's life and property-casualty insurance businesses, whose business consisted primarily of the sale of "credit default swaps" to parties that wanted a hedge or an insurance-like guarantee in the event specific mortgages or securities backed by subprime mortgages fell into default[2]. At its peak, the subsidiary had over $500 billion outstanding in CDS contracts, which ultimately AIG, as the parent company, could not honor[3]. The Federal Reserve rescued AIG's creditors in the interest of preventing a wider systemic financial crisis. There has been much interest ever since and understandably so, on both sides of Atlantic, in preventing "future AIGs."

> Whatever views one holds about the correctness of the Fed's actions with respect to AIG or the other non-banks whose creditors were rescued during the crisis, it is clear that insurers do not have the same kind or magnitude of interconnectedness with the financial system as did AIG.

Likewise, policymakers in both parties and in the regulatory agencies in the United States want to avoid bailouts in the future of other large and/or interconnected non-banks, whether they be financial or non-financial (as in the case of General Motors and Chrysler) – so-called "too big to fail" (TBTF) institutions. Title II of the Dodd-Frank Act, enacted in the wake of the financial crisis, established resolution procedures aimed at accomplishing this objective. Although these provisions remain controversial, it is widely agreed that no one knows whether they will really "work" until they are tested by a future financial crisis (that everyone

2. AIG also had losses in its securities lending operations, but these losses did not pose systemic risks.

3. See http://www.businessinsider.com/heres-the-untold-story-of-how-aig-destroyed-itself-2010-3.

also wants to avoid). At the same time, the intention of Title II is to allow *any* non-bank financial institution – in principle, including a systemically important insurance group – to fail, and its creditors to take losses[4].

Whatever views one holds about the correctness of the Fed's actions with respect to AIG or the other non-banks whose creditors were rescued during the crisis, it is clear that insurers do not have the same kind or magnitude of interconnectedness with the financial system as did AIG (through its non-insurance CDS counterparties), other rescued non-banks, or as is the case with large banks deemed by Congress as systemically important. Nor, as discussed in more detail below, can insurance liabilities in the insurance industry "run" in the way that bank deposits can.

These distinctions, coupled with the new resolution procedures in Title II of Dodd-Frank, mean that the failure of any insurer, including one designated to be systemically important in the United States, but at a minimum all other insurers not so designated, can be allowed to happen without the systemic consequences associated with large banks or financial institutions highly interconnected with other financial institutions. At a House Financial Services Committee hearing on July 23, 2014 assessing Dodd-Frank's impact, former Representative Barney Frank, a primary author of the legislation said, "[I] don't think insurance companies that just sell insurance as it is traditionally defined are systemically important. They don't have the leverage. Thus, failure isn't going to have that systemic reverberatory effect."[5]

European regulators have reached a different conclusion, however, in the EU's "Solvency II" directive scheduled to be effective for European insurers on January 1, 2016. That directive requires European national regulators to impose minimum capital standards not just for systemically important insurers and groups, but for *all* insurance groups doing business in Europe that obligate them to rescue any troubled subsidiary. This mandate reflects a regulatory philosophy intent on protecting insurers against failure and their creditors against loss.

Apart from any desire to harmonize U.S. regulation with that of the E.U., some might claim that the same approach is required under the "Collins Amendment" to the Dodd-Frank Financial Reform Act. As discussed below, this is not a correct interpretation of the Amendment, and moreover, at this writing, in a rare show of bipartisan agreement, the Senate unanimously approved legislation in June, 2014 making clear that any consolidation of capital within a group under the Collins Amendment should not apply to insurance.

As noted in the abstract, the international push to get U.S. regulators to follow the European, bank-centric approach to this issue extends beyond a quest for harmonization: it is a desire for *convergence* with a European model for regulating insurance groups through concentration on their "group capital," an approach that has never been adopted in the United States for the insurance industry and which ignores key differences between insurance and banking generally, and between insurance regulation in the United States and Europe more specifically.

This essay suggests that any move by U.S. policy makers to accept the pressure for regulatory convergence toward the European model for the regulation of insurers and insurance groups is premature, is fraught with danger for U.S. insurance consumers and insurers, and leaves open a number of questions that U.S. policy makers must answer before seriously considering the idea.

## Banking and Insurance: Key Similarities and Differences

It has become fashionable since the financial crisis to critique finance for its growing and out-sized role in the nation's economy.[6] Certainly, there were aspects of finance – excessive subprime mortgage lending, facilitated by the packaging of these loans into securities, coupled with excessive leverage of too many large banks and securities firms – that contributed to the crisis and its severity. And there is a respectable case to be made that the potentially large sums that successful "quants" could make in certain corners of finance – investment banking, hedge funds, and private equity – diverted some very talented and highly trained individuals, at least for a time, away from scientific and technical careers that could have brought greater benefits to the economy and to society.

4 Title II still recognizes that the failure of an insurance company should be handled under state law. See Note 1.

5. Frank, Barney. Testimony to the House Committee on Financial Services, *Assessing the Impact of the Dodd-Frank Act Four Years Later*. Hearing, July 23, 2014, Video Available at: http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=388239.

6. Two leading critics include Raghuram Rajan (2005), now director of the Central Bank of India and Thomas Phillipon (2013) of New York University. A recent paper measuring financial services not only by value added but also earnings on securities held shows sharp upward trends in the share of finance in GDP not only in the United States but also in all of the major European financial centers, especially in Great Britain. See the summary in "Comparing the Cost of Finance," *The Economist*, June 21, 2014, p. 68.

Nonetheless, the crisis also demonstrated the critical role played by finance, which has not changed since then (nor is it likely to any time soon). Despite the emergence of Internet-based payment services like Paypal and Bitcoin, banks and other depository institutions (thrift institutions and credit unions), continue to play the dominant role in the nation's payments system (whether through checks, debit cards, or most credit cards). In addition, depository institutions continue to hold much of the wealth of companies and individuals, while channeling those savings into loans to businesses, homeowners and individuals that facilitate the growth of the real economy.

In a very real sense, banks and other depositories represent the circulatory system of the economy. As the frozen interbank lending market illustrated in September, 2008, when the financial health of banks, especially the largest banks, is questioned, it is not only the financial system that was threatened, but so was the continued function of the "real" economy, the firms providing non-financial goods and services that could not operate without a healthy banking system.

> Insurer liabilities are very different from bank deposits. Policyholders cannot trigger a "run" in the same way that bank deposits can.

The insurance industry – property-casualty, life and health – is also critical to the functioning of the real economy. Insurance spreads the risks of life – losses from idiosyncratic events affecting our life, health, businesses, and property – so that we don't have to worry that we or our families will be financially wiped out if bad things, out of our control happen to us. That knowledge, in turn, is what allows many of us to take the prudent kinds of risks in our careers and in business that are necessary for advancing our own station in life, but also for developing and commercializing the innovations that benefit all of society.

There are important differences, however, between banking and insurance that are relevant to themes of this essay:

· The liabilities of the two businesses are very different, with important implications for the economy and public policy. Banks are funded primarily by deriving revenue from lending customers' deposits, which customers may withdraw on a moment's notice (though sometimes with a penalty in the case of certificates of deposit). This means that banks are exposed to failure if depositors lose faith either in specific banks or the banking system as a whole, which is why the federal government in the Depression created deposit insurance (technically, all banks pay for the losses incurred by the deposit insurance fund, but the fund has backstop borrowing authority from the Treasury).

· Insurer liabilities are very different from bank deposits. Policyholders of property-casualty or health insurers cannot trigger a "run" but first must wait for any legitimate claim for loss to incur, file that claim with the insurer, and then only if the insurer is insolvent, filing the claim with the relevant state guaranty fund that backs insurance policies. Life insurers sell investment-like products, but these too, cannot run in the same way that bank deposits can. Contractual withdrawal processing time allowances and interest charges on cash value life insurance loans serve to deter policyholders from tapping into the values of these contracts and policies, even in a crisis.[7] Life insurance cash value policyholder loans also incur interest charges, which deter "whole life" policy holders from tapping the value of their policies, also even in a crisis. Moreover, these cash values are usually small compared to the premiums paid for these policies. Finally, a very large segment of the life insurance industry, group and individual term life insurance, generally has no cash surrender value and could not be the subject of a "run."[8] *All of these factors explain why there have never been any "runs" on life insurers*, while state guaranty funds have handled individual insurer insolvencies without experiencing cash value runs by policyholders.

· In addition, because their customers are individual or even large commercial policy holders, and because they do not have other large financial institutions as counterparties, insurers or their groups generally are not as interconnected with other financial institutions as are banks.

· In sum, the distinctions between banks and insurers, and the nature of their liabilities mean that an insurer can fail without the same compelling governmental or systemic financial repercussions that are addressed by source of strength policies of a failed bank or banking group that is large and/or significantly interconnected.

· Because of the risks they pose to the rest of financial system, the largest banks and non-banks with significant

7. The typical penalty is a 7 percent surrender charge if the annuity has been held one year or less, but then declines one percentage point a year. Some insurers charge higher surrender charges. http://money.cnn.com/retirement/guide/annuities_basics.moneymag/index9.htm. There is also a 10% early withdrawal tax of 10 percent (on top of any income tax owed) if the annuity is withdrawn before the age of 59 and 1/2 and not reinvested in another carrier.

8. In addition to the restriction on surrenders mentioned earlier, life insurers are typically allowed by state regulators to take 30 days to process a surrender request and even longer (six months) if there are insurer liquidity issues.

interconnections to the rest of the economy have been designated as "systemically important" under procedures established under the Dodd-Frank Act. No insurer than three already mentioned above (because of their interconnections) has been so designated.

· The distinctive and unique systemic risks posed by bank deposit liabilities also have made banks "special" in another respect. Since 1991, in the Federal Deposit Insurance Corporation Improvement Act (FDICIA), bank regulators have had the authority to protect all uninsured depositors of a failing bank if they deem it necessary to prevent "systemic risk." This exception to the principle that uninsured creditors must suffer some "haircut" in the event of an institution's failure – in order to prevent or contain "moral hazard" – survived the enactment of Dodd-Frank (which imposes a haircut only on creditors of bank holding companies and non-bank financial institutions). One major reason for applying the "source of strength" doctrine to banking organizations (discussed in more detail below) is to reduce the likelihood that regulators would need to invoke the systemic risk exception. In contrast, there are no established federal mechanisms for protecting the covered claims of insurance policyholders above the amounts provided by state insurance guaranty funds (typically $300,000), nor given the differences between the liabilities of banks and insurers, is there a clear reason for having such federal protection.

· Banks are regulated prudentially by at least three federal agencies, and if they are chartered at the state level, by *both* federal and state regulatory agencies. In contrast, insurers and their holding companies have always been regulated by the states and never by the federal government. This has not changed with the establishment of the Federal Insurance Office within the Treasury Department as part of Dodd-Frank. The FIO has only advisory and information functions, and no regulatory responsibilities for any insurance functions. The Federal Reserve has supervisory authority only over insurers that have been designated as systemically important or which own a depository institution, but the nature and extent of this supervision is not yet clear.[9]

· Some services provided by banks and other depositories were subject to price regulation, such as the ceilings on interest payable on deposits, but these limits have no longer been the case since 1980. In contrast, insurers offering auto, property/liability, worker compensation and some health care coverage are subject to some form of state regulation of their premiums: at a minimum, the rates must be filed before taking effect (without much regulatory interference), but in some states, rates are both filed and subject to intensive regulatory scrutiny before the policies may be offered. In addition, the content (or the precise wording) of non-commercial insurance policies must be pre-approved by state regulators (commercial customers are assumed to have more financial knowledge than individual purchasers). Indeed, there is a long history of rate regulation of certain lines of non-life insurance in a number of states, which has been much criticized by economists specializing in insurance, with some but not yet total success.[10] At the federal level, the Affordable Care Act contains provisions overseeing the rates charged by health insurers through regulation of the "medical loss ratio,"[11] a backdoor system of rate regulation, even though states still have primary jurisdiction over initial rates. In short, rate regulation very much remains a fact of life in important parts of the non-life insurance business in the United States.

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· Furthermore, whereas in the U.S. insurers in some lines and in some states have their premiums closely scrutinized by regulators, insurers doing business in the European Union have not been subject to rate regulation since the European Parliament banned it in 1992.[12] *The difference in rate regulation on the two sides of the Atlantic is critical for solvency regulation.* In an unregulated rate environment, different entities belonging to the same insurance group do not need to worry that regulators will use the total capital of the entire group as an excuse to hold down premiums below levels that are actuarially appropriate. That is not the case in the U.S. in states that closely regulate insurance premiums. The implications of this difference for capital regulation of insurance groups are discussed in more detail below in several sections of this essay.

· Regardless of one's thoughts regarding the need for improvements in the existing state regulatory system for insurance, the political reality is that this system is likely to continue for a considerable period of time and so U.S.

9. A small number of companies predominantly engaged in the business of insurance also own thrifts, making them savings and loan holding companies supervised by the Fed. The notion of applying banking concepts to these types of holding companies has been met with stiff resistance in Congress.

10. See, e.g. Borselli (2009), pp. 124-28.

11. Health care insurers must spend 80-85 percent of their premiums on medical care claims, otherwise refund the shortfall to their customers.

12. See Eling, Klein and Schmit (2009), p. 19. However, individual member states belonging to the E.U. still regulate policy contract language.

international objectives should be constructed with this reality in mind.

Despite the foregoing differences between banking and insurance, customers and policy makers share a common interest: the solvency of institutions providing these services. Customers want the assurance that the institution where they deposit their funds (banks) or to which they pay premiums (insurers) will be financially capable of making good on their promises to repay deposits with interest (banks) or to fully pay claims to which policy holders are entitled under their contracts (insurers). Likewise, policy makers – regulators in particular – impose minimum capital requirements for banks and insurers and supervise the financial activities and transactions of these companies to ensure that the requirements are being met. Well-enforced and sufficient capital standards for banks help offset the moral hazard created by deposit insurance while helping to insulate the financial system against systemic risk. Although because of their funding structure, insurers do not pose the kind of systemic risks if they fail as banks do, well-enforced capital standards for insurers are important for maintaining customer confidence in insurers generally. As outlined at the beginning of this section, this is important given the critical role that insurers play in our modern economy.

## Group Banks and Insurers: Origins and Potential Implications for Capital Regulation

The banking and insurance businesses benefit from economies of scale like other businesses, which dictate running the entire business out of a single corporate entity. Both financial businesses gain from having information technology, marketing and legal budgets, for example, to spread over a larger base of customers.

Insurers, in particular, benefit from the law of large numbers; the more insurance policyholders in a given pool of similar risks, the more accurate claims projections are likely to be (although insurers are allowed to pool claims experiences in a central organization, the Insurance Services Office, which offsets to some degree the benefits of size).

As for banks, regulation can tilt the field toward larger single-entity institutions. Because banks cannot, by regulation, extend unsecured loans to any single borrower beyond 15 percent of their capital (25 percent if the loan is fully secured), they have access to a larger pool of the largest borrowers the more capital is in the bank, which encourages greater bank size (measured by assets). For a different set of reasons, the perception, even post-financial crisis and post-Dodd-Frank, that the creditors of the largest banks will be bailed out in the event of their failure is an inducement to being large. To be sure, the bailout likelihood is lower than before Dodd-Frank, which requires all banking organizations, holding companies as well as multiple banks belonging to the same organization, with more than $50 billion in assets to maintain larger capital-to-asset ratios and to submit themselves to more intensive regulatory scrutiny as "systemically important financial institutions" (SIFIs). But until Dodd-Frank's new resolution procedure is tested, it cannot be said that the Act totally eliminates the bailout risk, especially for *uninsured bank depositors* who still can be fully protected under the "systemic risk exception" for failed banks under the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

At the same time, there are "diseconomies of scale" which work in the other direction – namely, to limit the size of any single financial (or non-financial) entity, which by implication may induce an organization or group to establish multiple units or even separately incorporated subsidiaries. As organizations grow, they develop multiple layers of management and decision-making, which can slow innovation. More management layers also mean more committees, which slows decisions as well as drives organizations to be risk averse.

Other aspects of banking and insurance regulation can drive these businesses not to concentrate all their activities in a single corporate entity, but rather to spread their business across multiple units or subsidiaries, all owned by a single parent holding company. In the banking arena, Congress explicitly anticipated and authorized bank holding companies (BHCs) to own multiple subsidiaries in the Bank Holding Company Act of 1956, though at the time that legislation sought to limit the non-banking activities of BHCs to those "closely related to banking." The BHCA nonetheless established the legal framework for a single parent organization to own multiple banks. Over 80 percent of U.S. banks today belong to a holding company structure.[13]

The use of the holding company structure was heavily influenced by U.S. banking law. In particular, until 1994 (and actually three years later counting a three year legislative phase-in) banks were not permitted to operate nationwide. Until then, banking *organizations* were able to conduct business in multiple states only if individual states permitted them to do so. For banking organizations wanting to establish a multi-state footprint, the only way to do so was to establish separately chartered banks in each state. The few banks that wanted an international presence established many more bank and non-bank subsidiaries abroad.

13. http://www.fedpartnership.gov/bank-life-cycle/grow-shareholder-value/bank-holding-companies.cfm.

Insurers, having always been regulated just at the state level, never were prohibited from doing business in numerous states. State laws typically require insurers in *significantly different* lines of insurance – say, auto and life insurance – to establish separate companies for providing these services even if those insurers belong to the same group.[14] Moreover, insurers create multiple subsidiaries, for different lines of business, for different geographic areas (such coastal regions) to insulate risks from other areas of the country, to insulate operations organized in states without strict rate regulation from those where this is the norm, and insulate companies issuing participating (dividend paying) policies from policies where this is not the case (non-dividend paying policies).

Accordingly, as with multi-unit banks, many insurers offering different lines of insurance, and in some cases the same lines but in different states, have established holding company or group structures to own all of their units. In addition, the Savings and Loan Holding Company Act of 1967, which allowed holding companies owning a *single* thrift institution also to be engaged in non-banking (such as insurance) and even non-financial activities, did so only by requiring that the non-thrift operations be conducted out of separate subsidiaries.

To be fair, state and federal laws requiring separate subsidiaries are not the only reasons why banking, insurance and other financial organizations conduct business out of multiple subsidiaries. Tax and various regulatory policies, coupled with a desire (at least in the past) to avoid having to consolidate assets and liabilities for accounting purposes, have contributed to a proliferation of subsidiaries, in many of the largest banking organizations, some with over 2,000 subsidiaries.[15] The "living will" provisions of Dodd-Frank, which require banking organizations in particular to detail how they would "wind down" the activities of their multiple units in the event of financial trouble, should have the effect of reducing the number of subsidiaries of some highly complex banking organizations, either voluntarily or under threat of regulatory action. Likewise, the Federal Reserve seems to be using its stress tests, discussed in the last section of this essay, as a way to slim down or break up the institutions that fail.

Still, many multi-unit bank and insurance entities are here to stay. For my purpose here, their presence poses a special challenge for solvency regulation. In particular, should regulators respect the separateness of the various corporate entities within a multi-unit organization, meaning that no single subsidiary or the parent can be held financially responsible for any other subsidiary? Or should regulators ignore the legal boundaries between the entities, and treat the capital of the parent company and/or the capital of each of the subsidiaries as available to support the finances of any one or all of the other subsidiaries?

The next section provides the answers to these questions that regulators and policy makers gave before the financial crisis. Subsequent sections look at how those answers have changed or might change post-crisis, and why the answers matter – especially for insurance groups and their customers.

## The Historical Approach to Regulating Solvency of Group Banks and Insurers

For banking organizations, the same 1956 law that authorized bank holding companies to hold multiple subsidiaries also required (in Section 3(c)(2)) the Federal Reserve Board to take account of "the financial and managerial resources and future prospects of the company or companies" involved in any transaction. Because BHC acquisitions tended to be debt-financed, this language eventually was used to justify the Board's rejection, as early as 1966, of transactions that threatened the ability of the holding company to "serve … as a source of financial assistance to its subsidiary banks." This notion was later endorsed by the Supreme Court in its *First Lincolnwood* decision,[16] and later codified in the Fed's Regulation Y in 1984 as follows:

> "[a] bank holding company shall serve as a source of *financial and managerial strength to its subsidiary banks.*" (emphasis added).[17]

Furthermore, in enacting legislation in 1989 dealing with the thrift crisis (the Financial Institutions Reform, Recovery and Enforcement Act), Congress added what has since become known as a "cross-guarantee" provision which is related to the Fed's source of strength doctrine (which had no *explicit* legislative authorization). Henceforth under this Act, the FDIC would have ability to tap the capital of any sister depository institution to help pay for the cost of a failed depository.

So for banking organizations in the United States, the answers to the questions posed in the previous section

14. The National Association of Insurance Commissioners maintains a list of the various lines of insurance authorized within each of the 50 states and the District of Columbia. See http://www.naic.org/documents/industry_ucaa_lines_of_business_matrix.pdf.

15. Herring and Carmassi (2010).

16. Board of Governors of the Federal Reserve System v. First Lincolnwood Corp., 439 U.S. 234 (1978).

17. 12 C.F.R. § 225.4(a) (2011). For a thorough analysis of the history of the source of strength doctrine for banks, see (Lee 2012a).

are clear though not without controversy: ignore the legal boundaries between a holding company *parent* and any one of its *banking* subsidiaries.[18] The first is responsible for the second, and each bank is financially responsible for its sister or brother banks (those controlled by the same holding company). Prior to the financial crisis, source of strength did not apparently apply to *non-banking* subsidiaries of bank holding companies, nor were any of a holding company's banking subsidiaries apparently required to be a source of strength for any non-banking subsidiaries (though as discussed below, at least one analyst expressed concerns that banks could be weakened by transfers to non-bank affiliates). What accounts for the exceptions and distinctions?

Although I can find no explicit statement to this effect, one can reasonably infer that the source of strength doctrine for bank holding companies and their *banks* was developed and later the cross guarantee requirement was added because banks had access to deposit insurance. This meant, among other things, that because all insured banks that paid deposit insurance premiums were responsible for the costs of all bank failures, requiring holding companies and sister banks to first rescue failing banks would minimize draws on the deposit insurance fund and thus potentially on the banks that backed that fund. Likewise, because the insurance fund was able to borrow from the Treasury in extremis, limiting the losses of the insurance fund through application of source of strength also reduced the financial exposure of the federal government to failed banks. The fact that the FDIC may protect the uninsured depositors of failed banks that present a "systemic risk" also underscores the potential threat to the Treasury from such institutions, and is likely another motivation for both the source of strength and cross-guarantee doctrines.

Another rationale for both doctrines lies in the nature of deposit liabilities – which are redeemable on demand by their holders. Thus, the failure of one bank in a larger group could cause reputational loss for other banks in the group, spreading the concern about their viability like an infectious disease, triggering deposits runs from all banks in the group. Making the holding companies and/or the other banks in the groups financially responsible for a failing bank is one way to stop the spread of this "financial infection."

William Keeton, formerly a senior economist at the Federal Reserve Bank of Kansas City, has outlined a different, but related rationale: that in the absence of source of strength, holding companies would have incentives (among other things) to bleed subsidiary banks for the benefit of the holding company, at the expense of the insurance fund.[19] Helen Garten voiced a different, but related concern: holding companies could have incentives to weaken bank subsidiaries by transferring funds out of them to support non-bank subsidiaries.[20] Opponents of source of strength argued that it violated the limited liability concept long enshrined in corporate law and made it more expensive for bank holding companies to raise funds in the capital markets.

These arguments against source of strength did not prevail in the banking context, though as a matter of logic, they apply with equal force, if not more so, to insurance where the systemic risk justification (with minor exceptions) does not exist and where the liabilities are so different. In fact, insurers doing business in the United States have long been regulated in a very different way from banks and banking groups. Insurers are not regulated at the federal level. While states have guaranty funds to protect policy holders up to some amounts (generally $300,000), until the Fed's rescue of AIG's creditors, no policyholder of any insurance company, to my knowledge, has ever received protection above the guaranty fund limit.[21] Furthermore, before and since the financial crisis there are no state obligations that require an insurer authorized to do business in that state to come to the rescue of any insurance affiliate, whether domiciled in that state or in another state, nor is it clear how regulators in one state even would have the *legal authority* to *compel* such interstate transfers.

> Insurers and insurance groups differ from banks in two key respects. As noted earlier, the liabilities of insurers cannot be withdrawn in the same way that banks can. Nor are they as connected to the rest of the financial system as are the largest banks.

This is not to deny that insurance groups may for reputational reasons *voluntarily* choose to protect the policyholders of a failing subsidiary in order to maintain sales of *new policies* from other insurers within the group through various lending mechanisms. In addition, it is conceivable that, despite the policy language stating otherwise, some customers perceive that their policies are backed by an entire insurance group rather than the individual insurer subsidiary that sells them the policy.

18. See generally Lee (2012a).

19. See Keeton (1990).

20. Garten (1990). For a discussion of various empirical studies of the source of strength doctrine – whether it has led to stronger banks (the verdict seems to be that it has) – see Lee (2012a).

21. In addition, there is no insurance equivalent of the federal "systemic risk exception" for uninsured bank depositors.

Still, insurers and insurance groups differ from banks in two key respects. As noted earlier, unlike banks, whose deposits owned by their customers can run, the liabilities of insurers cannot be withdrawn in the same way that banks can, nor are they as connected to the rest of the financial system as are the largest banks.

## Dodd-Frank and Post-Crisis Solvency Regulation of Banks and Insurers in the U.S.

The Dodd-Frank Act enacted in the wake of the 2007-08 financial crisis formally codified the source of strength doctrine for bank holding companies, while extending the concept to "systemically important" bank holding companies and non-bank financial holding companies, *even if they do not own an insured depository*. These institutions also must submit "living wills" describing how they would be broken up in the event of financial trouble and these wills must take account of aid from the parent company. Since Dodd-Frank was enacted, the Financial Stability Oversight Council has designated two insurers, AIG and Prudential, as systemically important, with speculation that Metropolitan Life will be added to this list at some point. This means that any insurance group receiving the systemic risk designation is subject to the source of strength requirement.

One rationale for applying source of strength to bank holding companies has already been discussed – namely that failed banks can impose costs on other banks through the deposit insurance system, and potentially on taxpayers if the failed banks are large or interconnected enough to qualify for the systemic risk exception. Another rationale for both the source of strength and cross guarantee doctrines, or collectively "group capital requirements," in the banking industry grows out of the potentially higher level of interconnectedness of these companies to other financial service providers and the economy.

What is the possible rationale for extending the group capital notion to systemically important financial holding companies that do not own a bank or thrift or to those that own a relatively small bank or thrift but are not significantly interconnected to other financial services providers and the economy?

The best explanation I can muster lies in the specter of a future AIG: namely that the failure of one or more systemically important non-bank financial institutions conceivably could impose costs on other financial institutions, and even on the Treasury, despite the fact that other parts of Dodd-Frank make either possibility remote. The Act reforms derivatives trading to make the failure of future "AIGs" much less likely, and adds a new resolution procedure in Title II that requires the liquidation of failed non-banks and losses to be imposed on creditors, with no federal guarantee. In addition, the Title II process allows the FDIC (as the liquidator) to temporarily borrow from the Treasury, but this money must be paid back by an assessment on other large financial institutions. While these provisions have not yet been tested in another crisis, they go a long way toward insulating other financial institutions, and especially the Treasury, against losses from failed systemically important non-bank financial institutions in the future, including insurance groups that may be designated as systemically important.

What about source of strength as applied to other financial institutions, including insurers, which are *not* deemed to be systemically important? The focus of solvency regulation of these institutions should be on the impact on their customers/policyholders, since in those situations, by definition, the firm's failure does not pose a systemic risk, or potential cost to other financial institutions and the Treasury.[22] Nor does the reputational argument hold here either. By their very nature, liabilities of insurers cannot easily "run" like bank deposits as there are no customer deposits for insurers issuing auto, homeowners, and workers compensation policies and limited customer accounts for certain life insurers. In short, there is no danger of "financial infection" from one affiliate to another should one subsidiary of a non-systemically important group fail (the same is true if the group *is* systemically important and does not own more than one depository institution, but Dodd-Frank seems to have overruled this reasoning).

Some might point to the "Collins Amendment" (named after Senator Collins who introduced it) included in the Dodd-Frank Act as authorizing the extension of source of strength obligations to parents of other financial institutions. Not so.

22. While too detailed a subject for this essay, a number of concerns have arisen in connection with the Federal Reserve's assumption of supervisory responsibility for savings and loan holding companies (SLHCs) from the former Office of Thrift Supervision. For example, although as part of the Dodd-Frank Act, Congress preserved the thrift charter and reaffirmed a distinct regulatory construct for numerous SLHCs predominantly engaged in a diverse range of businesses unrelated to banking, the Fed has pursued a course of action that imposes its current bank holding company regulatory regime upon all SLHCs regardless of their structural diversity. I would contend that at a minimum, where robust and effective functional regulation is in place for non-banking activities, the Fed's regulatory approach in these situations should focus on the impacts of holding company activity on the depository institution, and in the case of thrifts, the ability to successfully operate them within a non-banking complex. When an insurance company is the holding company, for example, this would mean policyholder/customer protection rests with the appropriate state insurance regulator, with the Fed focusing on the solvency of any depository institution subsidiaries.

The Collins provisions require federal banking agencies to set minimum capital standards (risk-weighted and non-risk-weighted) for bank holding companies, savings and loan holding companies, and *systemically important* non-bank financial institutions that are no lower than the standards for *banks* that existed on the day the Act was enacted (July 21, 2010). These capital requirements are to be established on a "consolidated basis", meaning that regulators must assure that the capital of the entire organization, as well as its subsidiaries, meet a minimum standard.

*But the consolidation requirement in the Collins Amendment does not explicitly extend the source of strength or cross guarantee doctrines to financial institutions, including insurers, which are not deemed to be systemically important*. Both of the rescue doctrines require the parent or any financially healthy banking subsidiary actively to come to the aid of a troubled banking subsidiary. This is different from simply requiring that the regulatory agencies in setting the capital standard for all entities that the capital of the parent and its subsidiaries must be combined. Indeed, on June 3, 2014, the Senate unanimously passed S. 2270 (with Senator Collins' support) making clear that the original Collins amendment was not intended to apply banking concepts to insurance, further clarifying that insurance activities should not even be included in defining the scope of the holding company subject to capital requirements, and reinforcing the belief that capital adequacy for insurers is best achieved by relying on the existing risk-based capital framework utilized by state insurance regulators.

But the consolidation requirement in the Collins Amendment does not explicitly extend the source of strength or cross guarantee doctrines to financial institutions, including insurers, which are not deemed to be systemically important.

Indeed, this is a good point to highlight a key distinction between consolidated supervision, on the one hand, and the source of strength and cross guarantee doctrines, on the other. The former, that is consolidated supervision, is designed primarily to ensure that the larger group of which any subsidiary bank (or insurer) is a part is financially sound and lacks incentives to weaken any of its subsidiaries (through inter-affiliate loans or transfers or dividends paid to the parent). Furthermore, any bank that belongs to a strong consolidated group is less likely to suffer reputational risk from the failure of any one part of the group, if the rest of the group is financially strong.

In contrast, the source of strength and cross guarantee doctrines impose an *affirmative obligation* on the parent (source of strength) or each of the subsidiaries (cross guarantees) to come to aid of any one or more financially troubled subsidiaries. These group capital requirements are aimed at shoring up weak subsidiaries, not at insulating financially strong subsidiaries from weaknesses in either their holding company parents or affiliates.

Put differently, the rescue doctrines imply that more capital is available "on call", as it were, to support the activities of any single subsidiary than the capital shown on that subsidiary's financial statements. As discussed further below, this "blending of capital" across corporate boundaries could have very important implications for parents and subsidiaries engaged in a price-regulated business such as insurance in ways that are not applicable to activities like banking where prices are not regulated and the liabilities are different.[23]

After initially contemplating the application of bank-centric risk-based capital rules on insurance, the Federal Reserve has since been taking a deliberate approach toward insurance companies subject to the Collins amendment. This is because insurance companies were not subject to the *bank* risk-based requirements on the day Dodd-Frank was enacted, and still are not subjected to those requirements (but to different risk-based standards developed and enforced by state regulators specifically for insurers). At this writing, the Fed has considered, but not yet put in place its own risk-based standards (that would effectively supersede applicable state rules) for systemically important insurers.

In sum, while Dodd-Frank codifies source of strength into law for any holding companies of a federally insured depository institution, it does not apply the doctrine to support other financial institutions within such holding companies, including insurers. Nor does the consolidation requirement in the Collins Amendment (especially as it would be clarified by S. 2270) do so. Dodd-Frank only extends the potential application of

23. In light of these distinctions between consolidated supervision and the financial rescue doctrines, it is noteworthy that other parts of Dodd-Frank restrict the full-blown extension of the source of strength doctrine. For example, Dodd- Frank did not repeal Section 5(c)(3) of the Gramm-Leach-Bliley Act (GLBA) which prohibited the Fed from requiring any "functionally related subsidiary" of a holding company that is in compliance with the minimum capital requirements of the federal banking agencies (for banks), the SEC (for securities firms), or state regulators (insurers) also to meet a higher Fed-imposed standard. Arguably even more significant and relevant to the reach of the source of strength doctrine, Dodd-Frank retained Section 5(g) of GLBA which prevents the Fed from requiring a securities or insurance subsidiary of a bank holding company to transfer funds to assist a troubled insured depository. This provision of GLBA reinforces the notion discussed earlier that before the crisis –and even since – the law has not required non-bank affiliates (through direction of a parent holding company) to come to the aid of troubled banks. See Lee (2012b).

the source of strength concept to nonbank financial institutions designated as systemically important.

## Post-Crisis Approaches to Insurer Solvency Regulation Outside the U.S.

Although the financial crisis began in the United States, it had global impacts, and thus it is not surprising that efforts were undertaken from the onset of the crisis to coordinate a global policy response. Finance ministers from the G-20 met in Washington in November, 2008 to discuss broad outlines of such a response, and the de facto secretariat of the G-20 – the Financial Stability Board – has been working since then on coordinated regulatory measures aimed at preventing future crises.

One of those measures is relevant to this essay: instructions by the G-20 to the International Association of Insurance Supervisors (IAIS) to develop by the end of 2014 "backstop" capital standards for all globally systemically important insurers (GSIIs) that are expected to serve as the basis for such standards for internationally active insurance groups (IAIGs). Importantly, the definition of IAIGs is not necessarily limited to insurers that are systemically important, and moreover, the global standards are expected to be applied eventually by individual states in the United States.[24]

This makes the question of whether and to what extent the IAIS standards for GSIIs as early as the end of this year are based on a "group capital" approach, and specifically whether parent insurers will be required to come to the aid of any troubled subsidiaries, extremely relevant *now* for U.S. policymakers. Specifically, if the IAIS standards embody a European-style approach to insurance solvency regulation that states are eventually expected to adopt in this country, then it would be short-sighted to dismiss the international effort as one only directed at the GSIIs and not potentially the entire insurance industry in the United States and elsewhere.

International capital rules initially meant for only a limited group of large or interconnected financial institutions can easily tend to reach a much wider portion of an industry, and it looks like international efforts to develop global insurance standards are following this pattern.

The history of the Basel standards is instructive in this regard. What started out as an exercise to develop capital standards only for the largest internationally active banks now applies to a much larger number of banks. So, international capital rules initially meant for only a limited group of large or interconnected financial institutions can easily tend to reach a much wider portion of an industry, and it looks like international efforts to develop global insurance standards are following this pattern.

In fact, financial regulators in the European Union are already taking a very different approach post-crisis to the issue of insurers and source of strength than is being followed in the United States. In December 2009, the Council of the European Union and the European Parliament adopted the "Solvency II" directive for regulating insurer capital ("Solvency I" was adopted in 1973). In December 2013, the Council scheduled the Directive to take effect January 1, 2016.

Solvency II has been described by some as "Basel" for insurers, but it only applies to insurers and insurance groups doing business in the EU, not in all of the Basel member countries as is the case for banks. Solvency II contains numerous provisions, including methods for calculating the minimum required capital any EU insurer must hold. The provisions of the Directive pertinent to this essay are in Title III which relate to capital requirements for insurance *groups, whether or not they are systemically important*.

The language in Title III actually was worked on before the crisis, and formally included when the Solvency II Directive was proposed. Not only does the Title require capital to be computed at the group, or parent level of an insurance group, but the group parent and each of its subsidiaries are obligated to be responsible for the losses of any constituent part of the entire organization.[25] In essence, Title III incorporates for insurers both the source of strength doctrine for bank holding companies and the cross-guarantee provisions for bank subsidiaries that have prevailed in the United States.

The country in which the insurance parent of a group is domiciled is responsible for supervising the group under Title III. The supervisory authority extends even to insurance subsidiaries outside Europe, so long as the parent is headquartered in Europe. The non-EU subsidiaries may have their required capital calculated according to local law, but these calculations will be accepted by the EU member state supervisor of the group only if the "third country" is deemed by the group supervisor to have an "equivalent" solvency regime.[26]

24 Testa and Postal (2013).

25. http://www.linklaters.com/Publications/Publication1386Newsletter/PublicationIssue20070801/Pages/PublicationIssueItem2531.aspx

26. http://www.mapfre.com/mapfrere/docs/html/revistas/trebol/n57/docs/Articulo1en.pdf.

As for the group capital itself, surpluses in one part of the organization cannot be used to make up for shortfalls elsewhere. At the same time, however, required capital for the group as a whole may be given a credit for diversification benefits generated by multiple subsidiaries.

Since the broad source of strength and cross-guarantee provisions of Solvency II had been drafted *before* the financial crisis, their broad scope cannot have been motivated by the subsequent failure of AIG, which required government intervention. The drafters of these provisions, however, presumably had in mind the need to protect national Treasuries from having to support failed insurers, though I have been unable to find any specific reference to this possible intention.

## Dangers of Applying the Source of Strength and Cross-Guarantee Doctrines for Banks to Insurance Groups

The application of the "source of strength" doctrine for bank holding companies has a long history, the cross-guarantee provisions relating to bank subsidiaries less so, but both have a reasonably clear rationale: to minimize risks to the deposit insurance fund and in the case of systemically important banks, potentially to taxpayers, of bank failures. As discussed above, a similar rationale is at least plausible for extending the source of strength doctrine to systemically important insurance groups, given the possibility (however remote) that the failure of these institutions could cause risks to other parts of the financial system, which in turn could trigger government bailouts of their creditors, or at the very least insurance-industry funded bailouts, which would entail moral hazard.

But beyond the fact that there is no precedent for going further to extend either or both group capital doctrines to all insurance groups doing business in the United States, there would be real economic costs to doing so.

The business of insurance is built on the premise that every insurer offering a given line of insurance is a "tub on its own bottom" even if the insurer belongs to a larger organization. This means that the premium revenue and capital of an insurer are available for its customers and *only its customers* to the extent that there is a covered claim under a policy. Purchasers of auto insurance or homeowners insurance (property-casualty), for example, understandably do not expect that the premiums they pay, and any retained earnings their insurer may build up over time may go to support claims of purchasers of life insurance offered by a related affiliate, a very different business with very different risks. Indeed, the state laws that authorize and regulate insurance require insurers offering significantly different lines of insurance to do so through separate subsidiaries to varying degrees while requiring insurers to obtain explicit regulatory approval for each line of insurance they are authorized to underwrite.

From the perspective of insurers, any approach to solvency regulation that would nullify the every tub on its own bottom principle is troubling for a different reason. Unlike banking services, whose prices are not subject to regulation, insurance premiums are regulated by states. Admittedly, the intensity or intrusiveness of this regulation varies across states and by lines of insurance, but the most heavily regulated lines tend to be auto, homeowners, and workers compensation. If state regulators could count on the capital of an entire insurance group, or any of its subsidiaries, to be "on call", or available to support any individual line of insurance offered in their state, then regulators may be tempted to limit the rates of multi-line insurers in those states to levels below those actuarially appropriate (that is, commensurate with the risks represented by those customers). After all, some regulators might wonder: if the capital of all parts of an insurance enterprise are fungible, then if rates charged by any one or more insurance entities turn out to be insufficient to pay claims, capital from other entities and the parent can always be counted on to make up the difference. The same logic, and danger, applies if an insurer were permitted (as it is not currently) to offer very different lines of insurance within the *same* legal entity, with some lines subject to stricter rate regulation than others.

Any such non-actuarially sound system of rate regulation that ignores the individual insurance contract would have several detrimental effects. For one thing, it would weaken the financial soundness of the insurance entity or entities within those states whose rates are regulated in this manner. If state regulators are going to consider all of the capital in a group as potentially available to pay claims, why should any single insurer build up its own capital, beyond the minimum required by state law, to pay an unexpectedly high level of claims? The national body representing state insurance regulators, the National Association of Insurance Commissioners, worried about a similar outcome, the weakening of the strong part of the group, if insurance group capital were fungible.[27]

Moreover, by forcing the rates of insurers belonging to insurance groups below actuarially appropriate levels, regulators effectively would be forcing smaller,

27. National Association of Insurance Commissioners (2013).

single-line insurers – those not members of a larger group -- to lower their rates to or close to these levels as well, or otherwise the competing insurers would lose business and potentially could be forced from the market altogether. In addition to weakening competition, which would harm insurance consumers in the long run, artificially suppressing rates induced by ill-advised solvency regulation thus would further concentrate insurance markets and artificially drive business to larger insurance groups, thus potentially aggravating the "too-big-to-fail" problem that Dodd-Frank was enacted to help mitigate.

Alternatively, assuming they have the freedom to do so, insurers belonging to insurance groups subject to actuarially inappropriate rate regulation, could decide simply to leave states that engaged in such regulatory practices, which also would reduce competition in state insurance markets. This outcome, too, would weaken competition, ultimately to the detriment of insurance consumers. Regulators may temporarily thwart insurers from leaving the state, however – as Florida did after Hurricane Andrew, forcing insurers that had been writing policies in the state before the hurricane at least to renew those policies, at tightly regulated rates. But any such restrictions only would draw out the inevitable, as homes are sold and policy holders move elsewhere, so that the volume of policies subject to any "stay-in-the-state" mandate gradually will shrink over time. The end result is the same as in the other scenarios: less competition.

In sum, in the presence of rate regulation, solvency regulation of insurance groups that effectively melds all capital of the groups and its subsidiaries together invites state regulators to suppress rates in a way that can only weaken insurers, reduce competition, and ultimately harm insurance consumers.

In sum, in the presence of rate regulation, solvency regulation of insurance groups that effectively melds all capital of the groups and its subsidiaries together invites state regulators to suppress rates in a way that can only weaken insurers, reduce competition, and ultimately harm insurance consumers.

## Other Issues Counseling Against Importing a European Model for U.S. Insurance Regulation

In a global economy, the desire for "harmonization" is understandable and worthy to the extent it lowers barriers to trade and finance. Freer trade and investment (long-term or "direct" in particular) is generally welfare-enhancing for all countries involved, and it is best accomplished if as many nations pursue it at the same time. This is not so much for economic reasons – unilateral removal of barriers to trade and investment is almost always a plus for a nation's consumers -- but because it's good domestic politics. Since import-competing industries and workers often lose in trade and investment liberalization efforts (or at least fear that they will) governments have an easier time selling them at home if they can point to gains by exporters and outward-bound investors.

It can be consistent with the objective of lowering barriers to trade and investment where nations also agree that some regulation is necessary – to protect the environment, food and product safety, and yes, financial safety and soundness. This is especially true after an incident or a crisis, such as the financial crisis of 2008, reveals that the prior regulatory regime was inadequate. Ideally, nations would cooperate when strengthening and reforming their regulatory systems, both to remove artificial incentives for "regulatory arbitrage" that can induce internationally-active firms to locate much of their activities in nations with the least onerous rules, and in related fashion, to respond to the desires of firms in each country to operate on a "level playing field." Both these motivations have been at work in the multi-decade effort, under the auspices of the Basel Committee on Banking Supervision, to harmonize rules for bank capital, and on ongoing basis since the financial crisis, beginning with a meeting of the finance ministers of the G-20 in November, 2008, shortly after the crisis began.

But there also limits, even drawbacks, to trying to adopt identical regulatory models even in an industry like finance, which is heavily (though not entirely) international in character.

First, there are unanswered questions about how to reconcile a national, or even supra-national regulatory approach to insurance regulation in Europe, with the state-based, or sub-national, approach here. If the United States were to apply the group capital approach (despite the dangers already identified), how would it go about it? Which state would take the lead: the state in which the holding company is headquartered, or the state of the insurance entity where most business is written or the entity that has the largest amount of capital (absolutely, or in relation to some other variable, like premiums or not-yet-paid claims)? What if no state is willing to change its laws that currently prohibit assets transfers to an insurer out of state, even if that insurer belongs to the same insurance group?

In addition, which accounting standards would be used in any group capital regulatory system: Generally accepted accounting principles (GAAP), statutory accounting principles (which U.S. insurers now use, in part because they are more conservative than GAAP and are tailored better to the insurance business model) , or the new international financial reporting standards (IFRS)? Requiring large U.S. insurers to convert either to the first or the third could entail hundreds of millions of dollars of expense. Smaller insurers would also find any forced conversion expensive in relation to their total expenses, and because they do not have the economies of scale of larger insurers, would suffer a disproportionately negative impact. Indeed, the Financial Accounting Standards Board in the United States earlier this year pulled back from a new approach to property-casualty insurance accounting because its costs far outweighed any perceived benefits.[28]

Second, countries may have the same goals – ensuring the safety of consumers and citizens, and financial systems, for example – but have very different tolerances toward risk and philosophies of government, especially in their willingness to tolerate the failure of financial firms and losses to their creditors. While both U.S. and European policy makers went to great lengths during the recent financial crisis to bail out the creditors or large financial and certain on-financial firms (General Motors and Chrysler) that either presented the risk of contagious runs (banks) or domino-like reactions because of their interconnectedness (certain banks, AIG, and the auto companies), U.S. policy makers across the political spectrum since have expressed their desire to end, or at the very least, curtail "too big to fail" (TBTF) policies in the future. While debate continues in this country over how best to accomplish that objective, there is at least agreement on that objective.

While European policy makers are also attempting generally to address the TBTF problem in their own countries, that attitude is not yet manifest in their group capital approach to insurance regulation which puts rescue of all failing insurers first. Various Articles of the Solvency II directive make clear that failure of insurance subsidiaries is to be avoided through strong holding companies, or what this essay has referred to as "group capital regulation." Article 235, for example, instructs the "group supervisor shall ensure the calculation of the solvency of the group is carried out at the level of the insurance holding company …" If any individual insurer belong to a group is threatened with failure, then Article 242 makes clear that the legal walls between the different entities are to come down.

28 Financial Accounting Standards Board (2014).

The European approach to insurance groups differs markedly from the U.S. approach (for insurers that are not deemed to be systemically important). In the United States, state regulators place primary emphasis in ensuring solvency of insurers *in order to protect policyholders*, not the creditors of insurance companies. The existence of state guaranty funds underscores this philosophy. That such funds exists makes it possible for state insurance regulators to allow individual insures to fail, while still protecting policyholders. *In sum, the critical issue is whether we want customer-centric or creditor-centric regulation of insurance, especially of non-systemically important insurers*.

Insurance regulation is not the only area of financial regulation where U.S. regulatory philosophies and practices differ from those abroad. In the banking sector, U.S. regulators have a history of relying on their own rules to supplement and/or replace international rules, such as the Basel capital standards. Even before the crisis, the Federal Deposit Insurance Corporation (FDIC) required banks to meet a minimum "leverage ratio", one that did not weight assets by any risk factor, in addition to meeting the Basel standards. For many banks, this became the de facto minimum capital standard.

Since the crisis, while U.S. bank regulators have actively participated in the Basel III revision process, they have used their own measures of bank health. For example, in February, 2009, U.S. Treasury Secretary Tim Geithner announced that the U.S. regulators, including the Fed, would subject the largest banks to "stress tests" to see whether their capital was sufficient to withstand a major negative macroeconomic shock. More recently, the Fed Governor in charge bank of supervision, Daniel Tarullo, announced in a speech in May, 2014 that the Fed did not trust the latitude that Basel III (like its predecessor Basel II) gave banks to use their own models to assess risk and thus minimum capital.[29] Because of this, the Fed was putting greater emphasis on stress tests. While regulators in E.U. countries have also subjected their banks to stress tests, they have not been as explicit as the Fed in departing from the Basel III standards.

The critical issue is whether we want customer-centric or creditor-centric regulation of insurance, especially of non-systemically important insurers.

There are also well known differences in regulatory approaches between the United States and other

29. Tarullo's remarks were summarized in "INSIGHT – Fed may shun global risk rules banks spent millions to meet," Reuters.com, June 4, 2014. Available at: http://www.moneynews.com/Personal-Finance/federal-reserve-global-risk-rules-billions/2014/06/04/id/575088/.

countries outside the financial arena. A prime example is the "precautionary principle" followed in the EU and its member states, under which new products (not just drugs) effectively bear the burden of proof of safety before being allowed into the market. The United States historically has taken the opposite approach: (again with the exception of drugs), let the market judge innovative products, and only withdraw them or regulate their externalities (in the case of environmental risks) if evidence subsequently develops that they present undue risks to health. Trade negotiators from the U.S. and E.U. have been hard at work within the framework of the Transatlantic Trade and Investment Partnership (T-TIP) talks at bridging this fundamental difference in regulatory philosophies, but at this writing, there is no evidence that this will be accomplished.

A third reason solvency rules in particular may not follow the same pattern in different countries is that variations in other rules of conduct between countries may justify variations in solvency regulation. EU financial regulators, the FSB and IAIS, for example, want the United States to adopt the "group capital" model for insurers developed by the EU but not yet even implemented ("Solvency II" directive is scheduled to become effective January 1, 2016) *which is diametrically opposite from the legal entity approach that state insurance regulators have long followed in this country. This is convergence, not harmonization*, and for reasons outlined earlier in this essay, the group capital approach is not only inconsistent with the way insurers in this country are regulated, but would undermine the very essence of insurance in the states that use that approach to solvency regulation to justify limits to insurance rates below actuarially appropriate levels. The United States is interested in maintaining both the solvency of its insurers and competitiveness of its insurance marketplace, and thus has ample reason for rejecting an approach to solvency regulation of multi-unit insurers that the E.U. has decided is appropriate for its insurance groups.

Finally, the weak to non-existent prior efforts to require uniform insurance rules across national boundaries – in contrast with the well-established efforts to do so in banking – is yet another justification for not letting the pursuit of identical or near identical solvency rules trump what rules make sense in the U.S context. More specifically, the Basel Committee on Bank Supervision has been active for almost four decades (since its founding in 1976), and as imperfect as its bank capital standards have been, member countries have taken them seriously since they were first introduced in 1988. In contrast, the international body devoted to insurance issues, the International Association of Insurance Supervisors, was established only in 1994, and serves primarily as a platform for exchanging best regulatory practices. It has not yet built up the kind of recognized international authority as its banking counterpart, the Basel Committee, even though the IAIS has been charged by the Financial Stability Board for coming up with Basel-like rules for global insurers.

While the E.U.'s efforts at convincing U.S. regulators of an appropriate way to regulate multi-unit insurers is geographically more limited than the 140 member IAIS, the stakes involved for insurers on both sides of the Atlantic are great. The absence of true international agreements in the solvency regulation of insurance groups up to now is just one more reason why the U.S. would not be violating some well-established international norms if it were to go its own way, for its own good reasons, on this particular issue.

## Conclusion

The financial crisis has led to a fundamental rethinking everywhere about how to prevent future such episodes. The spectacular and unanticipated failure of one of the world's largest insurance groups, AIG, during the crisis has put the spotlight on insurance solvency regulation in particular.

It is important in thinking about how to go about to reform to keep in mind the old adage "If it ain't broke, don't fix it." To be sure, AIG failed, but its failure was driven primarily by its *non-insurance activities*. That is not a reason to completely overturn a long-standing practice, embodied in state law and in the fundamental economics of the insurance practice, and force the blending of capital of all units of potentially all multi-unit insurers for purposes of ensuring their solvency. This is especially true where certain of the underlying causes of AIG's demise – such as its failure to post adequate margin or collateral on the risks of the credit default swaps underwritten by one of its non-insurance subsidiaries – have since been addressed through reforms of the derivatives markets mandated by the Dodd-Frank Act.

Moreover, there are key differences between the businesses of banking and insurance – specifically reflected in the nature of their liabilities – that entail very different risks to the rest of the economy should any one or more the firms in these industries fail. Unlike banks, insurers of all types do not present the risk of a contagious "run" of their liabilities because of the nature of those liabilities and/or contractual restrictions on withdrawing funds that may be held with an insurer. In addition, insurers generally are not as interconnected with other parts of the financial industry or the economy. These differences alone call into question the application of the group capital approach in banking to an industry like insurance that presents very different (lower) risks to the economy.

Insurers in different lines of insurance have long operated as separately capitalized entities, collecting premiums actuarially determined by the risks presented by expected claims losses of customers of those particular lines of business. No auto insurance customer, for example, expects that any portion of his or her premium, or the capital of the company that is collecting that premium, will ever be used to pay claims of residential homeowners or life insurance customers of affiliated companies. Yet that understanding is precisely what would be threatened if U.S. policymakers were to adopt a European-style notion of group capital regulation.

U.S. insurance markets would suffer, too, from application of the source of strength and cross guarantee doctrines to insurance regulation. Some insurers, in states with excessive strict premium regulation, could decide to leave those states, where they can, to the detriment of consumers and competition in those states. If they are forced temporarily to stay under such circumstances, restrictive regulation could harm the competitive position of less diversified insurers without the ability to subsidize one set of customers from the parent company or other affiliates. Either way, competition could be distorted.

Finally, there are unanswered questions of how even a revised EU approach to insurance regulation would apply to a very different state-based system of regulating insurers in this country.

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For all these reasons, it is premature and potentially dangerous for U.S. policy makers to embrace group capital regulation for insurers at this time, even if it is initially proposed only for a limited set of globally systemically important insurance groups. The history of international bank capital standards, plus the apparent objectives of the IAIS, makes clear that any initial limits on global standards tend or are meant to apply to a much larger group of financial institutions over time. Sound public policy requires understanding all of the potential consequences of shifting from a customer-centric regulatory system to a creditor-centric regime before taking that leap.

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