**INTRODUCTION**

Eight years have passed since the advent of the global financial crisis, and the issue of systemic risk and systemically important financial institutions (SIFIs) is still being hotly debated. The main controversy is centered on the identification of SIFIs among non-bank financial institutions and particularly insurance companies. Notwithstanding the merit of identifying those financial institutions posing systemic risk, the suitability and wisdom of the enhanced regulatory and supervisory requirements to which non-bank SIFIs are subject due to their systemic importance are still points of contention.

Questions abound regarding whether these measures applied to SIFIs are targeted towards remediating the factors believed to contribute to systemic risk or creating a permanent regulatory infrastructure whose mission is to simply manage said systemic risk. In a crisis with the banking sector at its core, the controversial inclusion of insurance companies among those companies whose activities could be a source of systemic risk has been questioned and challenged by state insurance regulators and the insurance industry. While all designations of insurers as SIFIs have elicited strong reactions, guidance may be provided by the U.S. courts following MetLife’s decision to legally challenge the Financial Stability Oversight Council (FSOC) decision to designate the insurer as a SIFI.

**FINANCIAL STABILITY OVERSIGHT COUNCIL PROCESS FOR NON-BANK FINANCIAL COMPANIES**

To prevent a repeat of the excessive risk-taking that led to the failures of the financial system, the federal Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was enacted in 2010. The notion of broader, macro-prudential supervision was introduced to keep systemic risk in check and protect financial stability. Central to the concept of macroprudential supervision is the need to recognize those financial institutions whose failure or distress could threaten the financial stability of the United States.

To that end, pursuant to Title I of Dodd-Frank, the FSOC was established to identify financial firms of systemic importance and designate them as SIFIs, as well as monitor the overall stability of the nation’s financial system and promote regulatory cooperation. Those institutions designated as SIFIs would theoretically become subject to more stringent regulatory standards under the Board of Governors of the Federal Reserve System. The treasury secretary, whose vote is mandatory for a SIFI designation, chairs the FSOC. The heads of eight regulatory agencies—Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency (OCC), Consumer Financial Protection Bureau (CFPB), U.S. Securities and Exchange Commission (SEC), Commodities Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), and National Credit Union Administration Board (NCUA)—and one independent member with insurance expertise, appointed by the President, also have voting rights on the FSOC. Five non-voting members also sit on the FSOC, including the directors of the Federal Insurance Office (FIO) and Office of Financial Research, a state banking supervisor, a state insurance commissioner, and a state securities commissioner.

To aid in the definition of a SIFI, the FSOC, as authorized by section 113 of Dodd-Frank, determines whether a non-bank financial institution is a SIFI if its material financial distress, or its nature, scope, size, scale, concentration, interconnectedness or the mix of its activities could pose a threat to the financial stability of the country. Title I of Dodd-Frank defines a non-bank financial company as one that is predominantly engaged in financial activities—including insurance, investment banking and asset management—other than bank holding companies and certain other types of firms.

According to FSOC rules and regulations regarding non-bank financial companies, released in April 2012, SIFIs are drawn from a population of non-banking financial institutions with at least $50 billion in consolidated assets, $30 billion in credit default swaps where the company is the reference entity, $3.5 billion in derivative liabilities, $20 billion in total debt outstanding, 15-to-1 leverage ratio and 10% short-term debt-to-asset ratio. These six quantitative thresholds in this first stage of the process help filter through the initial set of companies meriting further evaluation. A non-bank financial company will be moved on to the next stage if it meets both the total consolidated assets threshold and any one of the other thresholds.

While these thresholds are specifically designed to be uniform, transparent and readily calculable by all, the FSOC has clarified the universe of selected companies may go beyond

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those meeting the quantitative thresholds. The FSOC has reasoned the thresholds may not adequately measure unique risks posed by particular companies, and, therefore, it has retained the discretion to consider companies not captured in Stage 1 for any reason.

The companies captured in the first stage, and any others subsequently added by the FSOC, are then analyzed in the next stage of the process, based on six overarching framework categories to determine a company’s potential systemicness. The company-specific factors in the second stage include both quantitative and qualitative measures such as size, interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The first three factors are oriented towards assessing the likely impact of companies’ financial distress on financial stability, while the remaining three focus on the degree of vulnerability of the companies to possible financial distress.

When evaluating a non-bank financial company using the six measures in Stage 2, the FSOC is examining a number of statutory considerations, including the amount and nature of the company’s financial assets; the amount and nature of the company’s liabilities, including the degree of reliance in short-term funding; the extent of the company’s leverage; the extent and nature of the transactions and relationships with other significant financial institutions; the importance of the company as a source of credit for households (with an additional emphasis on low-income, minority communities) and businesses, as well as a source of liquidity for the financial system; the extent to which assets are managed rather than owned by the company; and the degree to which the company is already regulated by one or more primary financial regulatory agencies.

During the public comment period regarding these rules, the FSOC acknowledged a number of commenters pointed to the differences between insurance companies and other types of non-bank financial institutions, suggesting the focus should be on the unregulated, non-traditional activities undertaken by insurers instead of their well-regulated core activities, which do not pose any systemic risk. Furthermore, it was stressed products and services of regulated, traditional insurance companies are highly substitutable, adding insurers operate without significant leverage or reliance on short-term debt and, even more importantly, are subject to high levels of existing regulatory scrutiny.

In Stage 2 of the process, the FSOC analyzes companies that have triggered the Stage 2 thresholds using additional public information and regulatory information. During this stage of the process, the FSOC also begins the consultation with the company’s primary financial regulatory agencies. At the conclusion of Stage 2 of the process, the FSOC votes on whether to move the company to Stage 3 of the process. If the FSOC votes to move the company to Stage 3 of the process, then it informs the company it has entered Stage 3 and can request information directly from the company. During that time, the FSOC may request additional material and information concerning the companies’ enterprise risk management (ERM) framework and procedures, strategic plans, counterparty exposures, resolvability, potential acquisitions or disposals, and any planned or anticipated changes in their business model or orientation that may affect the country’s financial stability.

Stage 3 builds on Stage 2 analysis using the additional quantitative and qualitative information submitted by the companies under consideration. Among the qualitative factors are considerations that could mitigate or aggravate the potential of the non-bank financial company to pose a threat to the country’s financial stability, such as the company’s resolvability, the opacity of its operations, its complexity and, once again, the extent and nature of its existing regulatory scrutiny. Once the three-stage review process is completed, the FSOC decides, by a two-thirds vote of its members, whether a company should be designated as a SIFI and subject to Board of Governors supervision. At that time, the FSOC provides the company with a written notice of proposed determination and explanation of the status basis. The FSOC also notifies the company’s existing regulators and its subsidiaries. The SIFI designation is then revisited on an annual basis, with the decision whether to renew or rescind put to a vote again.

A company disagreeing with the FSOC determination may request a hearing to contest the proposed designation in accordance with section 113(e) of the Dodd-Frank Act and § 1310.21(c) of the rule.

**Insurer SIFI Designations**

**American International Group**

In July 2013, the FSOC for the first time exercised its authority under Title I of the Dodd-Frank Act and designated American International Group (AIG) as a SIFI in a 9-0 vote (one (Continued on page 11)

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7 Ibid.
8 Ibid.
9 Ibid.
10 Ibid.
11 United States Senate, Committee on Banking, Housing, and Urban Affairs. “Brief Summary the Dodd-Frank Wall Street Reform and Consumer Protection Act.”
member recused) subjecting the insurer to consolidated supervision and enhanced prudential standards.\(^\text{12}\) Although the FSOC’s designation of AIG as a SIFI was not unexpected by state regulators, given the company’s role in the financial crisis, the NAIC objected to the language and the rationale offered by the FSOC for this decision.\(^\text{13}\)

The rationale provided by the FSOC pointed to the potential for a run-like scenario for certain withdrawable insurance products and a possible broader loss of public confidence in the insurance industry as a result. However, as the NAIC contended, the insurance industry proved very resilient during the crisis, and no insurer, including AIG, suffered a run or the same loss of confidence experienced by the banking sector.\(^\text{14}\)

The FSOC also noted the size of AIG’s market presence in certain P/C and surplus lines, and fears about the ability of AIG’s policyholders to find similar coverage in the event AIG exits the market.\(^\text{15}\) State insurance regulators countered that while it may be true the exit of a major insurer could be disruptive, there is a proven history in the insurance market of a robust, competitive market with the capacity to absorb the business of failing insurers and attracting new capital.

**Prudential Financial**

In September 2013, the FSOC designated Prudential Financial, Inc. as the second non-bank financial institution SIFI in a 7-2 vote, with S. Roy Woodall Jr., independent member having insurance expertise, and Edward J. DeMarco, acting director of the FHFA, voting against, and contrary to the advice of John M. Huff, director of the Missouri Department of Insurance (DOI) and the state regulator FSOC representative.\(^\text{16}\) The dissenting independent member of the FSOC with insurance experience argued the FSOC’s underlying analysis used scenarios antithetical to a fundamental and expert understanding of the insurance business, the insurance state regulatory framework, and the state insurance company resolution and guaranty fund systems.\(^\text{17}\)

The non-voting commissioner’s dissent was based on the FSOC’s misapplication of bank-like concepts to insurance products and their regulation.\(^\text{18}\) The NAIC voiced again state regulators’ concerns about the unknown consequenc- es of such designation and the potential disruption in the insurance marketplace. The NAIC also reiterated its conviction that traditional, core insurance activities do not pose a systemic threat to the financial system, and encouraged the FSOC to instead focus on highly leveraged, thinly capital- ized, or unregulated activities of non-banks as it exercis- es its authority.\(^\text{19}\)

**MetLife**

In December 2014, the FSOC, in a 9-1 vote, decided to designate MetLife as a SIFI, the third insurer and fourth non-bank financial company to be designated. In its decision, the FSOC explained MetLife is such a significant participant in the U.S. economy and in financial markets, and it is interconnected to other financial firms through its insurance products and capital markets activities. The FSOC also explained that a substantial portion of MetLife’s liabilities included the option of surrendering in exchange for cash, and some policies also let policyholders borrow against the accumulated cash value. In the event of mass surrenders, MetLife would be forced to liquidate its relatively illiquid asset portfolio disrupting trading or funding markets. Therefore, the FSOC reasoned, material financial distress at MetLife could be damaging to the economy by severely impairing financial intermediation or financial market functioning.\(^\text{20}\)

The sole dissenting vote in FSOC’s decision was cast by the independent member with insurance experience who argued the decision to designate MetLife was flawed. The FSOC used the event of material financial distress as the sole justification for its determination without fully considering other factors to assess the insurer’s systemicness in the absence of distress.\(^\text{21}\) Furthermore, the independent member pointed to the implausible and contrived scenario of mass surrenders and forced asset liquidation charging the FSOC failed to appreciate fundamental aspects of insurance and annuity products and, more importantly, the existence of robust state insurance regulation.\(^\text{22}\)

The non-voting state insurance regulator representative, North Dakota Insurance Department Commissioner Adam Hamm, also expressed his dissent, taking issue with the FSOC’s persistent attempt to diminish the state insurance regulatory framework and its effectiveness in reducing the


\(^{13}\)FSOC Press Release, July 9, 2013.


\(^{16}\)FSOC Press Release, September 20, 2013.


\(^{18}\)NAIC Statement on FSOC’s Prudential Designation, September 19, 2013.

\(^{19}\)Ibid.


\(^{21}\)Financial Stability Oversight Council (FSOC), 2014. “Dissenting and Minority Views.”

\(^{22}\)Ibid.
likelihood of failure, as well as the impact on the financial system from an insurer’s material financial distress. The commissioner also objected to the FSOC’s unfounded criticism of risk-based capital (RBC) considered in isolation from all other regulatory tools and the purely speculative outcomes related to the liquidation of assets based in large part on hypothetical and highly implausible claims of significant policyholder surrenders. He stressed the tools currently at the disposal of state insurance regulators are either equally or more effective than the Fed’s enhanced prudential standards would be in addressing many of the risks identified by the FSOC.23

**REACTION TO DESIGNATIONS**

Following their designations as SIFIs by the FSOC, AIG made no attempt to fight it, while Prudential unsuccessfully challenged its designation in an evidentiary hearing. Prudential appealed the designation and asked for a hearing as it was entitled under Dodd-Frank guidelines. When the FSOC reaffirmed its original decision following the closed door hearing Prudential had requested, the insurance company decided not to pursue a legal challenge.

MetLife also launched an appeal, becoming the second insurer to exercise its right to challenge the proposed SIFI designation in a hearing before the FSOC. After losing the appeal, despite presenting what MetLife called substantial and compelling evidence, the insurer, in January 2015, filed a lawsuit in the United States District Court for the District of Columbia, charging it would be irreparably harmed if the designation was allowed to stand.24 The CEO of MetLife stated the company had hoped to avoid litigation, pointing to the fact the company has always been a big supporter of robust regulation, and it has operated under a stringent state regulatory system for decades without any problems.25 MetLife’s lawsuit marked the first time a SIFI designation has been challenged before a federal judge.26

**METLIFE’S LEGAL COMPLAINT**

MetLife’s legal challenge contests both the specifics of the SIFI designation and the general process in the process followed by the FSOC for insurance companies. The insurer rejected the idea it could pose a threat to the country’s financial stability and argued the conclusion reached by the FSOC was arbitrary and capricious. Furthermore, MetLife charged the FSOC’s process effectively denied the company its due process rights and violated the constitutional separation of powers because FSOC members acted and functioned interchangeably as lawmakers, prosecutors, investigators and judges at the same time.27

MetLife also charges the FSOC made a series of critical errors fatally undermining the reasoning in its designation of MetLife as a SIFI. First and most important of the errors was the FSOC’s failure to understand, or give meaningful weight to, the comprehensive state insurance regulatory regime that supervises every aspect of MetLife’s U.S. insurance business, despite statutory and regulatory requirements that specifically direct the FSOC consider existing regulatory scrutiny. The second error, according to MetLife’s lawsuit, was the FSOC fixation on the company’s size and so-called interconnectedness—two factors when considered alone would most certainly lead to the designation of virtually any large financial company—while ignoring other statutorily mandated considerations that weighed sharply against designation.

The third error was the FSOC’s reliance on vague standards and assertions, unsubstantiated speculation, and unreasonable assumptions inconsistent with historical experience and accepted principles of risk analysis. At the same time, the FSOC ignored tools used by federal regulators to assess the potential impact of severely adverse economic conditions in other contexts, including the Fed stress tests. The fourth error, according to MetLife, was the FSOC refusal to give the company access to data and materials used by the FSOC in its determination, depriving MetLife of a meaningful opportunity to refute the assumptions made, in violation of due process rights.28

MetLife also contended in the lawsuit it is not predominantly engaged in financial activities, and the FSOC designation authority is limited in Section 113(a)(2) of the Dodd-Frank Act to U.S. non-bank financial companies. MetLife derives more than 15% of its revenues from, and more than 15% of its assets are related to, insurance activities in foreign markets. Also, MetLife notes despite the FSOC having an obligation to consider reasonable alternatives to the SIFI designation such as following an activities-based approach, it elected not to do it. In a more general criticism, MetLife argued the FSOC designation process was opaque.

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25 Ibid.
IMPLICATIONS OF SIFI DESIGNATIONS
If a non-bank financial company is designated as a SIFI, it is subject to consolidated supervision by the Federal Reserve (Fed) and enhanced prudential standards as spelled out by the Fed in its regulatory rulemakings. The enhanced regulation expected by the Fed may include a combination of measures including, but not limited to, increased capital requirements, increased reporting, stress testing, debt-to-equity ratio requirements, stricter credit exposure limits, early remediation requirements, and “living wills” documenting resolution and liquidation plans.

In the bank-centric world of federal financial regulation, state insurance regulators considered calls for bank-style oversight of insurers particularly misplaced and ironic considering the state-regulated insurance industry served as a model of stability in 2008 when the federal banking and mortgage system nearly collapsed.

While Dodd-Frank gives the Fed the authority to subject insurance companies designated as SIFIs to the same regulatory capital rules banks have to follow, the recognition of the critical differences between banks and insurers motivated the Fed to work towards adapting the rules to insurers’ unique business model and risk profile. The Fed has reached out to the large insurance holding companies under its regulatory charge to get their assistance in creating a more appropriate capital regulatory framework.

In order to better tailor capital requirements for insurance companies, the Fed sent out a quantitative impact survey (QIS) in October 2014 to collect data from insurers in order to get a baseline understanding of the insurance industry’s capital levels. The Fed had asked insurance companies to submit all the information to the agency by the end of 2014.29

FSOC EFFORT TO REFORM
The criticisms to insurer SIFI designations submitted by the dissenting voting and non-voting members of the FSOC, as well as those outlined in MetLife’s legal complaint, are widely shared by the insurance industry, state insurance regulators and members of Congress. In addition, the FSOC has been subject to criticism relating to its lack of transparency, a concern that has been shared by Congress, public interest groups, the industry and state insurance regulators.

In an effort to respond to some of these criticisms, the FSOC announced in January 2015 its intent to change the SIFI designation process. In February, FSOC members voted to implement a series of changes and formalize certain practices relating to its process for reviewing non-bank financial companies for potential designation.30

The chairperson of the FSOC, Treasury Secretary Jacob J. Lew, said the newly adopted changes will help increase the transparency of the designation process and strengthen the work of the FSOC in general. He stressed the fact the FSOC is a new organization and as it grows and matures, it must continue to be flexible and adjust its processes as needed to fulfill its mandate.31

The FSOC changes meant to supplement its rule and interpretive guidance regarding non-bank financial company determinations fall in three main categories:32 1) Engagement with companies under consideration. The FSOC will inform companies earlier when they come under review, and provide additional opportunities for companies under consideration and their regulators to productively engage with the members of the FSOC. 2) Transparency to the broader public regarding the designations process. The FSOC will make more information available to the public about its designation work, while ensuring sensitive, nonpublic information remains protected. 3) Engagement during the FSOC’s annual reevaluations of designations. The FSOC will create a clearer and more robust process for the annual reviews of its designations. This new process is designed to enable more engagement between designated companies and the FSOC, with ample opportunity for companies to present information and to understand the FSOC analysis.33

Commissioner Hamm has indicated the changes are a good first step. However, he remains concerned the FSOC has not fully addressed the concept of an “exit ramp” to designation nor has it made fully clear to the public or regulators the specific activities of such firms that have led to the designation of these companies. The NAIC, in written testimony to the Senate Banking Committee, indicated the failure to provide an “exit ramp” contributes to, rather than reduces risks to, the financial system.

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**CONCLUSION**

Given the experience during the financial crisis, identifying which activities could threaten the stability of the U.S. economy is profoundly important. At the same time, it would be judicious to be cautious about presuming non-bank financial companies as systemically risky and particularly insurance companies, which have enjoyed a less turbulent history than their banking counterparts.

The proposed reforms of FSOC’s designation process, if implemented, are expected to enhance transparency and accountability allowing for increased consideration of the relevant views of the affected insurance companies and their primary regulators. However, establishing a clear path towards de-designation via an exit ramp should help insurance companies and their primary regulators understand better the changes they need to make in their operations and activities to eliminate any potential for posing a threat to the financial stability of the country.

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**ABOUT THE AUTHOR**

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