A Critical Take on Group Regulation of Insurers in the United States

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U.S. insurance regulation focuses predominantly on individual insurance entities rather than on groups of commonly owned and managed companies. Yet the bailout of AIG and emerging international norms increasingly suggest that effective insurance regulation must operate on both a legal-entity and a group-wide basis. For this reason, state insurance regulators have in recent years articulated a "windows and walls" framework for group insurance regulation. This framework attempts to insulate individual insurance companies from potential financial risks associated with their parents and affiliates ("walls"), while simultaneously allowing regulators to remain attuned to these risks ("windows"). This Article argues that this framework largely fails to meet the goals of group regulation in insurance because it relies almost exclusively on the capacity and willingness of state insurance regulators to investigate, diagnose, and respond to group-level risks effectively. This is problematic because group risk in insurance is immensely complicated and inherently dynamic. Meanwhile, state insurance regulators have poor incentives to invest their limited efforts and resources towards regulating group risk, as the potential negative consequences of group risk extend well beyond their states' borders. This Article illustrates these points by focusing on two recent case studies: the precrisis regulation of securities lending at AIG and the recent rise of shadow insurance among U.S. life insurers. In both instances, the Article argues that the entity-centric orientation of state insurance regulators caused them to fail to appreciate or prevent the buildup of substantial risk within groups of affiliated insurance companies. Ultimately, the Article suggests that effective group regulation in insurance requires either group-oriented state insurance regulation that relies less on the discretion of individual regulators or regulation of group-level risk by a federal entity.

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INTRODUCTION

U.S. insurance regulation focuses on individual corporate entities that are engaged in the business of insurance.[1] By contrast, it pays much more limited attention to groups of companies that are commonly owned or controlled and engage predominantly in the business of insurance.[2] Thus, one AIG insurance company may be dangerously undercapitalized, while another AIG insurance company may be extremely well capitalized. Similarly, one Allstate company may be permitted to sell narrow policy forms and have a substantial history of market-conduct violations, while another may only sell generous policy forms and have a sterling market-conduct record.

Although this regulatory focus is on individual legal entities, most insurance companies are operated almost entirely as a group—or, in some cases, as several groups[3]—of related companies.[4] In most insurance groups, a common set of board members and team of senior managers direct the financial, business, and risk-

1. *See generally* NAT'L ASS'N OF INS. COMM'RS, THE UNITED STATES INSURANCE FINANCIAL SOLVENCY FRAMEWORK (2010); Kris DeFrain, *Insurance Group Supervision*, CIPR NEWSL. (NAIC & Ctr. for Ins. Policy & Research, Kansas City, Mo.), Apr. 2012, *available at* http://www.naic.org/cipr_newsletter_archive/vol3_ins_group_supervision.htm [http://perma.cc/VHA4-SF78].

2. *See* FIN. STABILITY BD., PEER REVIEW OF THE UNITED STATES 32 (2013), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_130827.pdf [http://perma.cc/LCR3-WJ2H] ("The FSAP found that while the state-based regulatory system was effective in assuring policyholder protection and the soundness of individual insurance companies, it lacked a systemic focus and the capacity to exercise group-wide oversight."); Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI. L. REV. 1569 (2014).

3. In some cases, an insurance group may practically operate as several groupings of companies. This is particularly likely when a large insurance group is acquired by another group. For instance, the Zurich group of insurance companies includes the Farmers group of companies, but the Farmers group operates with some independence from the larger Zurich operation.

4. INT'L ASS'N OF INS. SUPERVISORS, INSURANCE CORE PRINCIPLES, STANDARDS, GUIDANCE AND ASSESSMENT METHODOLOGY 23 (2011) (defining an insurance group by reference to whether the individual companies are collectively managed and substantially influence one another's activities); Elizabeth F. Brown, *The New Laws and Regulations for Financial Conglomerates: Will They Better Manage the Risks than the Previous Ones?*, 60 AM. U. L. REV. 1339, 1357–89 (2011) (exploring generally the problems with the supervision of financial conglomerates prior to Dodd-Frank).

management decisions of individual companies within the group. Additionally, operations of individual companies within a group are often integrated across entity lines: sales, underwriting, legal, portfolio management, and adjusting personnel often work, in practice, for the larger group of insurance entities within the holding company, rather than for any single legal entity within that group.

U.S. entity-centric insurance regulation thus defies the "on-the-ground" realities of how many, if not most, insurance companies actually operate. Recognizing this fact, U.S. insurance regulation supplements entity-centric regulation with various group-focused regulatory strategies, which have recently been organized under the heading of "windows and walls."[5] Most importantly, U.S. insurance regulation employs various ring-fencing rules (i.e., "walls") that attempt to insulate individual insurance companies from potential financial risks that might arise in connection with their affiliates or parent companies.[6] At the same time, U.S. insurance regulation has increasingly sought to keep regulators attuned to risks from parents or affiliates of regulated entities (i.e., "windows"). Thus, insurance regulators have begun to require holding companies to produce various risk-management assessments, increased their authority to demand from regulated entities information about their affiliates, and attempted to better coordinate their regulation of companies within a group through supervisory colleges, collaborative working groups, and voluntary exchanges of information.[7]

Despite these various group-oriented supplements to entity-centric insurance regulation, this Article argues that U.S. insurance regulation does not, and cannot, achieve the goals of group-wide regulation of insurers. The Article first briefly explains why effective group-wide supervision of insurance groups is necessary, echoing the conclusions of much of the international insurance supervisory community.[8] Next, this Article argues that the "windows and walls" approach of

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5. Memorandum from Grp. Solvency Issues (EX) Working Grp., to Christina Urias, Dir. & Chair of the Solvency Modernization Initiatives (EX) Task Force (Feb. 26, 2010), *available at* http://www.naic.org/documents/index_smi_group_solvency_windows_and_walls.pdf [http://perma.cc/RY9T-2DU4].

6. *See* NAT'L ASS'N OF INS. COMM'RS, INSURANCE HOLDING COMPANY SYSTEM REGULATORY ACT (2011) [hereinafter NAT'L ASS'N OF INS. COMM'RS, SYSTEM REGULATORY ACT], *available at* http://www.insurance.wa.gov/current-issues-reform/agency-meetings/documents/MDL.pdf [http://perma.cc/S58Y-XMXH] (Model #440); NAT'L ASS'N OF INS. COMM'RS, INSURANCE HOLDING COMPANY SYSTEM MODEL REGULATION WITH REPORTING FORMS AND INSTRUCTIONS (2011), *available at* http://www.naic.org/store/free/MDL-450.pdf [https://web.archive.org/web/20150713074006/http://www.naic.org/store/free/MDL-450.pdf] (Model #450). For an overview of ring-fencing, see Steven L. Schwarcz, *Ring-Fencing*, 87 S. CAL. L. REV. 69 (2013).

7. *See* Elizabeth F. Brown & Robert W. Klein, *Insurance Solvency Regulation: A New World Order?, in* RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW (Daniel Schwarcz & Peter Siegelman eds., forthcoming 2015) (manuscript at 61–71) (on file with the UC Irvine Law Review); *see also* FED. INS. OFFICE, U.S. DEP'T OF TREASURY, HOW TO MODERNIZE AND IMPROVE THE SYSTEM OF INSURANCE REGULATION IN THE UNITED STATES 40 (2013).

8. *See* FIN. STABILITY BD., *supra* note 2, at 32; INT'L ASS'N OF INS. SUPERVISORS, COMMON FRAMEWORK OF INTERNATIONALLY ACTIVE INSURANCE GROUPS FOR CONSULTATION 35 (2013), *available at* http://www.actuaries.org/LIBRARY/Submissions/FTP8_2013_IAIS_Consultation

U.S. state insurance regulation is unlikely to achieve the objectives of group supervision. At its core, the reason is that the effectiveness of the "windows and walls" framework is highly "enforcement sensitive": it relies almost exclusively on the capacity and willingness of state insurance regulators to investigate, diagnose, and respond to group-level risks effectively.

In practice, however, there is very little reason to believe that state insurance regulators are able or willing to conduct effective group-oriented supervision that relies so heavily on their discretionary oversight. The core problem is that state insurance regulators simply do not have strong incentives to appreciate group risk, even when they are asked to do so in supervisory colleges or National Association of Insurance Commissioners (NAIC) working groups.[9] State insurance regulators are politically and financially beholden to their individual jurisdictions: the time they invest in investigating, understanding, and responding to risks that extend beyond the borders of their individual states do not clearly advance the interests of their constituents. Such activities, therefore, are unlikely to be sufficiently funded or encouraged.[10]

Yet, understanding the enterprise-level risks of massive insurance groups is a full-time job, to say the least. Large insurance groups may have hundreds of individual legal entities operating across the globe and pursuing extremely complex business, investment, and risk-management strategies. Appreciating risk across these entities requires not just understanding the exposures of these individual companies, but also understanding how they may interact, both to increase or decrease financial strength. It is simply not realistic to expect that individual state insurance regulators—whose funding and job responsibilities are inherently tied to the jurisdiction from which they reside—will be able to devote sufficient resources and time to preemptively identifying and responding to these risks.

This Article illustrates these points by focusing on two recent case studies: the precrisis regulation of securities lending at AIG and the recent rise of shadow insurance among U.S. life insurers. In both instances, the Article argues that the entity-centric orientation of state insurance regulators caused them to fail to appreciate or prevent the buildup of substantial risk within insurance holding companies.

Ultimately, the Article stops short of opining on what types of reform would best improve the regulation of insurance groups in the United States, saving this topic for future work. But the Article does conclude by noting that its arguments

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Document.pdf [http://perma.cc/UT2J-2T3S]; INT'L ASS'N OF INS. SUPERVISORS, *supra* note 4, at 342–60 (noting all principles apply to both the insurer and the group unless otherwise stated).

9. For an overview of supervisory colleges, see Gita Timmerman, *Supervisory Colleges: A Regulatory Tool for Enhancing Supervisory Cooperation and Coordination*, CIPR NEWSL. (NAIC & Ctr. for Ins. Policy & Research, Kansas City, Mo.), July 2012.

10. *See* WALLACE E. OATES, FISCAL FEDERALISM 14–16 (William J. Baumol ed., 1972); *see also* Martin F. Grace, *The Economics of State vs. Federal Regulation*, *in* RESEARCH HANDBOOK ON THE ECONOMICS OF INSURANCE LAW, *supra* note 7 (manuscript at 7–10).

suggest two potential reform routes. First, state insurance regulation could embrace less enforcement-sensitive forms of group supervision, such as consolidated capital requirements and more rule-based restrictions on transactions among affiliates. Second, group supervision of insurance-oriented companies could be systematically moved to a federal regulator such as the Federal Reserve (Fed), in a manner that would build on the Fed's current regulation of certain nonbank financial companies under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).

I. THE IMPORTANCE OF GROUP-WIDE SUPERVISION IN INSURANCE

In the last decade, the international community has come to embrace the need for effective group-wide supervision of commonly controlled insurance entities. Indeed, the need for both effective entity-level and group-wide supervision is a core principle of the International Association of Insurance Supervisors (IAIS).[11] The need for such a supervisory perspective is based on the fact that the risks associated with any individual insurance entity are deeply influenced by that entity's affiliate and parent companies.[12] In many cases, a strong insurance group can serve as a source of strength for an individual entity facing financial stress. For instance, recent research shows that, in the midst of the financial crisis, many life insurers received large capital contributions from other entities within their parent companies.[13]

Even more relevant for regulatory purposes, an insurance entity's financial risk can also be substantially increased as a result of its relationships with its affiliate and parent companies. The mechanisms by which risk can spread across corporate boundaries within a holding company are numerous and include ill-advised transactions among affiliates, reputational harm spreading among affiliates, and an increased tolerance for risk fostered by the financial strength of the larger group. Complicated corporate structures can not only increase company risk but can also decrease regulatory effectiveness. For instance, they can facilitate regulatory arbitrage through strategies such as double gearing, which is the use of the same underlying capital for two regulated institutions.[14]

For some companies, effective group-wide supervision may be necessary for

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11. INT'L ASS'N OF INS. SUPERVISORS, *supra* note 4, at 342–60.

12. *See generally* Andrew Kuritzkes et al., *Risk Measurement, Risk Management, and Capital Adequacy in Financial Conglomerates*, *in* BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES, 2003, at 141, 151 (Robert E. Litan & Richard J. Herring eds., 2003) (noting that supervisors of individual subsidiaries within financial conglomerates face challenges in managing risk because they lack a "group-wide perspective").

13. For a detailed discussion, see Gregory Niehaus, Managing Capital and Insolvency Risk via Internal Capital Market Transactions: The Case of Life Insurers 1 (Feb. 2, 2014) (unpublished manuscript), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2429024.

14. BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT'L SETTLEMENTS, PRINCIPLES FOR THE SUPERVISION OF FINANCIAL CONGLOMERATES CONSULTATIVE DOCUMENT 15 (2012), *available at* http://www.bis.org/publ/joint29.pdf [https://perma.cc/QP2J-7QFJ?type=pdf].

macroprudential or systemic risk reasons as well. Risk-management, investment, and business strategies are all generally determined at the holding company level.[15] Failures in any of these domains can potentially have negative effects on the stability of the larger financial system because they can simultaneously impact all of the entities within the group structure.[16] AIG serves as a suitable example: AIG embraced a company-wide strategy that effectively treated extreme downturns in the U.S. housing market as impossible. When this in fact occurred, numerous AIG affiliates simultaneously experienced extreme financial distress, thereby contributing to broad financial and economic instability in 2008.

A third reason that group-wide supervision is important is because financial markets and policyholders generally interact with insurers on a group-wide basis. Most public insurance companies are owned only at the holding company level. And policyholders often assess financial strength and other elements of a company's reputation globally, on the basis of the larger insurance group. All of this is significant from a regulatory perspective because effective regulation often requires being attuned to market and policyholder reactions to companies, which can contain important information about potential regulatory issues at the company. At the same time, many forms of regulation require facilitating effective communication with markets, including product and financial markets, to enhance the power of market discipline.

II. AN OVERVIEW OF U.S. GROUP SUPERVISION IN INSURANCE

Insurance regulation in the United States is the primary responsibility of the individual states, rather than the federal government.[17] This principle is reflected in the central U.S. federal insurance statute, the McCarran-Ferguson Act, which proclaims that "the continued regulation and taxation by the several States of the business of insurance is in the public interest."[18] Although individual states regulate the business of insurance conducted within their geographic boundaries, they coordinate extensively through the NAIC.[19] This coordination includes drafting model laws and regulations for adoption in the states, organizing enforcement

15. *See* Brown, *supra* note 4, at 1339.

16. *See* Xavier Freixas et al., *Regulating Financial Conglomerates*, 16 J. FIN. INTERMEDIATION 479, 482 (2007) (explaining that integrated conglomerates have common liabilities and consequently, "[l]arge-scale losses in non-bank divisions therefore harm bank depositors, and so result in a call upon the deposit insurance fund").

17. *See generally* Jonathan R. Macey & Geoffrey P. Miller, *The McCarran-Ferguson Act of 1945: Reconceiving the Federal Role in Insurance Regulation*, 68 N.Y.U. L. REV. 13, 20–26 (1993); Susan Randall, *Insurance Regulation in the United States: Regulatory Federalism and the National Association of Insurance Commissioners*, 26 FLA. ST. U. L. REV. 625, 629–34 (1999).

18. McCarran-Ferguson Act, ch. 20, 59 Stat. 33 (1945) (codified as amended at 15 U.S.C. §§ 1011–15 (2012)).

19. *See* KENNETH S. ABRAHAM & DANIEL SCHWARCZ, INSURANCE LAW AND REGULATION: CASES AND MATERIALS (6th ed. 2015).

efforts, and monitoring one another to ensure the sufficiency of their regulatory authority and resources.[20]

State insurance regulation currently focuses most of its solvency-related efforts on the financial health of individual insurance companies. Under the state regulatory regime, individual operating insurance companies must file various financial statements using Statutory Accounting Principles (SAP).[21] Unlike Generally Accepted Accounting Principles (GAAP), financial reports produced under SAP do not aggregate the financial information of commonly-owned companies. Instead, they provide regulators with a detailed breakdown of the financial status of individual insurance entities.[22] They also provide regulators with the sole source of data on which all of the core forms of U.S. solvency regulation are built: capital standards, reserve requirements, investment restrictions, and financial monitoring and analysis are all conducted using the data in annual financial statements regarding individual insurance companies.[23]

Although the financial statements of individual operating companies are filed (though the NAIC) with each state in which they are licensed to do business, these reports are generally closely reviewed and audited by only two sources: the NAIC and the state in which the operating company is domiciled.[24] The NAIC uses an Insurance Regulatory Information System (IRIS) to test the financial data submitted by insurance companies for potential signs of financial distress.[25] Meanwhile, the state in which an insurer is domiciled also reviews this data to ensure that various regulatory requirements—such as capital, reserve, and investment restrictions—are satisfied.[26] By contrast, this financial data is generally not closely scrutinized by the states in which individual companies are licensed to conduct business but are not domiciled. Instead, these states defer to the financial analysis and regulation of the state of domicile, relying on the fact that every state is accredited by the NAIC as possessing the necessary laws, resources, and expertise to conduct such regulation effectively.[27]

This entity-centric approach of U.S. insurance regulation is fundamentally connected to its state-based architecture. Historically, many large insurance holding companies adapted to the mismatch between state-based insurance regulation and the national and international scope of their operations by incorporating individual

20. *Id.*

21. NAT'L ASS'N OF INS. COMM'RS, *supra* note 1, at 15.

22. *Legislative Proposals to Reform Domestic Insurance Policy*: *Hearing Before the Subcomm. on Hous. and Ins. of the Comm. on Fin. Servs.*, 113th Cong. 80–97 (2014) [hereinafter *Legislative Proposals*] (statement of Daniel Schwarcz, Associate Professor & Solly Robbins Distinguished Research Fellow, Univ. of Minn. Law School).

23. NAT'L ASS'N OF INS. COMM'RS, *supra* note 1, at 4.

24. *Id.* at 26.

25. ABRAHAM & SCHWARCZ, *supra* note 19, at 122.

26. NAT'L ASS'N OF INS. COMM'RS, *supra* note 1, at 26.

27. For an overview of this process of coordination of state solvency regulation via the accreditation process, see ABRAHAM & SCHWARCZ, *supra* note 19, at 118.

insurance entities within multiple different states.[28] In many cases, they also incorporated different entities within a single state to address state-specific regulatory issues, such as form or price regulation.[29]

In concert with its entity-focused approach, state insurance regulation also employs what it describes as a "windows and walls" approach to group supervision.[30] The "walls" of the state regulatory process are designed to ring-fence individual regulated entities from various risks that may be associated with their affiliates or holding companies. The most important elements of these "walls"[31] are laws—contained in every state—requiring that insurers' transactions with affiliates be on terms that are "fair and reasonable."[32] In the case of any material transactions with affiliates, insurers must notify regulators of their intent to enter into such a transaction and can only proceed if the commissioner does not disapprove doing so within a specified period of time (usually thirty days).[33] These transactions include, among others: (i) extraordinary dividends or other distributions; (ii) substantial sales, loans, or investments; (iii) most reinsurance agreements; (iv) management agreements, service contracts, and tax allocation agreements; and (v) various guarantees.[34] To monitor compliance with these provisions, state regulators require insurers to report in their annual financial statements a complete list of every member of the holding company system and all nonroutine transactions with any of these entities.[35]

The "windows" of U.S. insurance regulation are designed to allow regulators of individual operating entities to assess potential risks from affiliates that may impact the operating entity. These "windows" include required detailed financial information of any entity controlling the insurer, provision of preexisting financial statements of all affiliates, and the right to acquire information from operating insurance entities and their insurance affiliates regarding potential enterprise risk to

28. *See generally* Kathy R. Petron & Douglas A. Shackelford, *Taxation, Regulation, and the Organizational Structure of Property-Casualty Insurers,* 20 J. ACCT. & ECON. 229 (1995) (exploring how regulatory factors influence whether property/casualty insurers expand into other states by acquiring a license or by establishing a separate subsidiary); Steven W. Pottier and David W. Sommer, *Regulatory Stringency and New York Licensed Life Insurers*, 65 J. RISK & INS. 485 (1998) (exploring how life insurers adapted to New York's "appleton rule," which requires that any insurer that conducts business in New York must comply with New York regulations in any state in which it does business by incorporating separate New York life insurance entities).

29. *See The Impact of Credit-Based Insurance Scoring on the Availability and Affordability of Insurance: Hearing Before the S. Comm. on Oversight and Investigations of the Comm. on Fin. Servs.*, 110th Cong. 8-9 (2008) (statement of Eric S. Poe, Chief Operating Officer, CURE Auto Insurance) (explaining how Geico maintains four separate legal entities so as to charge different rates to different classes of policyholders).

30. DeFrain, *supra* note 1.

31. These walls also include substantial scrutiny of sales or purchases of insurance entities or changes in control of those entities.

32. *See* NAT'L ASS'N OF INS. COMM'RS, SYSTEM REGULATORY ACT, *supra* note 6, at 440-15.

33. *Id.* at 440-19 to -20.

34. *Id.* at 440-16.

35. *Id.* at 440-19 to -22.

the insurer.[36] Additionally, they include a requirement that the ultimate controlling entity file an annual "Enterprise Risk Report" as well as an Own Risk and Solvency Assessment (ORSA); both reports identify the main enterprise risks to the holding company system.[37] State insurance regulators do not, however, have the regulatory authority to demand information directly from noninsurer affiliates of regulated insurance entities.

To help analyze these data, insurance regulators designate a lead state among the various domestic regulators of the individual entities.[38] Additionally, they coordinate with one another as well as with other functional regulators of entities within the group. This coordination occurs through regulators' participation in supervisory colleges and NAIC working groups such as the Financial Analysis Working Group (FAWG).[39]

In sharp contrast to the entity-centric approach of state regulators, insurance groups that are determined to be systemically significant by the U.S. Financial Stability Oversight Council are subject to consolidated regulation at the federal level by the Fed under Dodd-Frank.[40] Currently, three insurers—AIG, Prudential, and MetLife—have been found to be systemically significant, although MetLife is contesting this designation in court as of publication.[41] Insurers are also subject to consolidated regulation by the Fed if they control a depository institution, a category that includes approximately one dozen insurers in the United States.[42] Under Dodd-Frank, this regulation of insurance groups must include, among other things: "(A) risk-based capital requirements; (B) leverage limits; (C) liquidity requirements; (D) resolution plan and credit exposure report requirements; (E) concentration limits; . . . and (I) overall risk management requirements."[43] Unfortunately, the details of these forms of consolidated regulation by the Fed are still very much unclear, as the Fed has not issued rules as of publication specifying how it will

36. NAT'L ASS'N OF INS. COMM'RS, FINANCIAL ANALYSIS HANDBOOK 2 (2014), *available at* http://www.naic.org/documents/committees_e_isftf_group_solvency_2014_financial_analysis_handbook.pdf [http://perma.cc/H96H-NG2D]. Insurance regulators do not generally have any direct authority over an insurer's noninsurer affiliates or parent companies. Although the NAIC's Model Holding Company Act does allow states to require parent companies of insurers to file an enterprise risk report, it provides regulators with no enforcement authority over the parent (rather than the insurer) if the parent does not comply. *See* NAT'L ASS'N OF INS. COMM'RS, SYSTEM REGULATORY ACT, *supra* note 6, § 4L.

37. Brown & Klein, *supra* note 7, at 53.

38. *See* NAT'L ASS'N OF INS. COMM'RS, *supra* note 36, at 3.

39. Brown & Klein, *supra* note 7, at 52.

40. *See* Dodd-Frank Act of 2010, Pub. L. No. 111-203, § 113, 124 Stat. 1398, 1398–1402 (codified as amended at 12 U.S.C. § 5323 (2012)). *See generally* Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance*, 5 U.C. IRVINE L. REV. (forthcoming 2015).

41. *See* Zachary Tracer & Ian Katz, *MetLife Challenges Risk Tag, Sets Stage for Court Clash*, BLOOMBERGBUSINESS (Oct. 3, 2014, 1:10 PM), http://www.bloomberg.com/news/2014-10-03/metlife-challenges-risk-tag-sets-stage-for-court-clash.html [http://perma.cc/KV3D-47RK].

42. § 113, 124 Stat. at 1521–23.

43. *Id.* at 1398–1402.

approach these issues. However, the Fed has substantial experience regulating bank holding companies, as it is the regulator of all such entities under the Bank Holding Company Act.[44]

III. THE ENFORCEMENT-SENSITIVE NATURE OF THE "WINDOWS AND WALLS" FRAMEWORK

All forms of financial regulation can be located on a spectrum reflecting the extent to which their effectiveness in constraining risk-taking relies on active monitoring and enforcement by regulators.[45] On one end of the spectrum are relatively enforcement-insensitive strategies, such as simple leverage rules or fixed capital requirements.[46] Each of these forms of regulation is relatively straightforward in its application to individual companies and thus hard for firms to game. For that reason, even when regulators do a relatively poor job of monitoring and enforcement, most firms will tend to comply simply because it is easy to identify transgressions. Even if regulators were sufficiently clueless or captured that they would not act in the face of blatant regulatory violations, risk-management personnel within the firm, investors, or media outlets would be relatively likely to respond to any such violations, at least if they were long sustained.

By contrast, many forms of financial regulation are enforcement sensitive in that their effectiveness is highly contingent on effective monitoring and enforcement by regulators. For instance, financial exams depend critically on the ability of individual examiners to accurately identify and assess risk and then convey those assessments clearly in their reports and related documents or determinations.[47] Similarly, extremely complex rules, such as restrictions on "proprietary trading" contained in the Volcker rule, may be relatively enforcement sensitive because they may be easy for firms to game, either through aggressive

44. Bank Holding Company Act of 1956 (BHC Act), 12 U.S.C. § 1841 et seq. (2012).

45. The distinction between enforcement-sensitive and -insensitive regulatory rules tracks, to some degree, the more general distinction between rules and standards. But the overlap is imperfect. For instance, sufficiently complex rules can be enforcement sensitive. Even simple regulatory rules may be enforcement sensitive if there is little transparency with respect to firms' observance of these rules or the threat of litigation associated with violating these rules. On the other hand, most regulatory standards are indeed probably enforcement sensitive.

46. Peter Eavis, *Banks Ordered to Add Capital to Limit Risks*, N.Y. TIMES, Apr. 9, 2014, at A1 (noting that regulators have argued that increasing leverage ratio from three percent to five percent is "a more straightforward tool that will be harder to evade and easier to enforce than many of the new regulations covering the sprawling, complex businesses of banking"). For a powerful defense of simple leverage and capital rules as the primary tool for the regulation of financial enterprises, see ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT 94–96 (2013).

47. *See generally* Julie Andersen Hill, *Bank Capital Regulation by Enforcement: An Empirical Study*, 87 IND. L.J. 645, 648 (2012) (arguing that enforcement-sensitive capital requirements are not effective and that capital rules should be set so that they are sufficient without the need for significant discretionary capital increases). For one recent indictment of the pitfalls of enforcement-sensitive banking supervision that made its way into the popular press, see *This American Life: The Secret Recordings of Carmen Segarra*, CHICAGO PUBLIC RADIO (Sept. 26, 2014) (downloaded using iTunes).

interpretations of the rule's application or by regulatory arbitrage strategies.[48] Violations—or aggressive interpretations—of complex rules may also be much harder for potential watchdogs to identify or respond to by generating public outcry. Of course, enforcement-sensitive regulatory approaches have their own virtues: for instance, they are generally more nuanced and adaptable than enforcement-insensitive regulatory strategies.

Insurance solvency regulation—like most other forms of financial regulation—generally uses a blend of enforcement-sensitive and -insensitive regulatory strategies.[49] On one end of the spectrum, investment restrictions and certain rules governing reserving (such as those applicable to Level Term policies) are relatively enforcement insensitive because the application of these rules to individual insurance entities is usually relatively unambiguous. Additionally, various nonregulatory actors—including private rating agencies, public interest groups, and academic researchers—can, and do, double-check compliance with these rules in the course of performing their own analyses of risk at these companies. On the other end of the spectrum, insurance regulators also use various enforcement-sensitive approaches to safeguarding insurers' financial health, such as requirements that senior management of insurers be experienced and qualified.[50]

However, virtually every component of the "windows and walls" framework of U.S. insurance regulation is highly enforcement sensitive.[51] Consider first the "windows" of the system. These "windows" are designed to allow regulators to observe and assess risks to individual entities that may arise from their affiliates or parents. But in order for this to occur, regulators must effectively analyze and comprehend lengthy and complicated reports of insurance groups. They must be able to spot assumptions, logical flaws, or gaps in information, and then they must be willing to proactively follow up with groups to affirmatively request missing information or analysis. In contrast to the reserve requirements, investment restrictions, or financial ratio analyses of standard solvency regulation, there are not relatively self-applying quantitative restrictions at the group level.

In the event that insurance regulators become concerned about group-level risks, their options for action are hardly straightforward: they may prioritize financial exams of the underlying entities, more stringently evaluate proposed

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48. *See* Kimberly D. Krawiec, *Don't "Screw Joe the Plumber": The Sausage-Making of Financial Reform*, 55 ARIZ. L. REV. 53, 55 (2013); Charles A. Piasio, *It's Complicated: Why the Volcker Rule Is Unworkable*, 43 SETON HALL L. REV. 737, 739–40 (2013).

49. *See generally* ABRAHAM & SCHWARCZ, *supra* note 19.

50. *See* NAT'L ASS'N OF INS. COMM'RS, WHITE PAPER ON HIGH-LEVEL CORPORATE GOVERNANCE PRINCIPLES FOR USE IN U.S. INSURANCE REGULATION ¶ 5.2.6 (on file with the UC Irvine Law Review).

51. *See* Theresa M. Vaughan, CEO, NAIC, Comments to the NAIC Solvency Modernization Initiative (SMI) Task Force: Group Supervision and the IAIS Common Framework for the Supervision of Internationally Active Insurance Groups (Mar. 28, 2011), http://www.naic.org/documents/smi_vaughan_110328.pdf [http://perma.cc/TM7G-XEBY] (emphasizing that group supervision in the United States "is more about supervision than regulation").

transactions with affiliates, or raise concerns within supervisory colleges. Here too, there is a sharp contrast with ordinary state solvency regulation, wherein prompt corrective action provisions specify clear rules for how and when regulators must act depending on the regulated entity's Risk-Based Capital (RBC) ratios.[52] In sum, the value of the "windows" of U.S. insurance regulation depends entirely on how regulators use them.

Surprisingly, the "walls" of the U.S. insurance regulatory system are also highly enforcement sensitive. This is for two reasons. First, the core premise of these rules is the broad standard that transactions must be "fair and reasonable."[53] As with all broad standards, this requirement inherently derives its meaning and stringency from ex post application to specific cases.[54] In the absence of effective enforcement, such standards become largely meaningless. Second—a crucial fact that has seemingly escaped comment in existing critiques of the U.S. regulatory system—is that the NAIC Model Holding Company Act creates a file-and-use system for transactions among affiliates, whereby all such transactions are permitted in the face of regulatory inaction.[55] The default stance of all U.S. state insurance regulation is thus that all transactions among affiliates are permissible.

This default setting is likely to be quite significant, though no empirical research exists focusing on state regulators' scrutiny of transactions among affiliates. First, a very large literature documents that defaults often influence outcomes in a wide variety of settings.[56] By setting the regulatory default such that all transactions among affiliates are permissible, U.S. insurance regulation relies on regulators to affirmatively intervene to stop transactions that they find objectionable. Second, it is well known that state insurance departments are often resource constrained.[57] In many cases, it may simply be that regulators cannot devote prompt and careful attention to analyzing the propriety of transactions among insurance affiliates. In such cases, all such transactions are allowed.

Interestingly, these insurance-oriented group regulatory rules contrast sharply with the analogous rules in U.S. banking regulation, which are contained in sections

52. *See generally* J. David Cummins et al., *Insolvency Experience, Risk-Based Capital, and Prompt Corrective Action in Property-Liability Insurance*, 19 J. BANKING & FIN. 511 (1995).

53. *See* NAT'L ASS'N OF INS. COMM'RS, SYSTEM REGULATORY ACT, *supra* note 6, § 5(A)(1)(a), at 440-19.

54. *See* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557, 591 (1992).

55. *See* NAT'L ASS'N OF INS. COMM'RS, SYSTEM REGULATORY ACT, *supra* note 6, § 5(A)(2) ("The following transactions involving a domestic insurer and any person in its insurance holding company system, including amendments or modifications of affiliate agreements previously filed pursuant to this section, which are subject to any materiality standards contained in subparagraphs (a) through (g), may not be entered into unless the insurer has notified the commissioner in writing of its intention to enter into the transaction at least thirty (30) days prior thereto, or such shorter period as the commissioner may permit, and the commissioner has not disapproved it within that period.").

56. *See generally* Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651 (2006).

57. *See* FED. INS. OFFICE, U.S. DEP'T OF THE TREASURY, *supra* note 7, at 34 (noting that state insurance regulators may not have sufficient resources or expertise to adequately assess complex insurer self-assessment of risks).

23A and 23B of the Federal Reserve Act.[58] In addition to similar requirements that transactions must be fair and reasonable, these rules contain various quantitative requirements that are harder (though certainly not impossible) to undermine through lax enforcement. Examples include restrictions on covered transactions with affiliates to no more than twenty percent of capital and requirements that loans and guarantees between affiliates be fully collateralized.[59] Additionally, the default in banking regulation is set so that covered transactions are not permitted unless the relevant regulator affirmatively approves those transactions.[60]

Taking a broader perspective, it is hardly surprising that any U.S. insurance regulation that is focused on the group, rather than individual legal entities, is highly enforcement sensitive. In large part, this diagnosis stems inevitably from the fact that all insurance financial reporting in the United States is inherently linked to individual operating entities.[61] Indeed, consolidated financial reports are not even produced under SAP,[62] and using individual financial reports of operating companies to generate an understanding of the group's strength is difficult, if not impossible. Meanwhile, while publicly owned insurance groups report consolidated data, they do so using GAAP, an accounting system which state insurance regulators actively resist for purposes of generating regulatory requirements.[63] The lack of quantitative data at the holding company level limits the capacity of state regulators to craft formulaic or rule-like restrictions at the group level.

IV. THE PROBLEM WITH ENFORCEMENT-SENSITIVE APPROACHES TO INSURANCE GROUP REGULATION IN THE UNITED STATES

Enforcement-sensitive regulatory approaches are, by definition, only as effective as the regulators who implement and enforce them. Yet, there is very little reason to believe that individual state insurance regulators in the United States can or will consistently identify and respond to group-level insurer risk if doing so requires them to exercise a substantial amount of effort, resources, and political will. This is for at least two reasons.

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58. Section 23A of the Federal Reserve Act restricts transactions, such as lending, between federally insured deposit-taking banks and their nonbank affiliates. *See generally* Saule T. Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1686 (2011).

59. For an overview of the various quantitative and qualitative restrictions that are imposed under Sections 23A and B, see RICHARD SCOTT CARNELL ET AL., THE LAW OF FINANCIAL INSTITUTIONS 403–07 (5th ed., 2013).

60. *See* Omarova*, supra* note 58, at 1692.

61. *See Legislative Proposals*, *supra* note 22.

62. *See generally* NAT'L ASS'N OF INS. COMM'RS, ACCOUNTING PRACTICES AND PROCEDURES MANUAL AS OF MARCH 2007 (2007); NAT'L ASS'N OF INS. COMM'RS, STATUTORY ACCOUNTING PRINCIPLES WORKING GROUP MAINTENANCE AGENDA SUBMISSION FORM, FORM A, ASU 2014-10: DEVELOPMENT STAGE ENTITIES 2 (2014) ("Statutory financial statements are completed on a legal entity basis, and are not consolidated. GAAP guidance regarding consolidation is rejected . . . .").

63. *See generally Statutory Accounting Principles (SAP)*, NAT'L ASS'N OF INS. COMM'RS & CTR. FOR INS. POLICY & RESEARCH, http://www.naic.org/cipr_topics/topic_statutory_accounting_principles.htm [http://perma.cc/9LUZ-P5C6] (last updated May 14, 2015).

The first reason to doubt the efficacy of enforcement-sensitive group regulation in the United States is that individual state insurance regulators are politically accountable only to the constituents in their jurisdictions.[64] The insurance commissioners who run individual state insurance departments are all either directly elected or appointed by the state's governor.[65] And the state insurance department's budget is determined by the state legislature. For these reasons, state insurance departments face limited incentives to devote their attention to regulatory activities whose potential benefits extend beyond their state borders.[66] Yet large insurance groups operate nationally and internationally, and the benefits of effectively supervising these groups—in addition to supervising the legal entities within the group—are almost entirely felt outside of the boundaries of any individual state.[67]

The second reason for doubting the efficacy of enforcement-sensitive group regulation by state regulators is that, quite apart from incentives, state insurance regulators are ideologically committed to a system of entity-focused regulation.[68] As described above, entity-based regulation is deeply and inextricably linked to the state-based system of insurance regulation in the United States. Substantially shifting regulators' energies to group-wide supervision of insurers would effectively concede that the state-based regulatory system makes little sense, particularly for insurance groups that operate nationally or internationally.[69] Similarly, state insurance regulation is generally resistant to emerging international norms—including those emphasizing the importance of group-wide supervision.[70] The reason is that subnational regulators generally understand their larger community of similar regulators to consist of other subnational regulators. In the United States, this community is the NAIC, where the norms and incentives that tend to favor entity-centric regulation over group regulation are mutually reinforced in what amounts to an echo chamber.

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64. *See* Schwarcz & Schwarcz, *supra* note 2, at 1629.

65. *See* Martin F. Grace & Richard D. Phillips, *Regulator Performance, Regulatory Environment and Outcomes: An Examination of Insurance Regulator Career Incentives on State Insurance Markets*, 32 J. BANKING & FIN. 116, 121 (2008).

66. *See* OATES, *supra* note 10, at 16–17.

67. *See* Brown & Klein, *supra* note 7 (emphasizing the increasing internationalization of the insurance industry); Martin F. Grace & Richard D. Phillips, *The Allocation of Governmental Regulatory Authority: Federalism and the Case of Insurance Regulation*, 74 J. RISK & INS. 207 (2007) (noting that regulation of insurance companies often has significant extraterritorial effects). Of course, this point is generally applicable to much international financial regulation. Indeed, the collective-action problem resulting from the positive externalities of effective financial regulation lie at the heart of the justification for such coordination in the first place. For this reason, effective financial regulatory coordination often requires enforcement-insensitive strategies that actually constrain individual supervisors in ways that are observable and verifiable.

68. *See* Daniel Schwarcz, *Transparently Opaque: Understanding the Lack of Transparency in Insurance Consumer Protection*, 61 UCLA L. REV. 394, 457–58 (2014).

69. *Cf.* Grace, *supra* note 10 (noting that there is a strong prima facie case for regulating solvency at the federal level given the lack of state-specific preferences on this issue, economies of scale in effective regulation, and the fact that regulation in one jurisdiction has effects in other jurisdictions).

70. *See* Elizabeth F. Brown, *The Development of International Norms for Insurance Regulation*, 34 BROOK. J. INT'L L. 953, 984–88 (2009).

To illustrate these points, consider two recent settings in which state insurance regulators' entity-centric focus led them to overlook substantial aggregations of risk among insurance holding companies: the regulation of Securities Lending at AIG and the rise of Shadow Insurance.

A. Securities Lending at AIG

State insurance regulators have repeatedly described the problems at AIG, which led to the biggest bailout of a private company in history, as stemming entirely from products and transactions that did not involve the company's insurance entities. According to this narrative, AIG's problems leading up to its bailout were entirely attributable to the ill-fated Credit Default Swaps (CDSs) that were sold by its Financial Products division.[71] This narrative is convenient for state insurance regulators because AIG's financial products division was not a regulated insurance entity. Instead, the U.S. regulator most clearly charged with regulating this entity was the Office of Thrift Supervision, which was the group regulator for AIG prior to 2008.[72] Additionally, the Commodities Futures Modernization Act—a federal law—had specifically exempted derivatives, including CDSs, from regulation,[73] such that state insurance regulators probably could not have regulated these products even if they desired to do so.[74]

In fact, an equally important explanation for AIG's massive problems leading up to 2008 was its ill-fated securities-lending program, which both relied upon the assets of AIG's insurance companies and substantially jeopardized the financial health of these companies.[75] Securities lending is a relatively common practice among insurance companies. It involves the lending out of securities to other firms on a short-term basis.[76] It is generally understood to be a relatively safe way for

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71. *See American International Group: Examining What Went Wrong, Government Intervention, and Implications for Future Regulation: Hearing Before the S. Comm. on Banking, Hous., and Urban* Affairs, 111th Cong. 60 (2009) (testimony of Eric Dinallo, Superintendent, N.Y. State Ins. Dep't); *see also* Jeffrey E. Thomas, *Insurance Perspectives on Federal Financial Regulatory Reform: Addressing Misunderstandings and Providing a View from a Different Paradigm*, 55 VILL. L. REV. 773, 773–77 (2010) (arguing that "insurance had little, if any, role in the crisis" because "AIG's collapse was not an insurance problem").

72. William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 988 (2009).

73. *See* Commodity Futures Modernization Act (CFMA) of 2000, Pub. L. No. 106-554, 114 Stat. 2763A-365 (codified as amended in scattered sections of 7 U.S.C., 11 U.S.C., and 15 U.S.C. (2012)); *see also* Gramm-Leach-Bliley Act (GLBA), Pub. L. 106-102, 113 Stat. 1338 (1999) (codified as amended in scattered sections of 12 U.S.C. and 15 U.S.C. (2012)).

74. *See* M. Todd Henderson, *Credit Derivatives Are Not "Insurance,"* 16 CONN. INS. L.J. 1 (2009) (rejecting as unconvincing a possible argument that certain CDS's could have been regulated by state insurance departments).

75. For an excellent and comprehensive discussion of the role of securities lending in AIG's failure, see generally Hester Peirce, *Securities Lending and the Untold Story in the Collapse of AIG* (Mercatus Ctr., George Mason Univ., Working Paper No. 14-12, 2014), *available at* http://mercatus.org/sites/default/files/Peirce_SecuritiesLendingAIG_v2.pdf [http://perma.cc/CS52-VS5A]. Although Peirce's discussion of securities lending at AIG is careful and comprehensive, her article draws various policy prescriptions from this story that are both highly contestable and largely unmoored from her analysis of AIG's securities-lending programs.

76. NAT'L ASS'N OF INS. COMM'RS & CTR. INS. POLICY & RESEARCH, CAPITAL MARKETS

insurers to make money because entities that borrow securities must post cash collateral that generally exceeds the amount of the borrowed securities. Insurers generally make money in this exercise by reinvesting the cash collateral that they receive.[77] In fact, insurers that lend out securities generally pay a fee to the entities that borrow the securities precisely because they can earn a return on the cash collateral that they receive in exchange for the borrowed securities.

Securities lending can result in substantial instability because most such transactions are open for only very short periods of time: usually a single day. As a result, insurers' counterparties in these transactions effectively retain the right to have their cash collateral returned to them at any point, in exchange for the borrowed securities.[78] In other words, the cash that is provided to insurers in securities-lending transactions is an incredibly short-term liability. This can result in substantial asset/liability mismatches if the insurer has used its securities-lending program to invest in assets with impaired liquidity. To the extent that their collateral cannot be retrieved, counterparties in securities-lending transactions retain the contractual right to look to the assets of the underlying insurance companies to satisfy the amounts owed.[79]

This is exactly what occurred to AIG in 2007 and 2008.[80] Operating through AIG Global Asset Management Holding Company (Global Asset Management) and its subsidiaries, AIG Securities Lending Corporation and AIG Global Investment Corporation, AIG operated a securities-lending program that spanned the entire company.[81] Under this program, Global Asset Management amassed a portfolio of $160 billion in securities to lend out.[82] Approximately eighty percent of these securities were from AIG's domestic insurance companies at the end of 2007.[83] And by 2007, AIG invested up to seventy percent of its entire securities-lending operations in residential mortgage-backed securities and related instruments.[84]

As AIG began experiencing substantial stresses throughout 2007 and 2008, its counterparties became increasingly wary of the company. Many started to terminate securities-lending transactions, and others continued such transactions only on much less favorable terms than had historically prevailed. But in September 2008, AIG's counterparties ran en masse from AIG, redeeming up to $5.2 billion in cash

SPECIAL REPORT: SECURITIES LENDING IN THE INSURANCE INDUSTRY (2011), *available at* http://www.naic.org/capital_markets_archive/110708.htm [http://perma.cc/JP9J-DLDX]; Scott E. Harrington, *The Financial Crisis, Systemic Risk, and the Future of Insurance Regulation*, 76 J. RISK & INS. 785, 791–93 (2009).

77. *See* NAT'L ASS'N OF INS. COMM'RS & CTR. INS. POLICY & RESEARCH, *supra* note 76, at 1.

78. Harrington, *supra* note 76, at 790.

79. *Cf.* Robert L. McDonald & Anna Paulson, *AIG in Hindsight* 12–15 (Nat'l Bureau of Econ. Research, Working Paper No. 21108, 2015) (examining the rights of AIG's securities-lending counterparties had AIG declared bankruptcy and its insurance entities been placed into receivership).

80. *See* Sjostrom, *supra* note 72, at 961–62.

81. *See* Peirce, *supra* note 75, at 18–20.

82. *See id.* at 18.

83. *See id.* at 20.

84. *Id.* at 21–25.

collateral on a single day, September 15. The problem, of course, was that AIG faced massive liquidity problems in attempting to meet these redemptions because the market for mortgage-backed securities dried up concurrently so that these assets were, for all intents and purposes, completely unsellable. AIG could not, therefore, liquidate its investments in these instruments, which were financed using the cash collateral provided by securities-lending counterparties, to meet the rash of redemptions that it faced.

The massive concentration of AIG's securities-lending portfolio in mortgage-backed securities created unique risks for AIG's insurance entities because of the fact that other entities within AIG—particularly its notorious Financial Products division, which had entered into the company's disastrous CDSs—had also bet massively on the U.S. housing sector. These correlations in risk exposures across AIG's individual entities was at the core of AIG's failure: it was not chance that AIG's counterparties lost faith in the company at the same time that its securities-lending portfolio was completely illiquid. Instead, the correlations in risk exposures across the financial products division and the securities-lending program were responsible for this unfortunate series of events.

Despite the massive risks of AIG's securities-lending program to its insurance companies as well as to AIG itself, state insurance regulators generally failed to identify or respond to this risk prior to September 2008. According to a U.S. Government Accountability Office report on AIG's failure, "prior to mid-2007, state regulators had not identified losses in the securities-lending program and the lead life insurance regulator had reviewed the program without major concerns."[85] State regulators began discussing the securities-lending issue as a group for the first time when the Texas Department of Insurance raised the issue in an AIG Supervisory College in November 2007.[86] However, it was not until mid-2008 that state insurance regulators began to take concrete steps—such as requiring AIG to wind down its securities-lending operations and issuing general guidance—to address AIG's securities-lending programs.[87] These efforts, of course, proved to be too little, too late. Ultimately, approximately forty-six percent of AIG bailout funds was used to pay securities-lending counterparties.[88]

In large part, state insurance regulators' failure to diagnose or respond to the risks of this program are directly linked to the entity-centric nature of state insurance regulation. The basic problem was that AIG's securities-lending program was operated at the holding company level. As a result, no individual insurance regulator took responsibility for carefully scrutinizing that program, despite the fact that AIG had several "lead" state insurance regulators. As former New York insurance

85. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-616, FINANCIAL CRISIS: REVIEW OF FEDERAL RESERVE SYSTEM FINANCIAL ASSISTANCE TO AMERICAN INTERNATIONAL GROUP, INC. 13 (2011).

86. *Id.* at 31.

87. *Id.* at 17–18.

88. Peirce, *supra* note 75, at 43.

commissioner Eric Dinallo admitted, in defending state insurance regulation during the crisis, AIG's securities-lending operations "le[d] to . . . regulatory assignment questions."[89] Thus, while states clearly had the authority to examine AIG's securities-lending programs prior to the crisis, and did in fact do so, their analysis was generally perfunctory and superficial.

State insurance regulators also failed to appreciate the risks from AIG's securities-lending program for a second reason related to their entity-centric approach: they were blind to AIG's group-wide exposure to mortgage-backed securities. In particular, state insurance regulators generally had no information regarding the prospect that an AIG subsidiary like the company's Financial Products division could have placed such large bets on the U.S. housing market by entering into CDSs. But the existence of these bets changed the character of the risk associated with AIG's securities-lending portfolio because they resulted in the entire AIG company being exposed to the same tail-end risk. In other words, the investments of AIG's securities-lending program would not have been nearly as risky if other AIG subsidiaries had not also placed such large bets on other financial instruments linked to the U.S. housing sector (i.e. CDSs). In the absence of AIG's CDS portfolio, AIG's securities-lending counterparties would have been much less likely to terminate these agreements with AIG, and, even if they had, the company could have almost certainly replaced the funding of this program with alternative sources. Thus, the securities-lending program of AIG turned out to be so risky precisely because it was deeply correlated with risks that pervaded the entire AIG holding company. State insurance regulators' entity-centric approach blinded them to these correlations of risk taking across the holding company.

To be sure, none of this means that enhanced group-wide regulation would have prevented AIG's bailout. In fact, as mentioned above, AIG was indeed regulated at the group level by OTS, which proved just as blind to the massive aggregations of risk at the company as state insurance regulators. Of course, many explanations for OTS's inept regulation of AIG and various other entities, such as Countrywide, have been offered, with a prime candidate being the ability of institutions to shop for their preferred regulator prior to Dodd-Frank.[90] But the main point here is that the enforcement-sensitive nature of state group regulation contributed to state insurance regulators failing to respond sufficiently to aggregations of risks at AIG that substantially involved and impacted the company's regulated insurers. This does not mean that less enforcement-sensitive group

89. *The Role of Derivatives in the Financial Crisis: Hearing Before the Fin. Crisis Inquiry Commission*, 111th Cong. 206 (2010) (testimony of Eric R. Dinallo, Former Superintendent, N.Y. State Ins. Dep't). For a theoretical exploration of the importance of clarity of responsibility in the context of regulation, see Ethan Bueno de Mesquita & Dimitri Landa, *Clarity of Responsibility and Dynamic Policy Making* (2011), *available at* http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.194.2144&rep=rep1&type=pdf.

90. *See, e.g.*, KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS (2011). *But cf.* Dain C. Donelson & David Zaring, *Requiem for a Regulator: The Office of Thrift Supervision's Performance During the Financial Crisis*, 89 N.C. L. REV. 1777 (2011).

regulation by states or better group-focused regulation by a more competent federal regulator would have prevented the AIG debacle. But it does mean that enforcement-sensitive state regulation of insurance groups will tend to do little to decrease the risk of such failures in the future.

B. Shadow Insurance

A second, and more recent, example of state insurance regulators' inability to assess and respond to group-wide risk involves a broad phenomenon known as "shadow insurance."[91] In a shadow-insurance transaction, a life insurer reinsures a block of its business with an affiliated company that is a "captive" of its parent insurance company and that is not an "authorized" reinsurer.[92] Historically, captive insurance companies were viewed as presenting limited regulatory concerns: many of the ordinary problems associated with insurance markets do not apply to standard insurance captives, which are used by noninsurance companies to self-insure. As a result, captives are subject to very limited regulatory restrictions: their financial statements are not publicly available, they do not have to comply with statutory accounting rules and the associated reserve requirements, and they generally are not subject to standard risk-based capital requirements.[93]

By engaging in shadow-insurance transactions, life insurance companies can take advantage of these limited regulatory rules for captive insurance companies and avoid regulatory rules with which they do not want to comply.[94] The reason is that life insurers who reinsure their business are generally permitted to take a reserve credit in the amount of the reinsured business, thus effectively eliminating the reinsured liabilities from their balance sheets.[95] Consistent with the entity-centric nature of state insurance regulation, however, state regulators do not allow insurance entities to take reserve credits for reinsurance unless they have substantial confidence that the reinsurer will actually pay claims when they come due, as the ceding insurer is ultimately responsible for paying policyholder claims even if the reinsurer is unable to do so. In order to take this credit, reinsurers must either be authorized (i.e., regulated in much the way that insurers themselves are) or they must provide collateral to support their reinsurance obligations.[96] Captives in shadow-

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91. *See generally* BENJAMIN M. LAWSKY, N.Y. STATE DEP'T OF FIN. SERVS., SHINING A LIGHT ON SHADOW INSURANCE: A LITTLE-KNOWN LOOPHOLE THAT PUTS INSURANCE POLICYHOLDERS AND TAXPAYERS AT GREATER RISK 4–5 (2013).

92. NAT'L ASS'N OF INS. COMM'RS, CAPTIVES AND SPECIAL PURPOSE VEHICLES 16 (2013).

93. *See* LAWSKY, *supra* note 91, at 2, 21.

94. *See* FED. INS. OFFICE, *supra* note 7, at 32–34.

95. *See* NAT'L ASS'N OF INS. COMM'RS, CREDIT FOR REINSURANCE MODEL LAW (2012), *available at* http://www.naic.org/store/free/MDL-785.pdf [http://perma.cc/FC85-K6QP].

96. Richard Spiller, *Collateral for Reinsurance Obligations*, FORC JOURNAL, Spring 2010, at 5, 6, *available at* http://www.forc.org/public/journals/54.pdf [http://perma.cc/9SKN-P8DK]; Susan Stryker, *Securing Reinsurance: Letters of Credit and Regulation 114 Trusts*, FORC JOURNAL, Spring 2010, at 10, 10, *available at* http://www.forc.org/public/journals/54.pdf [http://perma.cc/9SKN-P8DK].

insurance transactions always follow the latter course and provide collateral, typically either through a letter of credit or a trust maintained at a bank.[97]

From an entity-centric-insurance regulatory perspective, because shadow-insurance transactions are fully collateralized, state insurance regulators have generally viewed them as largely unproblematic. In the event that an unauthorized captive reinsurer cannot make good on its reinsurance obligations, the state insurance regulator can generally rest assured that the regulated entity will receive the funds owed through the collateralization of the reinsurer's obligations. For this reason, until recently, state insurance regulators have not generally resisted shadow-insurance transactions or seen them as posing much threat. Indeed, in the last decade the number of shadow-insurance transactions has increased exponentially in the life insurance market: shadow insurance grew from $11 billion in 2002 to $364 billion in 2012.[98]

Yet shadow insurance does in fact raise numerous risks that have been almost entirely overlooked by state insurance regulators for the last decade.[99] First, in many shadow-insurance transactions, the underlying primary, ceding insurer, remains exposed to substantial risk. In many cases, for instance, the entity that guarantees the captive reinsurer's obligations is itself a parent or affiliate of the ceding insurer. In such cases, the "collateral" that is used to support the reinsurance obligation—and on which the primary ceding insurer relied to receive a reinsurance reserve credit—may well be unavailable when it is needed because the exposure of the affiliate or parent that is supplying the guarantee would itself be substantially impacted by an event triggering a reinsurance obligation.

The ceding insurer that engages in a shadow-insurance transaction can be exposed to substantial risk even when a third-party bank provides a letter of credit to collateralize the reinsurance transactions. This is because such letters of credit are often guaranteed by the ceding insurer's parent or affiliate.[100] As a result, the ceding insurer's parent or affiliate will ultimately bear the loss associated with the inability of a captive insurance company to pay funds owed under a reinsurance treaty. This, in turn, can undermine the financial health of the original, ceding insurer by weakening the financial backing of its parent and affiliate.

Parental guarantees of letters of credit issued to collateralize a shadow-insurance transaction increase connectivity of risk among affiliated firms in an additional way. In particular, regulated entities that engage in shadow-insurance transactions face the risk that they will have to quickly unwind a shadow-insurance

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97. LAWSKY, *supra* note 91, at 13.

98. Ralph S.J. Koijen & Motohiro Yogo, *Shadow Insurance* 9 (Nat'l Bureau of Econ. Research, Working Paper No. 19568, Oct. 2013, revised Apr. 2014), *available at* http://www.nber.org/papers/w19568.pdf.

99. LAWSKY, *supra* note 91, at 1; MOODY'S INVESTORS SERVICE, THE CAPTIVE TRIANGLE: WHERE LIFE INSURERS' RESERVE AND CAPITAL REQUIREMENTS DISAPPEAR (2013); Koijen & Yogo, *supra* note 98, at 2.

100. *See* LAWSKY, *supra* note 91, at 7–8.

transaction because the third party supplying a letter of credit to collateralize the reinsurance obligation becomes uncomfortable with the financial position the ceding insurer's parent or affiliate that is guaranteeing the letter of credit. This, of course, is likely to be correlated with potential financial distress at the regulated entity itself. If shadow-insurance transactions had to be quickly unwound due to the nonrenewal of a letter of credit, then the reinsured liabilities would reappear on the ceding insurer's balance sheet at the precise time when it would be experiencing financial distress. This is significant because these liabilities are moved off of the ceding insurer's balance sheet in a reinsurance transaction precisely because insurers do not want to maintain sufficient assets to support the reserves that are required under ordinary state insurance law. In other words, insurers that engage in shadow insurance are at substantial risk of having to quickly unwind shadow-insurance transactions, resulting in substantial capital deterioration, at the precise time that they would be facing unrelated financial distress.

All of these concerns about shadow insurance speak only to the risks of this practice to individual regulated entities. But an even more significant concern is that shadow insurance may generate systemic risk because it allows for insurers' long-term liabilities to be supported by questionable and deeply opaque assets. The core goal of insurers that engage in shadow insurance is to hold less and lower qualities assets to support their long-term obligations. If these long-term obligations end up requiring substantially higher payouts than anticipated under prevailing models, life insurers could face systematic shortfalls in their ability to pay out under these policies. This could generate risk that might mutate to the banking sector (which issues many of the letters of credit that support shadow insurance), or it could result in panics within insurance markets themselves, as policyholders rush to withdraw funds from insurance products and decline to purchase new policies.[101]

Despite these risks, state regulators had largely downplayed the risks associated with shadow insurance until approximately 2013, when the New York Insurance Department published a report that was deeply critical of the practice. Since then, state insurance regulators have implemented some reforms aimed at shadow insurance. But whether these reforms are sufficient is itself a subject of substantial debate.[102]

CONCLUSION

It has long been understood that state insurance regulation inherently faces various coordination problems when it comes to the regulation of large and complex insurance companies. These coordination problems can create increased

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101. *See generally* Schwarcz & Schwarcz, *supra* note 2.

102. Letter from Benjamin Lawsky, Superintendent, N.Y. State Dep't of Fin. Servs., to Sherrod Brown, U.S. Senator (Apr. 27, 2015), *available at* http://www.dfs.ny.gov/about/press2015/04282015-ltr.pdf [http://perma.cc/8EQM-PDPT] ("While the results of that process place some minor guardrails on new captive transactions, it will not eliminate captives and actually perpetuates the use of questionable assets to support reserves.").

compliance costs for companies and potentially substantial gaps in regulatory efficacy. In response, states have coordinated extensively though the NAIC to mitigate compliance costs and improve regulatory efficacy. In some cases—such as the NAIC's accreditation program—these efforts have been very successful. In other cases, such as states' various efforts to coordinate licensing of insurance agents, these coordination efforts have worked poorly.

This Article argues that state insurance regulators' "windows and walls" approach to the regulation of insurance groups largely falls in the latter category. The core problem is that this approach relies principally on effective supervision of complex financial entities by regulators whose political accountability and personal incentives are substantially tied to state geography. But group regulation is necessary because of risks that extend well beyond state borders. The predictable result—as illustrated by both AIG's securities-lending operations and the marked increase in shadow-insurance transactions—is that state insurance regulation cannot be relied upon to consistently monitor or respond to risks to insurance holding companies.

This does not mean that federal regulation in this domain is necessary or even optimal. State regulation of insurance groups could prove reasonably effective if it were more enforcement insensitive. For instance, consolidated capital requirements for insurance groups could probably be implemented and enforced by state regulators relatively effectively. Similarly, rule-based restrictions on transactions among affiliates of insurers, such as those contained in Sections 23A and B, would likely limit group-related risk more effectively than the current walls of the state insurance regulatory system.

If, however, enforcement-sensitive regulation of group risks remains, then it would likely be wise to lodge this regulation at a federal level, likely with the Fed. The Fed already regulates at a group level certain insurers that are deemed systemically significant or that own a depository institution. But to the extent that group risk in insurance is relevant outside of these few firms—either because group risk is an important factor in ordinary insurance solvency regulation, or because the present system of identifying a small handful of systemically risky insurers fails to capture the full potential scope of systemic risk in insurance—then the Fed's role in regulating insurance groups should indeed be expanded in the absence of less enforcement-sensitive state regulation of insurance groups.