THE FEDERAL GOVERNMENT'S REACTION TO A WORLDWIDE BANKING CRISIS INCLUDED REGULATING INSURERS: HOW CAN INSURANCE COMPANIES SHAPE THE EMERGING POLICY AND MOUNT CHALLENGES TO A BANK-CENTRIC DESIGNATION?

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I. INTRODUCTION

The first words many readers of the *Wall Street Journal* laid their eyes upon on September 16, 2008 starkly summarized the previous ten days in the banking world, "[m]ore than 200 years after it was born at the base of a buttonwood tree, Wall Street as we have known it is ceasing to exist."[1] However, that morning's above the fold article failed to mention the looming government takeover of an entity that truly was "too-big-to-fail" and that exceeded the size of all but one of the previous bank failures. The next morning's paper brought that headline though: "U.S. to Take Over AIG in $85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up: Emergency Loan Effectively Gives Government Control of Insurer; Historic Move Would Cap 10

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[1] Carrick Mollenkamp & Mark Whitehouse, *Old-School Banks Emerge Atop New World of Finance*, WALL ST. J., Sept. 16, 2008, at A1. The buttonwood tree refers to the location where the New York Stock Exchange was founded. Ellen Terrell, *History of the New York Stock Exchange*, LIBR. OF CONGRESS (Jan. 28, 2013), http://www.loc.gov/rr/business/hottopic/stock_market.html. On May 17, 1792, twenty-four stockbrokers and merchants signed an agreement at 68 Wall Street under a buttonwood tree to begin the exchange of securities in New York. *Id.*

Days That Reshaped U.S. Finance."[2] Where the federal government had taken a laissez-faire attitude only the day before as Lehman Brothers filed the largest bankruptcy ever with an estimated $613 billion in debt[3] and Merrill Lynch was acquired by Bank of America,[4] now the government was essentially buying control of a worldwide company with multiple subsidiaries in insurance and non-insurance lines of business.[5] While the government stood back during the previous period of days, suddenly it had interjected itself. Ironically, it was the nature of American International Group ("AIG") at the time of its rescue that would have some of the most pronounced effects in shaping federal regulation in the coming years. Part II of this note will examine the background of the financial crisis that shaped the subsequent reform efforts.

Part III of this note will examine the far-reaching banking reforms that Congress and regulators enacted in the wake of the financial crisis and collapse of 2007 through 2009, including the new approaches considered for regulating insurance. The Dodd-Frank Wall Street Reform and Consumer Protection Act[6] ("Dodd-Frank Act") was the legislative response to the crisis that, among its many banking reforms, included provisions for the regulation of insurance companies that far exceeded previous forays into this field. While many of the changes to the structure of banking regulations at the federal level were to be expected, insurance regulation was historically left to the auspices of the states. Now, as a direct result of AIG's failure in its banking portfolio, Congress was adding an additional level of

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[2] Matthew Karnitschnig, Deborah Solomon, Liam Pleven & Jon E. Hilsenrath, *U.S. to Take Over AIG in $85 Billion Bailout*, WALL ST. J., Sept. 17, 2008, at A1.

[3] Sam Mamudi, *Lehman Folds with Record $613 Billion Debt*, MARKETWATCH (Sept. 15, 2008, 10:11 AM), http://www.marketwatch.com/story/lehman-folds-with-record-613-billion-debt?siteid=rss.

[4] Mollenkamp & Whitehouse, *supra* note 1.

[5] RICHARD CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, THE LAW OF FINANCIAL INSTITUTIONS 33 (5th ed. 2013).

[6] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 11-203, 124 Stat. 1376 (codified as amended in scattered sections of 12 U.S.C. 5301 et seq.).

insurance regulation, historically unknown to insurance companies in the United States, which had been regulated at the state level for decades. Part IV of this note will review the new designation process of a "systemically important" institution and how it will now subject insurance companies, which had weathered the financial crisis inordinately well compared to their banking counterparts, to a "bank-centric" regulatory regime with the Federal Reserve as an additional regulator.[7] While AIG had indeed come to the brink of failure, it was primarily the result of activities conducted by a non-insurance affiliate.[8]

Nevertheless, Congress's solution was to place banking regulations on large insurance companies even though the federal government's own official report on the causes of the financial crisis only refers to life insurance once.[9] As a result of these new regulatory burdens, insurance companies that are designated as systemically important have a new and unique hurdle they must exceed when challenging a potential designation by a banking regulator that will be examined in Part V of this note. No insurance company that has been designated as systematically important yet has formally litigated the designation; however, one did request an oral and written hearing before choosing to not appeal the decision of the Financial Stability Oversight Council (FSOC). But what would such an appeal have to look like to be successful? Part VI of this note will consider the potential legal arguments designated companies can make to avoid this potentially excessive

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[7] 12 U.S.C. § 5323 (2012). This is formerly section 113 of the Dodd-Frank Act prior to codification. Throughout this note, there will be references to both the statutory citation and section 113 as in many instances testimony or written statements cited were drafted prior to codification and speak to the legislative section.

[8] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-583, INSURANCE MARKETS: IMPACTS OF AND REGULATORY RESPONSE TO THE 2007-2009 FINANCIAL CRISIS 1 (2013).

[9] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT 376 (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf. The Financial Inquiry Crisis Commission was established pursuant to the Fraud Enforcement and Recovery Act to "examine the causes of the current financial and economic crisis in the United States." Fraud Enforcement and Recovery Act, Pub. L. No. 111-21, § 5, 123 Stat. 1617 (2009).

regulatory regime. This will include an analysis of what factors the Federal Reserve should consider when making a determination of systemically important for an insurance company when it is weighing banking activities, particularly as regulations have yet to be promulgated setting forth the standards to be used. In Part VII of this note, I will propose a remedy for both of these problems that acknowledges the difference between insurance company activities and banking activities. Of particular importance, I will discuss how the Federal Reserve should consider the total value of assets held by affiliates conducting traditional banking activities in proportion to the company's traditional insurance business.

A company will face additional problems as a result of potential designation, which poses problems beyond additional regulatory scrutiny. First, additional capital requirements could lead to higher prices for consumers when purchasing life insurance products.[10] This price disparity could place larger insurance companies at a competitive disadvantage to smaller companies not designated and subject to additional capital standards, potentially leading to actual declines in asset quality and investments.[11] Ironically, the government's own proposed solution could magnify the hypothesized problem.

II. THE FINANCIAL CRISIS OF 2008 AND REGULATORS' OPTIONS IN THE THROES OF AN EMERGING RECESSION

Just one day before receiving the $85 billion capital infusion from the federal government, AIG was seeking less than half that amount from the Federal Reserve.[12] However, when it could not raise that amount, it suffered a catastrophic ratings

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[10] Zachary Tracer & Craig Torres, *MetLife Joined by State Watchdogs Challenging Fed*, BLOOMBERG (July 2, 2013, 12:52 PM), http://www.bloomberg.com/news/2013-07-02/metlife-joined-by-state-watchdogs-challenging-fed.html; *see also* METLIFE, INC., 2013 ANN. REP. iv (2014).

[11] Tracer & Torres, *supra* note 10.

[12] Michael J. de la Merced & Gretchen Morgenson, *Big Insurer Seeks Cash as Portfolio Plummets*, N.Y. TIMES, Sept. 15, 2008, Late Ed., at C1.

downgrade that necessitated the far larger capital infusion.[13] But AIG was neither the first, nor the last of the major failures in the financial sector in 2008.

In March, the federal government provided JP Morgan Chase with $30 billion to acquire Bear Stearns, which after eighty-five years suffered a meltdown during a period of only four days, watching its stock price plummet from $57 a share before the weekend to $2 a share at the time of its sale.[14] This was only a precursor of larger problems in the financial sector.

A week before AIG's financial insolvency came to the public's view, the federal government had placed government-sponsored entities Fannie Mae and Freddie Mac into conservatorship as a condition of extending $200 billion to the two of them.[15] While the Federal Reserve stepped in to assist the purchase of Bear Sterns and Fannie and Freddie due to systemic concerns about the effect of their collapses on the entire financial market, the same did not occur in the immediate lead up to AIG's potential insolvency. The same weekend that AIG was searching for financing, the Federal Reserve indicated it would not conduct another bailout and that Lehman Brothers, which was also searching for financing, would be responsible for its own fate.[16] That Monday, Lehman Brothers filed for bankruptcy.[17] That same day, Bank of America became the largest brokerage house and consumer banking franchise when it purchased Merrill Lynch.[18]

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[13] Eric Dash, *5 Days of Pressure, Fear and Ultimately, Failure,* N.Y. TIMES, Sept. 15, 2008, http://www.nytimes.com/2008/09/16/business/16reconstruct.html?pagewanted =all.

[14] Neil Irwin & David Cho, *Fed Takes Broad Action to Avert Financial Crisis*, WASH. POST, Mar. 17, 2008, at A01.

[15] David Ellis, *U.S. Seizes Fannie and Freddie*, CNN MONEY (Sept. 7, 2008, 8:28 PM), http://money.cnn.com/2008/09/07/news/companies/fannie_freddie/.

[16] Andrew Ross Sorkin, *Bids to Halt Financial Crisis Reshape Landscape of Wall St.*, N.Y. TIMES, Sept. 15, 2008, at A1.

[17] *Id.*

[18] *Id.*

Following the fire sale of Merrill Lynch and the bankruptcy of Lehman Brothers the day before, the Federal Reserve swiftly reversed course and again provided a bailout, this time to AIG in the amount of $85 billion[19], with AIG providing 79.9 percent of equity in the company to the Federal Reserve.[20] Less than ten days later, federal banking regulators seized Washington Mutual, which represented the largest bank failure in the country's history, and simultaneously sold it to JP Morgan Chase for $1.9 billion.[21] Just more than a week later, Wells Fargo acquired Wachovia for $15.4 billion.[22] Ironically, Citigroup, which had been the government's preferred purchaser of Wachovia, needed its own government bailout of $25 billion three weeks later, and another $20 billion within another month, even after laying off approximately 50,000 employees.[23]

All told, 165 banks failed, not including those proactively acquired by other financial institutions in 2008 and 2009,[24]

[19] Edmund L. Andrews, Michael J. de la Merced & Mary Williams Walsh, *Fed's $85 Billion Loan Rescues Insurer*, N.Y. TIMES, Sept. 17, 2008, at A1; *see also* FIN. CRISIS INQUIRY COMM'N, *supra* note 9, at 344-51, for a more in-depth review of AIG's failure and bailout.

[20] *Streamlining Regulation, Improving Consumer Protection, & Increasing Competition in Insurance Markets: Hearing before Comm. on Banking, Housing, and Urban Affairs' Subcomm. on Securities, Insurance, and Investment*, 113th Cong. 2 (2013) (statement of Baird Webel, Specialist in Financial Economics, Congressional Research Service).

[21] Eric Dash & Andrew Ross Sorkin, *In Largest Bank Failure, U.S. Seizes, Then Sells*, N.Y. TIMES, Sept. 26, 2008, at A1.

[22] David Enrich & Dan Fitzpatrick, *Wachovia Chooses Wells Fargo, Spurns Citi*, WALL ST. J., Oct. 4, 2008, at A1.

[23] David Ellis, *Citi Dodges Bullet*, CNN MONEY (Nov. 24, 2008, 1:34 PM), http://money.cnn.com/2008/11/23/news/companies/citigroup/; Dan Wilchins & Jonathon Stempel, *Citigroup Gets Massive Government Bailout*, REUTERS (Nov. 24, 2008 6:52 PM), http://www.reuters.com/article/2008/11/24/ us-citigroup-idUSTRE4AJ45G20081124.

[24] *Failed Bank List*, FED. DEPOSIT INS. CORP., https://www.fdic.gov/bank/individual/failed/banklist.html (last updated Nov. 21, 2014).

compared to five life insurance company insolvencies during that same time period. [25]

What made AIG's downfall so much different than the others listed above was its worldwide reach through both its insurance and banking businesses. While a small portion of the losses affecting AIG were the result of some life insurance investments,[26] the vast majority were the result of one banking affiliate that wrote a large volume of credit default swaps, many of which were tied to subprime mortgage-backed securities, the same types of toxic securities that were responsible for the collapse of other banking institutions.[27] Even though credit default swaps are often compared to insurance, because a seller is described as insuring against a default of an underlying asset, these items were not regulated by insurance regulators at the state level because they were treated as over-the-counter derivatives.[28] The key difference between credit default swaps and insurance products is that credit default swaps could be obtained by any individual, not just one with an insurable interest.[29] As a result of credit default swaps not being regulated as insurance, companies were not required to put aside reserves in the event of losses as would have been the case if they were regulated as an insurance product.[30] In fact, federal regulators had resisted attempts by the states to regulate these products,

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[25] *Impairments and Insolvencies*, NAT'L ORG. OF LIFE & HEALTH INS. GUAR. ASS'NS, http://www.nolhga.com/factsandfigures/main.cfm/location/insolvencies (last visited Feb. 1, 2015).

[26] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-13-583, INSURANCE MARKETS: IMPACTS OF AND REGULATORY RESPONSE TO THE 2007-2009 FINANCIAL CRISIS 1 (2013).

[27] CARNELL, MACEY & MILLER, *supra* note 5, at 33.

[28] FIN. CRISIS INQUIRY COMM'N, *supra* note 9, at 50, 140. Derivatives are future contracts that allow companies to manage and hedge risk. Over-the-counter derivatives are those that are specifically negotiated between two parties. *Overview*: *OTC Derivatives Resource Center*, SIMFA, http://www.sifma.org/issues/regulatory-reform/otc-derivatives/overview/ (last visited February 1, 2015).

[29] FIN. CRISIS INQUIRY COMM'N, *supra* note 9, at 140

[30] *Id.* at 50.

not as insurance, but as mortgage products, relying on federal pre-emption rules.[31]

The affiliate, AIG Financial Group ("AIGFG"), which was regulated by the federal Office of Thrift Supervision, generated only six percent of AIG's total revenues.[32] However, it also managed AIG's $2.7 trillion in assets tied up in credit default swaps.[33] As a result of the previously mentioned credit ratings downgrade that AIG suffered, it was forced to post an immediate cash margin, which it was unable to do without the infusion of federal funds.[34] Additionally, profitable life insurance investments were also used as collateral to pay the margin.[35]

A. THE REACTION OF FEDERAL BANKING REGULATORS

In each of the aforementioned failures, federal banking regulators took one of four approaches: (1) let the company file for bankruptcy (e.g. Lehman Brothers); (2) directly infused funding to a failing company (e.g. AIG); (3) indirectly infused funding to a purchaser of a failing company (e.g., JP Morgan Chase's acquisition of Bear Sterns); or, (4) they established a buyer for the failing bank before shuttering it (e.g., Bank of America's or Wells Fargo's acquisitions of Merrill Lynch and Washington Mutual, respectively). In each of these instances, a federal banking regulator oversaw the banking entity of the failed companies, whether it was an affiliate, subsidiary or holding company.

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[31] *Id.* at 111-12.

[32] Arthur D. Postal, *Five Years Later AIG Bailout Still Resonates*, PROP. CASUALTY 360 (Sept. 17, 2013), http://www.propertycasualty360.com/2013/09/17/five-years-later-aig-bailout-still-resonates.

[33] FIN. CRISIS INQUIRY COMM'N, *supra* note 9, at 140.

[34] *Id.*

[35] Postal, *supra* note 32.

B. THE REACTION OF STATE INSURANCE REGULATORS

Conversely, state-based insurance regulators oversaw the books of insurance business, which was particularly true in AIG's case. States have traditionally regulated insurance since the enactment of the McCarran-Ferguson Act.[36] The McCarran-Ferguson Act was enacted in 1945 in response to the U.S. Supreme Court's ruling in *United States v. Southeastern Underwriters' Ass'n*.[37] The McCarran-Ferguson Act proscribed that "[t]he business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business."[38] The joint banking and insurance regulatory structure of AIG resulted from the enactment of the Financial Services Modernization Act of 1999,[39] also known as Gramm-Leach-Bliley. This law repealed parts of the Glass-Steagal Act of 1933,[40] permitted affiliations between banks, securities firms, and insurance companies;[41] thus resulting in the structure that AIG operated as, with each entity subject to different regulators.

C. COMPARISON OF THE APPROACHES

In the case of AIG, banking regulators, specifically the Federal Reserve, stepped in as previously described to ensure solvency on required cash payments. Following the announcement, state insurance regulators also stepped in

[36] *See generally* 15 U.S.C. §§ 1011-1015 (2012).

[37] U.S. v. Se. Underwriters' Ass'n, 322 U.S. 533, 538-39 (1944) (holding that the Sherman Antitrust Act applied to the sale of fire insurance).

[38] 15 U.S.C. § 1012(a). State-based insurance regulation had existed for almost 100 years prior to *Southeastern*. NAT'L ASS'N OF INS. COMM'RS, STATE INSURANCE REGULATION: HISTORY, PURPOSE AND STRUCTURE 1, *available at* http://www.naic.org/documents/consumer_state_reg_brief.pdf. The first state insurance commissioner was appointed in 1851 in New Hampshire. *Id.*

[39] Financial Services Modernization Act of 1999, Pub. L. No. 106-102, 113 Stat. 1338 (codified as amended in scattered sections of 12 U.S.C., 15 U.S.C. & 16 U.S.C.).

[40] Banking Act of 1933, Pub. L. No. 73-66, 48 Stat. 162. (1933).

[41] NAT'L ASS'N OF INS. COMM'RS, *supra* note 38.

through the coordinated effort of the National Association of Insurance Commissioners (NAIC), a standard-setting organization for insurance regulators. The NAIC established a working group to oversee AIG's insurance interests and coordinate with federal banking regulators.[42] At the time, NAIC President and Kansas Insurance Commissioner, Sandy Praeger, emphasized the different regulatory structures that existed between the banking and insurance affiliates of AIG, highlighting that it was likely that the insurance subsidiaries, which were subject to state regulation and remained profitable, would likely be sold to strengthen AIG's financial position.[43] During the following days, state insurance regulators individually reiterated the message that the insurance subsidiaries were not only solvent, but remained profitable.[44] State regulators would point to requirements that insurance subsidiaries be "walled off" from the rest of a holding company to protect insurance policyholders from the very type of financial instability that AIGFG caused its parent.[45]

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[42] Press Release, Nat'l Ass'n of Ins. Comm'rs, State Regulators: AIG Insurers Able to Pay Claims (Sept. 17, 2008), *available at* http://www.naic.org/Releases/2008_docs/AIG_pay_claims.htm.

[43] *Id.*

[44] *See* Press Release, Or. Dep't of Consumer & Bus. Servs., Oregon AIG Policyholders Are Safe, Insurance Division Says (Sept. 16, 2008), *available at* http://www.oregon.gov/DCBS/docs/news_releases/2008/091608-aig-statement.pdf; *see* Press Release, Md. Ins. Admin., AIG Policyholders Should Be Careful and Educated Before Replacing Policies (Sept. 25, 2008), *available at* http://www.mdinsurance.state.md.us/sa/docs/documents/news-center/news-releases/aigreplacements09-08.pdf; *see* Press Release, N.J. Dep't of Banking & Ins., DOBI Commissioner Goldman Says AIG's New Jersey Subsidiary Is Sound (Oct. 1, 2008), *available at* http://www.state.nj.us/dobi/pressreleases/pr081001.htm.

[45] Letter from Nat'l Ass'n of Ins. Comm'rs to Conference on Fin. Regulatory Reform Legislation 3 (June 3, 2010), *available at* http://www.naic.org/documents/testimony_100603_officers_letter_fin_reg_reform.pdf.

III. THE LEGISLATIVE AND REGULATORY RESPONSE TO THE FINANCIAL CRISIS

When the Federal Reserve reversed course by reinserting itself into the bailout process with AIG's credit downgrade looming, it signaled that the federal government would in fact prevent the downfall of any financial institution that posed a systemic risk if it failed, or colloquially was "too-big-to-fail." In these cases, a systemic risk refers to the likelihood that one institution's failure would cascade through the market causing other failures.[46] As such, an institution's systemic risk, or whether it was "too-big-to-fail," was a measure of its size relative to the national and international marketplace, market share concentration, and competitive barriers to entry or how easily a product can be substituted.[47] In the case of AIG, the Federal Reserve had emergency statutory authority to make loans to non-depository institutions[48] upon determining that that "unusual and exigent circumstances exist," that the institution is "unable to secure adequate credit accommodations from other sources," and that "action on the matter is necessary to prevent, correct, or mitigate serious harm to the economy or the stability of the financial system of the United States."[49] However, the Federal Reserve could not rely on this power to make capital infusions with the large number of banks, and more importantly, the size of the assets at risk, on the brink of failure. Rather, it would need intervention from Congress.

A. THE PRESIDENT AND CONGRESS TAKE IMMEDIATE STEPS TO STABILIZE THE ECONOMY

On September 24, 2008, President George W. Bush addressed the nation in seeking support of a plan developed late

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[46] PROP. & CAS. INSURERS ASS'N OF AM., SYSTEMIC RISK 1, *available at* http://www.pciaa.net/docs/default-source/default-document-library/Systemic_Risk_Definition.pdf?sfvrsn=2.

[47] *Id.*

[48] 12 U.S.C. § 347 (2006).

[49] 12 U.S.C. § 248(r)(2)(A)(ii) (2011).

the previous week to infuse $700 billion in capital to troubled financial institutions.[50] The Emergency Economic Stabilization Act of 2008[51] would authorize the United States Secretary of the Treasury to inject this capital into distressed markets, with $250 billion available immediately.[52] Upon transmission by the President to Congress of a plan to exercise certain authority as permitted by the bill, this authorization then increased to the maximum amount of $700 billion.[53]

The next day, as the financial markets looked on, the House of Representatives failed to pass the bill, with 228 members voting "no" and only 205 voting "yes."[54] The Dow Jones Industrial Average proceeded to plummet 777.68 points, its largest single day point loss ever, representing a loss of $1.2 trillion in market value.[55] In the three minutes following the close of voting, the stock market lost 359 points, representing almost half of the day's total losses.[56] Earlier that day, news of Wachovia's proposed acquisition by Citigroup at $1 a share emerged,[57] stoking concerns that the bank failures that had been

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[50] President George W. Bush, President's Address to the Nation on Financial Crisis (Sept. 24, 2008) (transcript available at http://www.nytimes.com/2008/09/24/business/economy/24text-bush.html?pagewanted=all&_r=0).

[51] Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

[52] *Id.* § 115(a)(1).

[53] *Id.* § 115(a)(3).

[54] Sarah Lueck, Damian Paletta & Greg Hitt, *Bailout Plan Rejected, Markets Plunge, Forcing New Scramble to Solve Crisis*, WALL ST. J., Sept. 30, 2008, at A1.

[55] *Id.* This remains the Dow Jones' largest one-day point loss. *Id.*

[56] *Id.*

[57] *Citi and Wachovia Reach Agreement-In-Principle for Citi to Acquire Wachovia's Banking Operations in an FDIC-Assisted Transaction*, BUS. WIRE (Sept. 29, 2008 9:23 AM), http://www.businesswire.com/news/home/20080929005766/en; Erich Dash & Andrew Ross Sorkin, *Citigroup Buys Bank Operations of Wachovia*, N.Y. TIMES, Sept. 29, 2008, http://www.nytimes.com/2008/09/30/business/30bank.html?hp=&pagewanted=all; *see also* Enrich & Fitzpatrick, *supra* note 22 (discussing how Wells

front page news for the previous few weeks would continue unabated. In light of this, the Senate took up the bill in a revised form on October 1, 2008 and passed it by a vote of 74-25.[58] The House of Representatives then reconsidered the bill two days later and wary of the market's reaction to its failure only four days earlier, passed it by a vote of 263-171.[59] President Bush signed it into law later that same day.[60]

Prior to the first distribution of Troubled Asset Relief Program ("TARP") funding, as created by the Emergency Economic Stabilization Act, to AIG on November 10, 2008, the Federal Reserve Board committed an additional $37.8 billion to the company in the form of a Securities Borrowing Facility.[61] The Dow Jones would suffer two more days of losses that exceeded 600 points before the first TARP investment was made to AIG.[62] AIG would receive its first TARP investment on November 10, 2008.[63] In short term though, the Dow Jones would suffer one more day of losses in excess of 600 points.[64]

Fargo purchased Wachovia after a deal in principle had already been reached between Citigroup and Wachovia).

[58] *Emergency Economic Stabilization Act of 2008*, GOVTRACK.US, https://www.govtrack.us/congress/bills/110/hr1424 (last visited Feb. 1, 2015).

[59] *Id.*

[60] *Id.*

[61] U.S. GOV'T ACCOUNTABILITY OFF., GAO-12-574, TROUBLED ASSET RELIEF PROGRAM: GOVERNMENT'S EXPOSURE TO AIG LESSENS AS EQUITY INVESTMENTS ARE SOLD 8 (2012).

[62] *Dow Jones Industrial Average, All-Time Largest One Day Gains and Losses*, WALL ST. J. MARKETS DATA CENTER, http://wsj.com/mdc/public/page/2_3024-djia_alltime.html (last visited Feb. 1, 2015). The Dow Jones lost 678.91 points on Oct. 9, 2008 and another 733.08 points on Oct. 15, 2008. *Id.*

[63] Matthew Anderson, *AIG Wrap Up: Treasury Sells Final Shares of AIG Common Stock,* U.S. DEP'T TREAS. (Dec. 12, 2012), http://www.treasury.gov/connect/blog/ Pages/AIG-wrapup.aspx.

[64] *Dow Jones Industrial Average, All-Time Largest One Day Gains and Losses, supra* note 62. The Dow Jones lost another 679.95 points on Dec. 1, 2008. *Id.* These four single day losses in excess of 600 points still represent the first, second, fourth and fifth largest single day losses for the stock market. *Id.*

It was in the face of these failures and near failures of complex financial institutions deemed "too-big-to-fail," particularly AIG, that Congress would consider far-reaching reforms of the financial system that placed a large amount of emphasis on the activities of insurance companies, particularly life insurance companies.

B. THE BEGINNING OF LONG TERM FINANCIAL REGULATORY REFORM EFFORTS

In the midst of the near collapse of the financial system, the United States elected a new President. As a candidate, Barack Obama pinned blame for the crisis on "speculators who gamed the system, regulators who looked the other way, and lobbyists who bought their way into our government."[65] Along with Obama's election as President, Democrats won firm control of the Senate, partially as a result of Obama's coattails.[66] That following January, Democrats controlled both the executive and legislative branches of government. Throughout 2009 and early 2010, many proposals for financial reform were proposed, debated, and sometimes even voted upon.[67] Following more than a year of congressional debate, amendments, and negotiation, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 into law on

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[65] *Obama's Remarks on the Economic Crisis*, REAL CLEAR POL. (Sept. 30, 2008), http://www.realclearpolitics.com/articles/2008/09/obamas_remarks_on_the_economic.html.

[66] Larry J. Sabato & Isaac Wood, *Grabbing Those Coattails*, CENTER FOR POL. (Mar. 3, 2012), http://www.centerforpolitics.org/crystalball/articles/ljs2011030301/.

[67] *See* Remarks on Financial Regulatory Reform, 2009 DAILY COMP. PRES. DOC. 2 (Jun. 17, 2009) (proposing an overhaul of the nation's financial regulatory structure); U.S. DEP'T TREAS., FINANCIAL REGULATORY REFORM: A NEW FOUNDATION (2009), *available at* http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf (representing President Obama's formal proposal); Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111th Cong. (1st Sess. 2009); Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2d Sess. 2010).

July 21, 2010.[68] Contained within this law was the most far-reaching entry into the regulation of insurance by the federal government in more than half a century that would compromise the existence of state-based insurance regulation.[69]

C. The Creation of a New Federal Regulatory Agency: The Financial Stability Oversight Council

Title I, Subtitle A of the Dodd-Frank Act created the Financial Stability Oversight Council (FSOC).[70] FSOC is composed of ten voting members[71] and five non-voting members.[72]

The purpose of FSOC is broadly:

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[68] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, GovTrack, https://www.govtrack.us/congress/bills/111/hr4173 (last visited Feb. 1, 2015).

[69] 12 U.S.C. §§ 5311-33 (2010). Just prior to the bill's passage by the Senate, Senator Susan Collins highlighted the existing state-based regulatory regime for insurance companies and that the regulatory capital standards contained in the Dodd-Frank Act imposed certain additional standards on bank holding companies, that also be placed on insurance companies that were designated nonbank financial companies: " . . . insurance companies are already heavily regulated by State regulators who impose their own, very different regulatory and capital requirements." 156 Cong. Rec. S5870, 5902 (daily ed. July 15, 2010) (statement of Sen. Susan Collins).

[70] 12 U.S.C. § 5321(a) (2010).

[71] *Id.* § 5321(b)(1). The voting members are: the Secretary of the United States Department of the Treasury, who serves as the Chairperson; the Chairman of the Federal Reserve Board of Governors; the Comptroller of the Currency; the Director of the Consumer Financial Protection Bureau; the Chairman of the Securities and Exchange Commission; the Chairperson of the Federal Deposit Insurance Committee; the Chairperson of the Commodity Futures Trading Commission; the Director of the Federal Housing Finance Agency; the Chairman of the National Credit Union Administration Board; and an independent member having insurance expertise appointed by the President, by and with the advice and consent of the Senate. *Id.*

[72] *Id.* § 5321(b)(2). The non-voting members are: the Director of the Office of Financial Research created pursuant to 12 U.S.C. § 5342 (2010); the Director of the Federal Insurance Office created pursuant to 31 U.S.C. § 313 (2010); a State insurance commissioner; a State banking supervisor; and a State securities commissioner (or equivalent), with each of the final three being designated by a selection process determined by their respective peers. *Id.*

> (A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and (C) to respond to emerging threats to the stability of the United States financial system.[73]

12 U.S.C. § 5322(a)(2) provides a laundry list of duties that fall under FSOC's statutory authority, including: collecting information from regulatory agencies; monitoring the financial marketplace to identify potential threats to the financial stability of the country; monitoring financial regulatory proposals; making recommendations to primary financial regulatory agencies to apply new or heightened standards; and requiring supervision by the Federal Reserve Board of Governors for certain nonbank financial companies. Of these, the first few face little if any potential challenges as valid exercises pursuant to FSOC's statutorily granted regulatory authority. However, the designation of a nonbank financial company as systemically important and subject to regulation by the Federal Reserve Board of Governors and oversight by this new regulatory regime represent a shift in direction away from state-based insurance regulation depending on the facts used in making the designation.

Highlighting this new regulatory regime, during floor debate prior to passage, Senator Susan Collins of Maine queried Senator Christopher Dodd of Connecticut, one of the bill's namesakes, regarding the specialized designation of insurance companies, stating,

> While I can envision circumstances where a company engaged in the business of insurance

[73] *Id.* § 5322(1)(A)-(C).

> could be designated under section 113, I would not ordinarily expect insurance companies engaged in traditional insurance company activities to be designated by the council based on those activities alone. Rather, in considering a designation, I would expect the council to specifically take into account, among other risk factors, how the nature of insurance differs from that of other financial products, including how traditional insurance products differ from various off-balance-sheet and derivative contract exposures and how that different nature is reflected in the structure of traditional insurance companies.[74]

Responding to Senator Collins inquiry, Senator Dodd confirmed this.[75] When pressed further by Senator Collins, Senator Dodd explicitly stated, "[t]he size of a financial company should not by itself be determinative."[76]

To make a determination that a nonbank financial company is systemically important and should be subject to supervision by the Federal Reserve Board of Governors, two thirds of FSOC's members must vote in the affirmative, including the Chairperson.[77] If FSOC determines that the Federal Reserve Board of Governors will regulate a nonbank financial company, the company will also be subjected to higher prudential standards.[78] In making this determination, FSOC must consider: the company's leverage; off-balance-sheet exposure and interconnectedness to other large financial institutions; the importance of the company as a source of credit and liquidity;

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[74] 156 CONG. REC. S5870, 5902 (daily ed. July 15, 2010) (statement of Sen. Susan Collins).

[75] *Id.* (statement of Sen. Christopher Dodd). Senator Dodd stated: "[t]he Senator is correct. The council must consider a number of factors . . . ." *Id.*

[76] *Id.*

[77] 12 U.S.C. § 5323(a)(1) (voting for designating U.S. nonbank financial companies); *id.* § 5323(b)(1) (voting for designating foreign nonbank financial companies).

[78] *Id.* § 5323(a)(1) (subjecting U.S. nonbank financial companies); *id.* § 5323(b)(1) (subjecting foreign nonbank financial companies).

the extent to which the company manages, rather than owns, assets; the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company; the degree to which the company is already regulated; the amount and nature of the financial assets of the company; the company's liabilities; and any other risk factors the Council deems appropriate.[79] One factor stands out from the rest: while almost all involve the operations or financial management of the company, any determination must also take into account "the degree to which the company is already regulated by 1 or more primary financial regulatory agenc[y]."[80]

Almost three years after the enactment of the Dodd-Frank Act, the Federal Reserve System adopted final rules defining "predominantly engaged in financial activities," "significant nonbank financial company," and "significant bank holding company."[81] Specifically, the regulations defined companies as "predominantly engaged in financial activities" when (1) the consolidated annual gross financial revenues or assets of the company in either of the two most recent fiscal years represented eight-five percent or more of its consolidated gross revenues or assets, respectively; or (2) if FSOC determines based on facts and circumstances that the consolidated annual gross financial revenues or assets of the company in either of the two most recent fiscal years represented eighty-five percent or more of its consolidated gross revenues or assets, respectively.[82] Furthermore, the regulations define a "significant nonbank financial company" as "[a]ny nonbank financial company supervised by the Board . . . "[83] thus allowing FSOC to rely on

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[79] Frank A. Mayer, III, *Client Alert: The Dodd-Frank Act and the Insurance Industry*, PEPPER HAMILTON, LLP (Mar. 10, 2011), http://www.pepperlaw.com/publications_update.aspx?ArticleKey=2036 (citing 12 U.S.C. § 5323(a)(2)).

[80] 12 U.S.C. § 5323(a)(2)(H). The equivalent applicable provision for foreign nonbank financial companies is "the extent to which the company is subject to prudential standards on a consolidated basis in its home country that are administered and enforced by a comparable foreign supervisory authority." *Id.* § 5323(b)(2)(H).

[81] 12 C.F.R. §§ 242.3-4 (2013).

[82] *Id.* § 242.3.

[83] *Id.* § 242.4.

the definition of "predominantly engaged" in 12 C.F.R. § 242.3, which focused on aggregate size of a company and its activities, rather than distinguishing between traditional insurance activities and activities that may be viewed as more related to traditional banking. As a result, a bank-centric model of regulation would now be applied to insurance company activities.[84]

IV. THE DESIGNATION PROCESS BEGINS

A. AIG'S DESIGNATION JUSTIFIED

On July 8, 2013, FSOC designated both AIG and General Electric Capital Corporation as significant nonbank financial companies.[85] Neither challenged the designation as permitted by statute.[86] Prior to this, AIG was described as "resigned to the

[84] AM. COUNCIL OF LIFE INSURERS, IMPACT OF DODD-FRANK ACT ON U.S. LIFE INSURERS 1 (2011), *available at* https://www.acli.com/Issues/Documents/48692d7e4e194c47b690801d4741c51dImpactofDoddFrankonLifeInsurers.pdf.

> [T]he final legislation reflects a bank-centered approach to regulation that does not always mesh well with the life insurance industry, our existing state regulatory structure, and the way we address consumer needs. The legislation left several important life insurance industry issues to be addressed through a formal rulemaking process that spans 13 different federal agencies with more than 150 directives.

Id.

[85] *Financial Stability Oversight Council: Designations*, U.S. DEPT. OF TREASURY, http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx#nonbank (last visited Feb. 1, 2015).

[86] FIN. STABILITY OVERSIGHT COUNCIL, U.S. DEP'T OF TREASURY, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING AMERICAN INTERNATIONAL GROUP, INC. 1 (2013), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf [hereinafter FIN. STABILITY OVERSIGHT COUNCIL, AIG DETERMINATION]; FIN. STABILITY OVERSIGHT COUNCIL, U.S. DEP'T OF TREASURY, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING GENERAL ELECTRIC CAPITAL CORPORATION, INC, 1 (2013), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20General%20Electric%20Capit

designation" while other companies were opposed to it at varying levels.[87] In response to the designations, NAIC CEO, Senator Ben Nelson, stated "this designation is not unexpected given AIG's role in the financial crisis."[88] However, at that same time, Senator Nelson cast doubt on the process as he continued, "the reasoning offered by [the] FSOC to justify the designation suggests a misunderstanding of the insurance business model and regulation of insurance" highlighting that elements of FSOC's rationale focused on either AIG's insurance activities or theorized potential scenarios where there would be a run on the insurance products.[89]

In coming to the designation, some of the items that FSOC focused on were: rapid liquidation of life insurance and annuity liabilities; the number of policies held by the company; and a cursory view of its existing regulatory structure.[90] While the designation notice spoke in broad terms about many of AIG's

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al%20Corporation,%20Inc.pdf. FSOC is required to provide written notice to a financial institution of a proposed designation as a nonbank financial company. 12 U.S.C. § 5323(e) (2013); 12 C.F.R. § 1310.21(b) (2012). The statute also permits an institution that is proposed for designation as a nonbank financial company to request a hearing no later than thirty days after the date of the proposed designation for a written or oral hearing. 12 U.S.C. § 5323(e)(2); 12 C.F.R. § 1310.21(c)(1). Subsequently, FSOC will schedule such a hearing within thirty days of receipt of the request. 12 U.S.C. § 5323(e)(2); 12 C.F.R. § 1310.21(c)(2). Finally, FSOC must make a final determination regarding the designation of a nonbank financial company within sixty days of the appeal hearing. 12 U.S.C. § 5323(e)(3); 12 C.F.R. § 1310.21(d). As a final recourse, a designated nonbank financial company may bring an action no later than thirty days of receipt of the final determination as a nonbank financial company in the United States district court for the judicial district of the home office of the company or in the United States District Court for the District of Columbia. 12 U.S.C. § 5323(h).

[87] Zachary Warmbrodt, *Rest of Insurance Industry: We're Not AIG!*, POLITICO (Apr. 17, 2013, 11:40 PM), http://www.politico.com/story/2013/04/rest-of-insurance-industry-were-not-aig-90249.html.

[88] Press Release, Senator Ben Nelson, NAIC CEO Reacts to AIG Designation as Systemic (July 11, 2013), *available at* http://www.naic.org/fsoc_statment_nelson_aig_designation_130711.htm.

[89] *Id.*

[90] FIN. STABILITY OVERSIGHT COUNCIL, AIG DETERMINATION, *supra* note 86, at 2.

products being long-term liabilities as life insurance or annuity products, it casually mentioned that they have features that could make them vulnerable to rapid and early withdrawals by policyholders, indicating that if financial distress were severe enough, funds would be withdrawn regardless of associated surrender charges or tax penalties.[91] This reflects Senator Nelson's description of an unlikely bank run-type of event occurring at a life insurer. Furthermore, the reliance on the size of the company would run counter to the legislative intentions of the law's sponsor.[92] Finally, when considering the existing supervisory and regulatory structure as required by 12 U.S.C. § 5323(a)(2)(h), FSOC highlights that each of the insurance businesses are currently regulated at the state level,[93] while their banking activities were previously subject to federal regulation by the Office of Thrift Supervision[94] and was already subject to regulation by the Federal Reserve Board.[95] Essentially, as part of the determination, FSOC disregarded the existing state insurance regulatory model, while relying on the previously failed federal banking model, which it was responsible for overseeing, in justifying part of AIG's determination as a significant nonbank financial company. While this note does not question FSOC's determination of AIG as a nonbank financial company (in fact it did operate as more of a bank based

[91] *Id.*

[92] 156 CONG. REC. S5870, 5902 (daily ed. July 15, 2010) (statement of Sen. Christopher Dodd).

[93] FIN. STABILITY OVERSIGHT COUNCIL, AIG DETERMINATION, *supra* note 86, at 9. AIG is incorporated in Delaware; however, each of its insurance businesses has a differing primary regulator: the Texas Department of Insurance regulates its life insurance and annuity products line of business; the North Carolina Department of Insurance regulates its private mortgage insurance business; and the Pennsylvania Insurance Department and New York Department of Financial Services both regulate its property & casualty insurance lines of business. *Id.*

[94] 12 U.S.C. § 5413 (2012).

[95] FIN. STABILITY OVERSIGHT COUNCIL, AIG DETERMINATION, *supra* note 86, at 9. The functions overseen by the Office of Thrift Supervision as a savings and loan holding company had been transferred to the Federal Reserve Board as a result of the enactment of 12 U.S.C. § 5412 (2012), part of the Dodd-Frank Act. *Id.*

on its incorporation as a savings and loan holding company and the vast array of products it sold), it is important to highlight FSOC's rationale for making that designation. In addition to ignoring the regulatory structure that existed at the time of the financial collapse as well as what existed at the time of determination, FSOC also applied standards to insurance products that do not operate in the same manner that demand deposit banking does.[96]

Additionally, the designation ignores the role state insurance regulators play in identifying solvency issues early and instituting prompt corrective actions, thus minimizing both insolvencies, as well as liabilities not paid to policyholders,[97] compared to the situation of a bank run, where depositors can lose large amounts that are not covered by the Federal Deposit Insurance Corporation (FDIC). The insurance equivalents of the FDIC are the various insurance guaranty funds that are state-operated, to mirror the existing structure of insurance regulation. Depending on the jurisdiction, insurance companies pay a certain amount into the guaranty fund annually based on

[96] *Insurance Oversight and Legislative Proposals: Before the House Fin. Servs. Subcomm. on Ins., Housing and Cmty. Opportunity,* 112th Cong. 9 (2011) (statement of the National Organization of Life and Health Insurance Guaranty Associations) *available at* http://www.nolhga.com/pressroom/articles/HFSCnolhgaTestimonyNov15_2011.pdf [hereinafter *Insurance Oversight*]. The hearing highlighted that:

> [T]he liabilities of a troubled insurance company do not all come due on the date that an insurer enters liquidation; for a typical insurer, many or most of its liabilities will not come due until years, decades, or even generations after the company fails. For that reason, much less liquidity is required to meet the covered liabilities of a failing insurer than in the case of, for example, an FDIC-insured bank, whose consumer liabilities primarily consist of deposits contractually available to the consumer on demand.

Id.; *see also* Editorial, *MetLife's Too-Big-to-Fail Fight: The Insurer Rejects Becoming Part of the Financial Bailout Net,* WALL ST. J., Sept. 6, 2014, at A14.

[97] *Insurance Oversight, supra* note 96, at 10; *see also* Letter from Benjamin M. Lawsky, Superintendent of N.Y. State Dep't of Fin. Servs., to the Hon. Jacob Lew, Sec. of the U.S. Dep't. of Treasury (July 30, 2014), *available at* http://www.dfs.ny.gov/about/press2014/pr140730-MetLife-FSOC-letter.pdf (describing the differences between insurance and banking regulations, solvency concerns, and how liabilities develop).

the size of their book of business. This amount is accumulated usually through a surcharge on each policy. In the event of an insolvency, the guaranty fund will cover exposed liabilities following a run-off.[98] This is comparable to the FDIC charging various insurance rates on banks based on their financial conditions, which are not directly passed on to depositors; rather the insurance amounts reduce the bank's operating profits (or increase its losses in certain cases). Thus, any insurance insolvencies can be both addressed and limited to an individual state jurisdiction, rather than represent a systemic risk. However, none of these issues could be addressed at the time as AIG has foregone any of the appeal processes permitted by the Dodd-Frank Act. It would require another designation to delve deeper into the process.

B. FSOC'S DESIGNATION OF PRUDENTIAL FINANCIAL, INC. AS A NONBANK FINANCIAL COMPANY: UNNECESSARY AND INCORRECT

The next designation would come just more than two months later when FSOC proposed Prudential Financial, Inc. for designation as a significant nonbank financial company.[99] In fact, Prudential had been notified of the proposed designation earlier in the summer; however, it decided to request an oral and written hearing within thirty days of notice as permitted by law.[100] FSOC's regulations permitted Prudential an opportunity to submit:

> [M]aterials concerning whether, in the nonbank financial company's view, material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration,

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[98] AM. COUNCIL OF LIFE INSURERS, *supra* note 84, at 2.

[99] FIN. STABILITY OVERSIGHT COUNCIL, U.S. DEPT. OF TREASURY, BASIS OF THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING PRUDENTIAL FINANCIAL, INC. 1 (2013), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf [hereinafter FIN. STABILITY OVERSIGHT COUNCIL, PRUDENTIAL DESIGNATION].

[100] 12 U.S.C. § 5323(e)(2) (2012); 12 C.F.R. § 1310.21(c)(2) (2013).

> interconnectedness, or mix of the activities of the nonbank financial company, could pose a threat to the financial stability of the United States.[101]

This language focuses primarily on the size of the company, rather than its existing regulatory framework, one of the statutory requirements. In guidance documents published in conjunction with the adoption of rules in 2012, FSOC acknowledged that it effectively consolidated the eleven statutory criteria into six regulatory categories: size; interconnectedness; substitutability; leverage; liquidity risk and maturity mismatch; and existing regulatory scrutiny.[102] Of these, size and interconnectedness were applied to six statutory considerations, while substitutability was applied to four statutory considerations; leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny were each applied to only one statutory consideration.[103]

Subsequent to the hearings, FSOC voted 7-2 to uphold the designation of Prudential as a nonbank financial company.[104] The following analyzes and critiques the factors publically disclosed by FSOC in its determination of Prudential as a significant nonbank financial company.

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[101] 12 C.F.R. §§ 1310.21(a)(2)-(c)(2) (describing the permitted submissions by a company prior to FSOC a proposed determination as well as holding an evidentiary hearing, respectively).

[102] 12 C.F.R. pt. 1310 app. A(II)(d)(1).

[103] *Id.* Further review of FSOC's description of size and interconnectedness specifically demonstrate a relationship between these two criteria for designation, effectively creating five regulatory categories and placing even more reliance on them than the other categories. *Id.*

[104] FIN. OVERSIGHT STABILITY COUNCIL, U.S. DEPT. OF TREASURY, RESOLUTION APPROVING FINAL DETERMINATION REGARDING PRUDENTIAL FINANCIAL, INC. 1 (2013), *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf [hereinafter FIN. STABILITY OVERSIGHT COUNCIL, RESOLUTION APPROVING].

V. PROBLEMS IN THE DESIGNATION PROCESS

A. DODD-FRANK REQUIRES ANY DESIGNATION TO BE CONTINGENT ON THE STATUTORY FRAMEWORK WHILE FSOC'S DETERMINATION RELIES ON SIZE DISPROPORTIONATELY

Similar to AIG's designation as a significant nonbank financial company, FSOC relied on making a similar determination for Prudential when it noted that more than eighty-five percent of Prudential's assets are related to activities that are financial in nature,[105] while not classifying each type of asset as either a banking asset or an insurance asset. FSOC designated Prudential as a significant nonbank financial company subject to enhanced prudential standards using the First Determination Standard.[106] This standard is based on whether the material financial distress of the company could pose a threat to the financial stability of the country.[107] Material financial distress exists when a nonbank financial company is in imminent danger of insolvency or defaulting on its financial obligations and is calculated in the context of a period of overall stress in the financial services industry and in a weak macroeconomic environment.[108] In simpler terms, any large financial services company could qualify under this broad standard, which was contrary to legislative intent.[109]

Throughout much of FSOC's final determination of Prudential, there are numerous references to the company's size

[105] FIN. STABILITY OVERSIGHT COUNCIL, PRUDENTIAL DESIGNATION, *supra* note 99, at 5.

[106] *Id.*

[107] *Id.*

[108] 12 C.F.R. pt. 1310 app. A(II)(b). FSOC did state that the final determination was not a conclusion that Prudential was experiencing financial distress. FIN. STABILITY OVERSIGHT COUNCIL, PRUDENTIAL DESIGNATION, *supra* note 99, at 1.

[109] 156 CONG. REC. S5870, 5902 (daily ed. July 15, 2010) (statement of Sen. Susan Collins).

or role in the financial services market.[110] Similarly, FSOC focused on the overall size of the company when addressing the potential sale of blocks of business if necessary to limit harm resulting from material financial distress.[111] Specifically, FSOC noted that "selling sizable business lines could be difficult" and that it could be complicated "in light of Prudential's size."[112]

Finally, as described earlier, regulations consolidated the eleven areas of review set forth by statute to six regulatory categories, particularly focusing on size by applying it to six of the eleven statutory considerations, and thus appear designed to subvert the statutory intent.[113]

B. FSOC Dismissed the Existing State Regulatory Structure Contrary to Legislative Intent

FSOC's determination of Prudential handled the review of existing supervision and regulatory oversight of the company in a far different manner than AIG's previous determination. Where AIG's determination acknowledged the various state insurance regulatory agencies, Prudential's determinations named none of its primary regulators in the proposed designation (it did note New Jersey and Connecticut in a footnote while not acknowledging Arizona).[114] Additionally, while the statute requires that FSOC consult with a company's primary financial regulator before the council makes any determination,[115] in the adoption of the regulations FSOC does

[110] Fin. Stability Oversight Council, Prudential Designation, *supra* note 99, at 2. "Prudential is one of the largest financial services companies in the United States." *Id.* "It is a market leader in providing a wide array of financial services." *Id.* "Prudential is among the largest U.S. insurance companies." *Id.* "Prudential plays a leading role in the annuity, retirement, asset management, and commercial mortgage servicing markets." *Id.* at 3.

[111] *Id.* at 4.

[112] *Id.*

[113] *See supra* notes 102-03.

[114] Fin. Stability Oversight Council, Prudential Designation, *supra* note 99, at 11.

[115] 12 U.S.C. § 113(g) (codified at 12 U.S.C. § 5323(g) (2012)); 12 C.F.R. § 1310.20(c).

not describe the "shall" as obligatory, but rather permissive in nature; contravening the explicit statutory requirement of consultation.[116]

Additionally, the designation of Prudential explicitly dismissed supervisory colleges held between an insurance company's lead regulators.[117] The International Association of Insurance Supervisors describes supervisory colleges as:

> [A] forum for cooperation and communication between the involved supervisors established for the fundamental purpose of facilitating the effectiveness of supervision of entities which belong to an insurance group; facilitating both the supervision of the group as a whole on a group-wide basis and improving the legal entity supervision of the entities within the insurance group.[118]

Supervisory colleges are organized by "lead states," those that are an insurance company's primary regulator. Other state insurance departments, which also may regulate the insurance company, take part in an exchange of information relating to the regulation of the company, thus permitting regulators a more

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[116] 12 C.F.R. pt. 1310; Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637, 21646 (Apr. 11, 2012).

[117] FIN. STABILITY OVERSIGHT COUNCIL, PRUDENTIAL DESIGNATION, *supra* note 99, at 11. Stating that:

> Supervisory colleges are a tool available to state regulators concerning group supervision, but they do not provide regulators with the same authorities to which nonbank financial companies would be subject if the Council determines that such nonbank financial companies shall be subject to supervision by the Board of Governors including consolidated, enterprise wide supervision.

Id.

[118] *Supervisory Colleges*, NAT'L ASSOCIATION OF INS. COMMISSIONERS, http://www.naic.org/cipr_topics/topic_supervisory_college.htm (last updated Nov. 25, 2014).

comprehensive picture of the company's activities.[119] Arguably, it was the exchange of information between the more highly regulated state insurance commissioners that prevented many of the banking issues that arose with AIG from affecting its insurance business at the height of the global financial crisis; and yet, FSOC was dismissing these apparently successful regulatory activities in favor of a new, untested regulatory regime, counter to the legislative intent of what a state insurance regulator's role is.[120]

Importantly, FSOC did not consider the existing statutes and regulations in Prudential's lead regulatory states. These statutes and regulations "wall off" assets from the various subsidiaries that insulate the losses of one subsidiary from another.[121] For example, state laws already require insurance companies to comply with state risk-based capital requirements,[122] counterparty limits,[123] and state administered rehabilitation.[124] Standards for risk-based capital are probably the most important of these, as these standards function as the minimum reserve requirements that insurers must maintain, directly addressing the ability to pay claims, even on an expedited timeframe as discussed next.

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[119] *Id.*

[120] 156 CONG. REC. S5832, 5832 (daily ed. July 14, 2010) (statement of Sen. Dodd). Senator Dodd stated that:

> one of the highlights of the bill is that we have far more than just one set of eyes now looking . . . including state regulators who I think can bring valuable contribution to the oversight responsibilities when it comes to determining whether institutions . . . endanger our financial system.

Id.

[121] *See* Letter from Nat'l Ass'n of Ins. Comm'rs to Conference on Fin. Regulatory Reform Legislation, *supra* note 45.

[122] ARIZ. REV. STAT. ANN. § 20-488.01(B) (2013); CONN. INS. REG. § 38a-72-2(a) (2013); N.J. ADMIN. CODE § 11:2-39.3(a) (2013).

[123] ARIZ. REV. STAT. ANN. §§ 20-531 to -562; CONN. GEN. STAT. §§ 38a-102-102i; N.J. STAT. ANN. §§ 17:240-1 to -36, 17B:20-1 to -8 (West 2013).

[124] ARIZ. REV. STAT. ANN. § 20-169; CONN. GEN. STAT. § 38a-962b(a): N.J. STAT. ANN. § 17:51A-3(a)(1).

C. FSOC APPLIED BANK CENTRIC STANDARDS

Also differing from AIG's determination was the fact that as a result of a vote, dissenting members of the council had an ability to provide insight into the reasoning for upholding the designation of Prudential as a nonbank financial company. Director of the Missouri Department of Insurance, John Huff, is the non-voting state insurance commissioner representative on FSOC pursuant to 12 U.S.C. § 5321(b)(2).[125] Although Director Huff is a non-voting member of FSOC, non-voting members are not excluded from any of the proceedings, meetings, discussions, or deliberations of FSOC except in limited circumstances when confidential supervisory information is considered.[126] As such, Director Huff had insight into the thought process that led to Prudential's designation as a nonbank financial company.

In Director Huff's view, the basis of the designation focuses on the liquidation of assets such as life insurance policies and annuity products. He points out that the bank-centric analysis contained in the basis of the designation equated these types of financial products to having similar withdrawal rights that demand deposits do.[127] Director Huff lays out the deficiencies in these arguments, pointing out that consumers do not view life insurance policies as "checking accounts, or even as typical investment products" and that this is the result of "the protection insurance provides."[128] Similarly, the dissent of Roy Woodall, the independent member knowledgeable about insurance, one of the voting members of FSOC, echoes Director Huff's dissent. The only manner in which Prudential could represent a systemic risk to the financial sector would be "the simultaneous failure of all of Prudential's insurance subsidiaries and a massive and unprecedented lightning bank-style run by a

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[125] *Dodd-Frank Financial Services Regulatory Reform: NAIC Initiatives*, NAT'L ASSOCIATION OF INS. COMMISSIONERS, http://www.naic.org/index_financial_reform_fsoc.htm (last visited Feb. 1, 2015).

[126] 12 U.S.C. § 5321(b)(3) (2012).

[127] FIN. STABILITY OVERSIGHT COUNCIL, RESOLUTION APPROVING, *supra* note 104, at 1 (Director Huff, dissenting).

[128] *Id.*

significant number of its cash value policyholders and separate account holders."[129]

Director Huff highlighted the apparent disregard for the current state-based insurance regulatory model as well; one that had proven successful time and time again, including its ability to work cooperatively across jurisdictional boundaries.[130] Additionally, Director Huff's comments regarding the mischaracterization of regulatory tools, including ring-fencing of troubled entities by state insurance regulators,[131] provided insight into a review process that seemed preordained from the start.

Prudential's policy for determining the best estimate of derivatives, including credit default swaps,[132] is to use mid-market pricing. The fair values of most over-the-counter derivatives, including credit default swaps and to-be-announced forward contracts on highly rated mortgage-backed securities issued by U.S. government sponsored entities, are determined using discounted cash flow models.[133] While the items are not accounted for individually, they are included in the general accounting of Prudential's portfolio.[134] According to Prudential's 2012 Annual Report, the company held total investments in the amount of $337.662 billion as of December 31, 2012.[135] Of this, only a maximum $8.091 billion potentially

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[129] FIN. STABILITY OVERSIGHT COUNCIL, RESOLUTION APPROVING, *supra* note 104, at 4 (Woodall, dissenting).

[130] FIN. STABILITY OVERSIGHT COUNCIL, RESOLUTION APPROVING, *supra* note 104, at 3 (Director Huff, dissenting). "Some of the statements and arguments in the basis suggest a lack of appreciation of the operation of the state-based regulatory, particularly its resolution process . . . . Insurance regulators have a history of working together in judicially overseen and orderly resolutions." *Id.*

[131] *Id.*

[132] FIN. CRISIS INQUIRY COMM'N, *supra* note 9, at 50, 140

[133] PRUDENTIAL FIN., INC., 2012 ANNUAL REPORT 186 (2013) *available at* http://www3.prudential.com/annualreport/report2013/annual/images/Prudential-AR2012.pdf.

[134] *Id.* at 185. Prudential records derivatives at fair value either as assets, within "other trading account assets," or "other long-term investments," or as liabilities, within "other liabilities." *Id.*

[135] *Id.* at 64.

includes investments in derivatives.[136] This amounts to approximately 2.4 percent of total investments. If one includes invested assets of other entities and operations, accounting for an additional $6.928 billion in investments, the total percentage of Prudential's investments which are either potentially related to derivatives or tied to other systemically important institutions or nonbank financial companies is only 4.4 percent.[137] Most of Prudential's liabilities are based on payouts that accrue through either premium payments or investments, which are tracked as assets. Any liabilities are either related to "future policy benefits," which are related to guaranteed living conditions that cannot be precisely estimated prior to payout, or "other liabilities," which primarily includes derivatives.[138] While the $1.496 billion in other liabilities, or derivatives, accounts for approximately 30.9 percent of Prudential's liabilities,[139] it represents only 0.44 percent when compared against the company's total investments.[140] When these figures are analyzed, one can see that the potential exposure of even the previously unregulated derivatives market represents a small fraction of the company's total exposure, even far smaller than AIGFG's exposures.[141] It is this reason why reliance on total size and bank-centric asset drawdown models fails in assessing how life insurance companies would weather another financial crisis.

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[136] *Id.* This is calculated by finding the sum of "other trading account assets, at fair value" and "other long-term investments." *Id.*

[137] PRUDENTIAL FIN., INC., *supra* note 133, at 64. I have included invested assets of other entities and operations as one of the considerations FSOC must consider in making a determination of a nonbank financial company is the extent and nature of transactions and relationships with other significant nonbank financial companies. 12 U.S.C. § 5323(a)(2)(C). For the purposes of this note, I will focus solely on the extent, rather than the nature of the investments, which are more particular than can be addressed in this work.

[138] PRUDENTIAL FIN., INC., *supra* note 133, at 52.

[139] *Id.*

[140] *Id.* at 52, 64.

[141] *See supra* notes 34-35 and accompanying text.

VI. CHALLENGES: ONE PASSED OPPORTUNITY AND ANOTHER IMMINENT OPPORTUNITY

A. WHILE PRUDENTIAL DID NOT CHALLENGE FSOC'S DETERMINATION IN A JUDICIAL ARENA, FUTURE DESIGNATIONS MAY: THE THRESHOLDS THAT MUST BE MET IN DOING SO

Judicial review of a final determination by FSOC is "limited to whether the final determination made under this section was arbitrary and capricious."[142] This language refers to the federal Administrative Procedures Act (APA), which provides that when a court reviews the legality of an administrative agency's action or rulemaking, "[t]he reviewing court shall (1) compel agency action unlawfully withheld or unreasonably delayed; and (2) hold unlawful and set aside agency action, findings, and conclusions found to be (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law . . . ."[143] Because most federal rulemaking agencies are located in Washington, D.C., almost all legal challenges to administrative actions under the APA are filed in the District Court of D.C.[144] The United States Supreme Court has explained that the reviewing court must examine whether the "the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[145] The Court has further stated, "[i]n reviewing that explanation, we must 'consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of

[142] 12 U.S.C. § 113(h) (2012).

[143] 5 U.S.C. § 706(1)-(2)(A) (2012).

[144] Lawrence D. Rosenberg & Richard M. Re, *Basic Legal Doctrines Frequently Arising in the D.C. Circuit*, ABA, http://www.americanbar.org/content/dam/aba/administrative/litigation/materials/sac_2012/34-basic_legal_doctrines.authcheckdam.pdf (last visited Feb. 1, 2015).

[145] Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983) (citing Burlington Truck Lines, Inc. v. United States, 371 U.S. 156, 168 (1962)).

judgment.'"[146] In *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, the Court found that National Highway Traffic Safety Administration's rescission of rules requiring passive restraint systems was undertaken without adequate bases or explanation, even when the government could no longer find that the requirement would produce significant safety results.[147]

While 12 U.S.C. § 113(h) expressly limits judicial review to whether a final determination is arbitrary and capricious, a potential challenge could still attack the regulations based on a theory of statutory review. Approaching a challenge in such a way would invoke the "*Chevron* doctrine," which evaluates whether the agency action is within the scope of regulation delegated to the agency by Congress.[148] A challenge would need to be based on an analysis of whether "the agency's answer is based on a permissible construction of the statute."[149] In this instance, the challenge to the designation would be based upon FSOC's rulemaking in accordance with congressional direction. In mounting such a challenge, a nonbank financial company designated by FSOC as significant would have to first address whether Congress has spoken to the question at issue, in this instance whether FSOC can designate a nonbank financial company based solely on the aggregate amount of assets held by the group level company.

As previously described, the regulations focus almost entirely on the size of a company and hypothetical or conceptual models that project a potential asset drawdown. This lack of limits would permit designation and subsequent application of these

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[146] *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43 (citing Bowman Transp., Inc. v. Arkansas-Best Freight Sys., Inc., 419 U.S. 281, 285 (1974)).

[147] *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 34.

[148] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 842-43 (1984). In *Chevron*, the Supreme Court laid out a two prong-test for reviewing an agencies' construction of a statute that it administers. *Id.* The first step is whether "Congress has directly spoken to the precise question at issue. *Id.* at 842. If the intent of Congress is clear, that is the end of the matter." *Id.* Subsequently if "the court determines Congress has not directly addressed the precise question at issue," or "the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute." *Id.* at 843.

[149] *Id.* at 843.

bank-centric regulations to any large insurance company based solely on the size of the company. Factors and models such as these fall outside the scope of permissible agency rulemaking since they have "no basis beyond mere speculation."[150] Any determination must be based on a "valid model,"[151] which FSOC would have the burden of demonstrating and to date has not yet done so.

In *Bus. Roundtable v. S.E.C.*, the Securities and Exchange Commission (SEC) adopted a rule that could "create potential benefits of improved board and company performance," related to permitting shareholder nominees to be elected to companies' boards.[152] At the time of adoption, two commissioners voted against the proposal, faulting the theoretical and empirical grounds.[153] The court pointed out that the SEC has a unique obligation to consider the effects of a new rule upon capital formation.[154] Similarly, in *Oceana, Inc. v. Evans*, while the court granted summary judgment in favor of the Secretary, it did find that the fishery management plan violated certain statutory provisions because it gave complete discretion to the Regional Administrator.[155] Of note, while the guidance relied on a goal, it did not focus on the methodology.[156] Although no company has challenged a designation as a significant nonbank financial company in federal court to date, there appears to be adequate case law to justify challenging a designation by FSOC.

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[150] Bus. Roundtable v. S.E.C., 647 F.3d 1144, 1150 (D.C. Cir. 2011).

[151] Oceana, Inc. v. Evans, 384 F. Supp. 2d 203, 221 (D.D.C. 2005).

[152] *Bus. Roundtable*, 647 F.3d at 1148.

[153] *Id.*

[154] *Id.*

[155] *Oceana*, 384 F. Supp. at 221.

[156] *Id.* at 234.

B. THE NEXT POTENTIAL CHALLENGE TO DESIGNATION AS A NONBANK FINANCIAL COMPANY SHOULD RELY ON SIMILAR ARGUMENTS TO BE SUCCESSFUL

While Prudential chose not to challenge FSOC's final determination of it as a significant nonbank financial company, it is anticipated that more insurance companies will be proposed for this designation by FSOC in the future, most notably MetLife.[157] MetLife acknowledged the possibility of being named a nonbank systemically important financial institution.[158] At

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[157] Jessica Meek, *Federal Insurance Oversight is Wrong Move, Connecticut Regulator Says*, RISK.NET (Mar. 14, 2014), http://www.risk.net/operational-risk-and-regulation/profile/2333565/federal-insurance-oversight-is-the-wrong-move-connecticut-regulator-says. Additionally, an argument can be made that Prudential may one day again challenge the designation. The Dodd-Frank Act provides that:

> The Council shall not less frequently than annually, reevaluate each determination made . . . with respect to such nonbank financial company supervised by the Board of Governors; and rescind any such determination, if the Council . . . determines that the nonbank financial company no longer meets the standards.

12 U.S.C. § 5323(d) (2012). While the statute does not explicitly permit a court challenge to appeal the continued designation as is provided for in the initial designation process, one can justify such a process. If FSOC were to repeatedly deny an insurance company's annual reevaluation, even if the company can demonstrate that the material financial distress posed by the company had diminished, changed or been eliminated, one would be hard pressed to justify the exclusion of a similar appeal mechanism. Without any such appeal process, one could argue that if FSOC never rescinded a designation, that their review was simply pro forma and effectively had become arbitrary and capricious.

[158] METLIFE, INC., 2012 ANNUAL REPORT iv (2013). Just prior to publication of this note, FSOC made a final determination that material financial distress at MetLife could pose a threat to the United States' financial stability and is subjecting MetLife to enhanced prudential standards under the supervision of the Federal Reserve Board of Governors. FIN. STABILITY OVERSIGHT COUNCIL, U.S. DEP'T OF TREASURY, BASIS FOR THE FINANCIAL STABILITY OVERSIGHT COUNCIL'S FINAL DETERMINATION REGARDING METLIFE, INC. 2 (2014), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf [hereinafter FIN. STABILITY OVERSIGHT COUNCIL, METLIFE DETERMINATION]. Notably, the designation was described by one of the voting members of FSOC as "anticipated and expected," seemingly indicating the foregone nature of it. FIN. STABILITY OVERSIGHT COUNCIL, U.S. DEP'T OF

that time, MetLife indicated that such a designation on any life insurance company, not just itself, was unnecessary due to the existing state-based regulatory structure.[159] Rather, MetLife advocated that a "more sensible approach would be to identify and regulate those activities that fueled the financial crisis in the first place."[160] At the same time, MetLife advocated that, if designation of it as a nonbank financial company were to occur, the final prudential rules be tailored to reflect the differences between life insurance companies and banks, pointing out that a bank-centric regulatory regime would limit capital and have a variety of potential results.[161] Despite the arguments in favor of not treating insurance companies the same as banks, on September 4, 2014 FSOC voted to propose labeling MetLife as a systemically important nonbank financial company.[162]

MetLife is not just a large life insurance company, as Prudential is; MetLife is the largest life insurance company in the United States.[163] As such, any legal challenge would mirror the approach laid out previously. MetLife's insurance business is

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TREASURY, VIEWS OF THE COUNCIL'S INDEPENDENT MEMBER HAVING INSURANCE EXPERTISE 3 (2014), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.

[159] *Id.*

[160] *Id.*

[161] *Id.*

[162] Victoria McGrane & Leslie Scism, *MetLife is Closer to 'Systemically Important' Tag After Vote*, WALL ST. J., Sept. 4, 2014, http://online.wsj.com/articles/fsoc-proposes-naming-metlife-systemically-important-1409862057. While FSOC did not publicly disclose the rationale of the proposed designation or what company being discussed, MetLife issued a statement later that day disagreeing with the action and indicating that it was "not ruling out any of the available remedies under Dodd-Frank to contest the SIFI designation." *Id.* As was the case in FSOC's designation of Prudential as systematically important financial institution, MetLife was evaluated using the First Determination Standard. FIN. STABILITY OVERSIGHT COUNCIL, METLIFE DETERMINATION, *supra* note 158, at 4.

[163] AM. COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 96 (2013), *available at* https://www.acli.com/Tools/Industry%20Facts/Life%20Insurers%20Fact%20Book/Pages/RP13-005.aspx.

primarily undertaken by five state-based subsidiaries.[164] The same Connecticut statutes and regulations that apply to Prudential (e.g., risk based capital reserves, counterparty limits and state administered rehabilitation, to name a few) also apply to MetLife Insurance Company of Connecticut and thus demonstrate specialized insurance regulation at the state level along with similar statutes in other states.[165] Similarly, subsidiaries in the other states would also be subject to their respective domiciliary states' laws.[166] This is in addition to the basic regulatory framework described earlier including supervisory colleges.

As a life insurance company, MetLife's asset and investment types are similar to Prudential's, thus providing an analogous challenge to usage of bank-centric capital reserve requirements and asset drawdown in the event of a financial collapse. In the case of MetLife, it has total assets of approximately $836.781 trillion and liabilities of $771.823 trillion.[167] Similar to

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[164] METLIFE, INC., *supra* note 158, at 176. The five subsidiaries are: Metropolitan Life Insurance Company; American Life Insurance Company; MetLife Insurance Company of Connecticut; Metropolitan Property and Casualty Insurance Company; and Metropolitan Tower Life Insurance Company, domiciled in New York, Delaware, Connecticut, Rhode Island and Delaware, respectively. *Id.*

[165] *See supra* notes 121-23.

[166] FSOC spent substantially more time discussing the existing state regulatory structure than it had in previous designations; however, it again focused not on the successful history of state-based regulation, but on the "size, scope, and complexity of MetLife's insurance subsidiaries" in dismissing existing regulatory structure. FIN. STABILITY OVERSIGHT COUNCIL, METLIFE DETERMINATION, *supra* note 158, at 27. Adam Hamm, Insurance Commissioner of North Dakota, and the current state insurance commissioner representative to FSOC, noted that "the Basis failed to acknowledge that most, if not all, of the concerns it identifies . . . are addressed by existing regulatory structure." FIN. STABILITY OVERSIGHT COUNCIL, U.S. DEP'T OF TREASURY, VIEW OF ADAM HAMM, THE STATE INSURANCE COMMISSIONER REPRESENTATIVE 8 (2014), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting %20and%20Minority%20Views.pdf. Ironically, the determination did acknowledge that the bank holding company that required financial assistance was previously subject to regulation by the Federal Reserve Board of Governor's at the time of its accessing funds. FIN. STABILITY OVERSIGHT COUNCIL, METLIFE DESIGNATION, *supra* note 158, at 28.

[167] METLIFE, INC., *supra* note 158, at 77.

Prudential, it values over-the-counter derivatives[168] at either quoted market values or uses a market standard valuation methodology. In total, MetLife's derivative portfolio includes $5.247 billion in assets and $1.775 billion in liabilities, with short-term immediate liquidity of $24.1 billion available.[169] Finally, in 2012, derivate losses represented $1.919 trillion,[170] or 0.22 percent of total company assets and 0.24 percent of all liabilities. While federal regulators focus on these potential losses, they represent a mere fraction of the company's portfolio. Additionally, the New York Department of Financial Services and other state regulators subject these investments to review and surveillance, including subjecting any investments to restrictions on size, concentration limits, and counterparty creditworthiness.[171]

At first blush, one of the items the FSOC used to distinguish MetLife from Prudential was the reliance on federal funds during the deepest days of the financial crisis. FSOC noted that MetLife used several emergency federal government-sponsored facilities to borrow funds a number of times.[172] However, FSOC did not mention that the entity that accessed those funds, MetLife Bank, had subsequently been sold off by MetLife more than a year and a half prior to its determination that MetLife represented a nonbank financial company.[173] It almost appeared that FSOC chose to ignore that the company had appeared to learn what potential liabilities it had on its books and that it had already taken remedial steps to address them in

[168] *Id.* at 15.

[169] *Id.* at 54.

[170] *Id.* at 78.

[171] Letter from Benjamin M. Lawsky, Superintendent of N.Y. State Dep't of Fin. Servs., to the Hon. Jacob Lew, Sec. of the U.S. Dep't. of Treasury, *supra* note 97.

[172] FIN. STABILITY OVERSIGHT COUNCIL, METLIFE DESIGNATION, *supra* note 158, at 28.

[173] Press Release, MetLife, MetLife Completes Sale of MetLife Bank Deposit Business to GE Capital (Jan. 14, 2013), *available at* http://investor.metlife.com/phoenix.zhtml?c=121171&p=irol-newsArticle&ID=1773932.

its business model moving forward. In light of much of this, as well as subsequent actions of FSOC, MetLife had chosen to litigate the designation, as permitted pursuant to 12 U.S.C. § 53223(h).[174]

VII. AN AMENDED REGULATORY REGIME CAN BE INSTITUTED TO ADDRESS THE SHORTCOMINGS OF FSOC'S DESIGNATION PROCESS AS IT IS CURRENTLY DESIGNED

A. CAPITAL STANDARDS

Besides life insurance companies mounting a costly legal challenge to future potential designations as nonbank financial companies, the evolving regulatory structure could be amended to reflect the distinct differences between banks and life insurance companies. Federal regulators have already begun to acknowledge the difference in the business models between banks and life insurance companies. This represents an acknowledgement that the regulation of life insurance companies in response to a banking crisis may have been a legislative and regulatory overreaction. In 2013, then-Federal Reserve Chairman of the Board, Ben Bernanke, acknowledged that federal regulators "are going to do our best to tailor our consolidated supervision to insurance companies."[175]

[174] Douwe Miedema, *U.S. Insurer MetLife to Sue Regulators over High-Risk Tag*, REUTERS (Jan. 13, 2015), http://www.reuters.com/article/2015/01/13/us-metlife-lawsuit-idUSKBN0KM1A720150113.

[175] Elizabeth Festa, *Bernanke Comments on Collins Amendment*, LIFEHEALTHPRO.COM (July 17, 2013), http://www.lifehealthpro.com/2013/07/17/bernanke-comments-on-collins-amendment. Chairman Bernanke provided this information in response to questioning about what capital standards were required pursuant to the Collins Amendments, secction 171 of the Dodd-Frank Act (codified at 12 U.S.C. § 5371 (2012)). However, some financial regulatory scholars indicated that a legislative remedy was not necessary as the Federal Reserve could apply risk weighting to its liking. More tellingly, more than a year earlier and only six days after FSOC adopted its final rules implementing the criteria and process that it will use to designate nonbank financial companies as systemically important, Chair Bernanke acknowledged that "further refinement of the criteria for designation will be needed." Ben S. Bernanke, Chairman, Fed. Reserve Sys., Remarks at the 2012 Financial Markets Conference: Fostering Financial Stability 6 (Apr. 9, 2012).

Bernanke's successor, Helen Yellen, indicated a similar point of view during her confirmation hearing before the Senate Banking Committee on November 14, 2013. At that time she stated that:

> I do believe that one-size-fits-all should not be the model for regulation and that we need to develop appropriate models for regulation and supervision of different kinds of institutions . . . . Insurance certainly has some very unique features that make them very different from banks. And we're taking the time to try to study what the best way is to craft regulations that would be appropriate for those organizations.[176]

Regardless of either position, Congress has at this time begun taking action to address the perceived need for clarification. Senator Susan Collins of Maine, author of section 171, which imposed certain capital standard requirements, has introduced legislation to exempt entities regulated by state insurance regulators from being considered in the establishment of minimum leverage capital requirements and minimum risk-based capital requirements by the Federal Reserve Board.[177] While Senator Collins insisted that her legislation is not necessary in light of legislative intent at the time of enactment, she acknowledged that due to the Federal Reserve Board's actions to date, it might be necessary to amend the current statute to explicitly address her concerns.[178] By exempting

[176] Arthur D. Postal & Elizabeth D. Festa, *Yellen: One-Size-Fits-All Not a Model for Regulation*, PROP. CASUALTY 360 (Nov. 14, 2013), http://www.propertycasualty360.com/2013/11/14/yellen-one-size-fits-all-not-a-model-for-regulatio. However, unlike Bernanke, Chairwoman Yellen did not comment on the necessity of legislation to amend Dodd-Frank to permit the Federal Reserve to impose different capital standards on life insurance companies.

[177] S. 2102 113th Cong. (2d Sess. 2014). The legislation specifically refers to "a person regulated by a State insurance regulator" which is defined in section 1002(22) (codified at 12 U.S.C. § 5481(22)) of the Dodd-Frank Act. *Id.* When read in conjunction with the definition of "person" in 12 U.S.C. § 5481(19), this would include companies and corporations, such as life insurance companies.

[178] Press Release, Senator Susan Collins, Finding the Right Capital Regulations for Insurers (Mar. 11, 2014), *available at* http://www.collins.senate.gov/public/index.cfm/press-releases?ID=02467e48-1aff-4085-

entities that are regulated by state insurance regulators, increased capital requirements, such as Basel III capital reserves,[179] would only be imposed on internationally, federally or unregulated lines of insurance business. In a post Dodd-Frank regulatory world, few types of items would qualify, with the exception of newly created products, which arguably should maintain higher reserve amounts until they can be actuarially justified.

In June 2014, the Senate took action on Senator Collins' Insurance Capital Standards Clarification Act of 2014.[180] Subsequently, the House of Representatives passed a similar bill on September 16, 2014.[181] However, the bills as passed were not identical. While Senator Collins' bill focused solely on insurance company capital standards, the House's bill included "divisive" measures including expanding exemptions for bank ownership of collateralized loan obligations under the Volcker Rule, as well as marginally expanding the definition of a Qualified Mortgage.[182] Because the two passed bills are not identical, one of the two houses must still pass the other's legislation to address this unresolved issue. Optimally, it would make more

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91e8-ff0c3884ac67. Senator Collins indicated that the Dodd-Frank Act, and specifically section 171, already permitted federal regulators to take into account the distinctions between banks and insurance companies for the purpose of capital standards, going so far as to note that supplanting state-based insurance regulation for a bank-centric capital regulatory regime would be both improper and contrary to Congress' legislative intent when enacting the Dodd-Frank Act. *Id.*

[179] OFF. OF THE COMPTROLLER OF THE CURRENCY, NEW CAPITAL RULE: COMMUNITY BANK GUIDE 7 (2013), *available at* http://www.occ.gov/news-issuances/news-releases/2013/2013-110b.pdf. Basel III requires at least eight percent of Tier 1 capital be held in reserve and available at any one time to remain well capitalized. *Id.* Prior to Basel III, banks were required to maintain six percent of Tier 1 capital on hand to be considered well capitalized. *Id.*

[180] *Insurance Capital Standards Clarification Act of 2014*, GOVTRACK.US, https://www.govtrack.us/congress/bills/113/s2270 (last visited Feb. 1, 2015).

[181] *H.R. 5461*, GOVTRACK.US, https://www.govtrack.us/congress/bills/113/hr5461 (last visited Feb. 1, 2015).

[182] Arthur D. Postal, *House OK's "Collins Amendment" Fix*, LIFEHEALTHPRO (Sept. 14, 2014), http://www.lifehealthpro.com/2014/09/17/house-oks-collins-amendment-fix.

sense for the House of Representatives to take up the less divisive version of the bill previously passed by the Senate, which focuses solely on capital standards. In fact, insurance industry and executives have indicated that a major factor in MetLife pursuing litigation to challenge any eventual designation may hinge on the type of capital rules imposed by the Federal Reserve.[183] Following MetLife's announcement that it was proposed for designation, Representative Carolyn Maloney, the prime sponsor of the House measure indicated that FSOC's action "underscores the need for a quick, clean vote . . . which will allow the Fed to write proper capital standards for large life insurers.[184] Unfortunately, if the House of Representatives does not act before the end of the 2013-2014 session, both houses will have to restart the process, thus continuing the regulatory uncertainty that currently exists. MetLife has indicated that this continued regulatory uncertainty regarding the level of capital would limit both returns to investors as well as jeopardize access to certain types of life insurance products.[185] Ultimately, inaction may cause problems for individuals more so than maintaining the status quo may protect them.

B. A JOINT REGULATORY REGIME THAT RECOGNIZES THE SUCCESSFUL STATE-BASED APPROACH

Furthermore, federal regulators should acknowledge the success of state-based regulators in the field of insurance, particularly when compared to federal regulators. The driving force of AIG's financial collapse was its business dealing with credit default swaps, a previously regulated product that federal regulators deregulated. Compare this to the state-regulated lines of insurance that not only withstood the pressures of the company's financial collapse, but also in some instances were used to prop it up prior to receiving its bailout.[186]

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[183] McGrane & Scism, *supra* note 162.

[184] *Id.*

[185] METLIFE, INC., *supra* note 10, at i, iii-iv.

[186] Press Release, Nat'l Ass'n of Ins. Comm'rs, *supra* note 42.

Rather than have an entirely new regulator examine companies on a consolidated basis with no regard for differences in products and investments of both companies and their subsidiaries, the regulations should be refined to recognize the different types of business and the types of capital necessary for each line to be reserved properly. Regulators may choose to impose various levels of reserves based on asset and investment quality, but even then, they should be based on recognition of the different types of business and investments that insurance companies engage in compared to traditional depository institutions. At the same time, if an insurance company does maintain a depository institution, that particular subsidiary should be regulated to the standards of other depository institutions; however, these standards should not be imposed on the insurance company as a whole.[187] Similarly, any regulation of new financial products would be divided between the federal and state regulators based upon the subsidiary developing, marketing, or selling them. Thus federal regulators could still regulate demand deposit products and require increased capital reserves, while state-based insurance regulators could require reserves at a different level.

VIII. CONCLUSION

Federal lawmakers and regulators had no choice but to act in some form following the financial crisis in 2008. Invariably, some statutory and regulatory responses were not only necessary, but appropriate in their scope in attempting to not only resolve the regulatory shortcomings that had emerged, but also in preventing them from occurring again. However, as is the case in other instances, some of the legislative and regulatory responses were ill-thought out, a dramatic overreaction, or simply a misappropriation of authority, among other shortcomings. The potential designation of life insurance companies as systemically important nonbank financial companies is one such example of a combination of all of these shortcomings.

[187] FIN. STABILITY OVERSIGHT COUNCIL, RESOLUTION APPROVING, *supra* note 104, at 7, n.13 (Woodall dissenting). Roy Woodall referred to these as capital requirements that are appropriate and that make sense. *Id.*

While neither of the life insurance companies designated thus far has challenged the legal basis for their designation in a judicial arena, future designees may choose to pursue this option. At the same time, federal regulators should begin to refine the process for designating life insurance companies as systemically important nonbank financial companies that recognize the different business, investment, and regulatory models that exist between depository-based banks and life insurance companies.