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Fearless Predictions

Resolution issues and a covered agreement will take center stage in 2016

By Charles T. Richardson & Patrick D. Hughes

In the February 2015 *NOLHGA Journal*, we wrote about the results of the 2014 mid-term elections and predicted what they meant for our industry and the guaranty system. Sara Powell and Scott Kosnoff (Faegre Baker Daniels) were interviewed by the *Journal* six months later about the state, federal, and international regulatory changes that matter the most to the system.

It's time now to bring both sets of prognostications forward to the present as we look at a Presidential/Congressional election year and beyond. What's hot and what's not? What matters and what doesn't? Who can change the safety net life as we know it, and who is chopped liver?

The Players

Take a look at this complex web of interactions (Figure 1).

These are the players we care about—and the actors whom NOLHGA President Peter Gallanis mentions in his financial services modernization reports at each MPC meeting.

Every single one of them will be potentially touching resolution/safety net issues in 2016.

For one thing, the predictions in our last two *Journal* articles mentioned above

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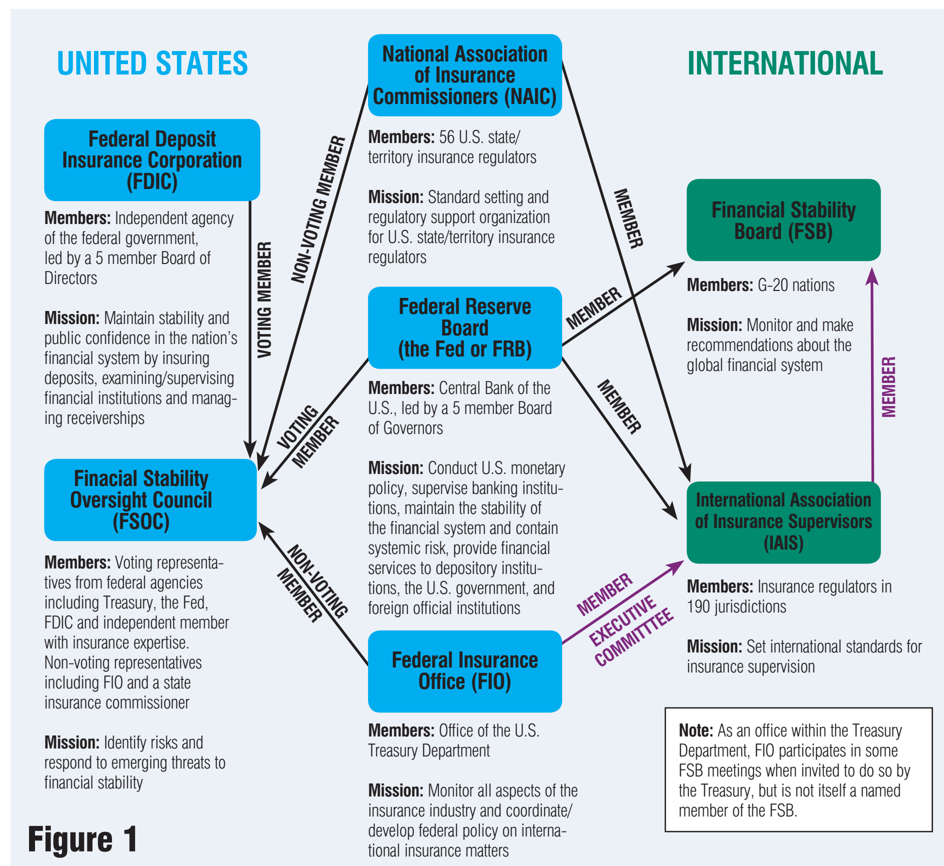

Figure 1

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Grace Under Pressure

The following was adapted from my President's Address, delivered on October 29, 2015, at NOLHGA's 32nd Annual Meeting.

As someone who has witnessed 30+ stirring renditions of it (and counting), Bob Ewald, former Executive Director of the Illinois Life & Health Insurance Guaranty Association and a founding father of the guaranty system, told me some years ago that he views the NOLHGA President's comments at the Annual Meeting—no matter who is delivering them—as being functionally similar to the U.S. President's annual report on the State of the Union: obviously not in pomp or splendor, but because this address serves as an occasion for an annual appraisal by all of us of where we stand and of our most significant current concerns.

In that regard, my message to you is that the state of the life and health insurance guaranty system remains strong, but we continue to face serious and complex challenges. As in the past, those challenges will require our best efforts and our clearest thinking.

A few observations, and then a story:

First, it continues to be the case that we have seen no new insolvencies triggering the guaranty system that remotely approach being "systemically important." In fact, we've never seen such a case, and we really haven't seen the failure of a life or health insurer of any material size since 1994, 21 years ago. Over that span of time, the only failures we've seen of companies that were even nationally visible—though not remotely systemically important—were, first, the abandonment in 2013 of an ELNY rehabilitation that had commenced in 1991, and the pending denouement of efforts to save Penn Treaty that have involved on-and-off regulatory intervention stretching back almost 15 years. These are not new insolvencies: They are the conclusions of legacy insolvencies that incepted a very long time ago.

Throughout the entire financial crisis—the greatest live-fire stress test that U.S. financial institutions have seen since the Great Depression—there were no new failures of nationally significant life and health insurance companies, and in total a failure of about a dozen tiny companies whose total liabilities to policyholders, in the aggregate, were around $900 million. Not $600+ *billion* like Lehman. Those insurer liabilities were satisfied to the policyholders to the tune of something better than 99 cents on the dollar. All this during a financial crisis that caused the failures of hundreds of banks and even more pension plans, hedge funds, private equity concerns, Fannie and Freddie, and the entire investment banking industry. Yes, the federal government stepped in to rescue AIG—or its counterparties, depending on which version persuades you—but AIG's problems did not originate in the regulated insurance entities, and it's no coincidence that no other significant insurer had AIG's problems.

Throughout the entire financial crisis—the greatest live-fire stress test that U.S. financial institutions have seen since the Great Depression—there were no new failures of nationally significant life and health insurance companies.

Second, the guaranty associations continued, through and since the crisis, to fully and promptly do their jobs in every single case in which they've been triggered. That's been true now for decades, in good times and bad.

Third, the guaranty system—as a "policyholder protection scheme"—is, as former New York Insurance Superintendent Eric Dinallo said yesterday, at or near the center of an inquiry about the "resolvability" of major U.S. groups that engages senior regulators in the United States and in the G-20 countries.

The question: Is there a significant risk that the failure of a major insurance group could harm the financial system and the general economy?

My answer is that there is no company involved in the traditional business of insurance that poses any material risk to the financial system or the general economy from its failure. As I've written at greater length elsewhere, I believe that to be true as a result of four factors: (i) the inherently conservative nature of the traditional insurance business model; (ii) strict and constantly evolving prudential supervision by state regulators, coordinated through the NAIC; (iii) an effective system for resolving the failure of the very few insurers that do fail, in which the prioritization of policyholder protection also serves the interest of minimizing spillover risk to the financial system; and (iv) a well-designed and case-tested policyholder protection program that is provided by an experienced, nationally consistent, and well-financed guaranty system.

Under the Microscope

My conclusions to that effect notwithstanding, we have been, and will continue to be, called upon to answer questions about our system—not only by federal and international regulators, but also by our current state regulators and by our own membership. Those constituencies have every right to ask those questions, and we must answer them.

We are now operating under what the FIO's Regulatory Modernization Report correctly called a "hybrid" regulatory system that continues to evolve as Dodd-Frank is built out and more fully implemented. In the meantime, state regulation has also continued to evolve in important ways that are centrally relevant to the "resolvability" discussion.

In the regulatory steps already taken under Dodd-Frank, both FSOC and FIO at different times have asked questions—not in an unfriendly way—about the guaranty system. Is it sufficiently uniform? The answer there is yes.

More importantly, could the system handle the failure of a very large insurer? I am sure that the answer to that question is "yes," but knowing what we now know about what it will take to persuade our questioners of the correctness of that answer, we have quantitative analysis that we need to perform and then discuss with the relevant constituencies. I look forward to that exercise.

It's not just federal regulators who need to be satisfied with this system, though. So also must be guaranty association member companies and the consumers they serve. They need to know as well that we have the systems and the capacity to do the job, and that newly emerging products and markets—for example, CDAs and annuities used in pension de-risking transactions—will continue to be well protected by our system. Moreover, as new NOLHGA Chair Lee Douglass has observed, all of our member companies—be they writers of life, annuity, or health business—must be reasonably satisfied that the operations of this system and the burdens allocated to their companies are professionally and fairly administered.

We have been, and will continue to be, called upon to answer questions about our system—not only by federal and international regulators, but also by our current state regulators and by our own membership.

High Expectations

I promised to wrap this up with a story. I heard this yesterday from marketing guru Bruce Turkel, and I thought you'd appreciate it.

When the little swimmer's head ducked under the waves and didn't pop right back up, his grandmother started running toward the lifeguard station screaming, "My grandson's drowning! My grandson's drowning! Help! HELP!"

The strapping lifeguard scanned the ocean with his binoculars in the direction the distraught woman was pointing. After a quick moment he spun the spyglass onto his chair, yanked off his sunglasses and pith helmet, and jumped off the lifeguard stand, charging into the surf.

Reaching a rough patch of ocean just beyond the cresting whitecaps, the lifeguard dove down again and again, searching for the little boy under the waves. Seeing nothing, his eyes burning from the saltwater, he would come up for a quick breath and dive back down again, checking the ocean floor for any sign of the boy.

Finally, after what seemed like an eternity, the lifeguard saw a limp figure crumpled on the sea bottom. The exhausted lifeguard filled his lungs with air and dove down one last time, deeper and deeper, until he was close enough to grab the little boy's wrist. With a mighty effort he pushed off the sandy bottom and made his way to the top, dragging the little boy and a swirling lacy train of bubbles after him.

Bursting up through the churning sea, the lifeguard took another enormous breath and started kicking furiously toward the beach. He fought his way through the undertow until he reached the shallows, cradling the defeated body of the little boy in his arms as he got closer and closer to the beach.

The lifeguard pulled himself out of the water and gently laid the lifeless form of the little boy down on the hot sand. Barely breathing himself, he dropped to his knees and began furiously administering CPR, alternately compressing the little boy's sunken chest and breathing air into his little lungs.

The sun beat mercilessly on the lifeguard's back as he attended to the limp child sprawled on the sand. The lifeguard pushed and pressed, and huffed and puffed, and pumped and pumped, but to no avail. Then suddenly, after more than 10 minutes of labor, the small body convulsed as the boy threw up mouthfuls of frothy seawater, coughing and gagging and fighting to sit up.

The lifeguard stood slowly, his knees etched with sand, and picked up the little boy. He walked slowly to where the boy's grandmother was standing on the beach, stretched out his arms and offered the little boy to her.

"Madam," the lifeguard said with what little breath he had left, "your grandson is okay. I was afraid we wouldn't make it, but he's going to be fine."

The old woman stared wordlessly at the lifeguard and her grandson for a long moment. Finally she arched her eyebrows and opened her mouth to speak.

"He had a hat."

["Grace Under Pressure" continues on page 24]

Safe Har

NOLHGA's members gather at Baltimore's Inner Harb and the future of insurance regulation

By Sean M. McKenna

After visiting San Diego in 2014, NOLHGA's Annual Meeting headed back east in 2015. More than 150 attendees came to Baltimore in October to eat crab cakes and hear from federal and state regulators and industry experts about the value of the guaranty system (to policyholders and regulators), the prospects for more regulatory changes in 2016 and beyond, and the certainty of more changes to the health insurance market.

Home & Abroad

Michael McRaith, Director of the Federal Insurance Office (FIO), addressed the potential tension between state and federal insurance regulators by noting that the federal government's Financial Stability Oversight Council (FSOC) "has not found that state regulation is lacking" in its designation of three insurance companies as systemically important financial institutions (SIFIs). "The council doesn't just look at a firm's insurance activity" he explained. "It looks at the nature and complexity of the firm across the system. It's not a referendum on state regulation." The value of FSOC, he added, is that it brings all the financial system regulatory bodies, insurance and otherwise, together.

Turning to international matters, Director McRaith said that the "Team USA" approach of bringing together FIO, the Federal Reserve, and state regulators to represent the United States in international regulatory matters is working well. "We can effectively lead the conversation globally as a team," he said. That international presence is necessary for two primary reasons: the interconnectedness of the financial markets worldwide and the "dramatic spike" in premiums outside the United States. Insurance is growing rapidly in foreign markets as consumers look to protect their assets and countries look to "incentivize spending of personal resources" in populations more accustomed to saving their cash for a rainy day. Team USA needs to be involved in these global discussions, he said, because "even if we withdraw, the conversation is going to continue."

bor

or to discuss the importance of the guaranty system

Director McRaith also touched on plans to pursue a covered agreement with the European Union on reinsurance collateral (for more information on this, see "Fearless Predictions" on page 1). He noted that the covered agreement process is an intricate one, involving a number of players and even congressional notification (which has since taken place), adding that the Team USA approach is being contemplated here as well. "A key piece of this for us is including state regulators."

Missouri Insurance Director and new NAIC President John Huff also spoke about the increasing importance of international insurance regulation to the U.S. market, zeroing in on the International Monetary Fund's Financial Sector Assessment Program (FSAP) evaluation of insurance regulation in the United States. While calling FSAP a "healthy process," Director Huff said that the report "treated insurance too much like banking" and added that evaluators failed to grasp the advantages of the broad authorities granted to insurance commissioners in state receivership laws.

He also took exception to the report's critique of the U.S. receivership system, in particular the guaranty system. "I was amazed at some of the criticisms of the guaranty system," he said. "It's almost like they're looking for something to criticize. Europe could learn a few things from the United States in this regard."

Director Huff also addressed the covered agreement with the EU, noting that state regulators are already working on collateral reduction and warning that a covered agreement could preempt state laws, including guaranty association statutes. "We need to think through what's best for our system," he said. "We need to be respectful of their system, and we want them to be respectful of ours."

Bill McCartney (Regulatory Advice & Consulting), a former NAIC President and current co-chair of the Bipartisan Policy Center's Insurance Regulatory Reform Task Force, called for the U.S. regulatory community to stand its ground in these discussions. "I don't understand why we're so willing to defer to the Europeans on a number of these insurance regulatory

matters," he said. He noted that European regulators seem to place a premium on protecting the financial system, while America regulators are more focused on policyholders. "To me, protecting policyholders and claimants is the most important job."

On the home front, McCartney noted that "the policymakers who implemented the Dodd-Frank Act really didn't understand the difference between banking and insurance. Bankers have been indoctrinated to avoid risk. Insurance is all about managing risk." This disconnect also extended to safety net mechanisms. "Banking experts understand the FDIC and prefunded systems," he explained, but they don't understand how guaranty associations work.

This lack of understanding is already having a negative effect on the insurance industry, McCarthy said, in particular the companies designated as SIFIs. While some analysts have questioned whether SIFIs have a competitive advantage, since there's an implicit promise of backing by the federal government, McCarthy argued the opposite. "They have a significant competitive disadvantage," he said, noting that for SIFIs, the great majority of their hiring after Dodd-Frank has been in compliance. This type of spending "increases costs, not revenue."

Scary Things

Karen Shaw Petrou (Federal Financial Analytics) opened her presentation on insurance and the financial services sector with a list of things that scare her and, more importantly, the Federal Reserve and other policymakers. At the top of the list was yield chasing, which she called "an endemic challenge across the financial services industry because of low interest rates." In the current environment, she said, "traditional investment strategies don't work." She also cited intra-group risk and operational risk as worrisome. "Insurance is no more immune from risks like cyber-security than the banking industry," she said. And while that industry has spent billions planning for operational risk, "it's much less clear" how prepared the insurance industry is because that sort of planning isn't regulated.

NOLHGA Chairs Discuss Health Challenges in Remarks

Heath insurance receiverships and the changing regulatory landscape were on the minds of Outgoing NOLHGA Chair Debbie Long (Protective Life Corporation) and Incoming Chair Lee Douglass (Arkansas Blue Cross and Blue Shield) as they spoke at NOLHGA's 2015 Annual Meeting.

Long pointed to the ongoing litigation in the Penn Treaty/American Network receivership, saying that "I'm afraid the main lesson we've learned from past insolvencies—that our system works best when it works in a timely fashion—has been lost in all that discussion and debate." She also highlighted the liquidation of CoOportunity Health Insurance Company, an Iowa-domiciled consumer-operated and oriented plan (CO-OP) founded under the Affordable Care Act (ACA), and the unique challenges the company's resolution presented. "One of the things we learned is that federal regulators—in the form of the Centers for Medicare and Medicaid Services, or CMS—don't always look at things the way we do," she explained, praising the work of the MPC Executive Committee's CO-OP Task Force, which is studying CO-OPs in anticipation of future receiverships.

Long added that the increasing importance of international regulatory bodies would pose challenges for the U.S. guaranty system, particularly because many of these regulators have a different philosophy when approaching insurance company failures. "International regulators seem more concerned about the integrity of the financial system than they are about protecting individual policyholders," she explained. "That's just a completely different approach from what we've done in the United States for decades. We think that if you don't protect the policyholders, the system has no integrity."

Douglass also cited the prevalence of health insurer receiverships (Penn Treaty's long-term-care policies are treated as health insurance for guaranty association purposes), saying that "this is a good year for a health insurance person to be NOLHGA's Chair." He noted that the Penn Treaty receivership has resulted in the guaranty system conducting a great deal of outreach to the health insurance industry over the past few years, and he called for that outreach to continue.

Douglass recited a list of challenges

Petrou also pointed to what she called policy risk, noting that "health insurance is now largely structured by national edict. This creates an array of new risks, and that troubles me, especially in a market where pricing is largely artificial."

With regulators increasingly concerned with these and other risks, and with no consensus on how to deal with them, the role of the guaranty system becomes even more critical—not just to policyholders, but to regulators seeking to guard against another financial crisis. "If the rules don't work, resolution has to," Petrou said. The effectiveness of the guaranty system is "a strong rebuttal to folks who want top-down, bank-centric regulation."

Living wills and stress tests, she added, would go a long way toward making the guaranty system and the entire receivership process even more effective. For a company, creating a living will is "a very painful, complex, and expensive exercise," she said. "But it works. Resolution planning is terrifically constructive. It's important to think how that would work in the insurance sector." Stress testing, she noted, "is making big changes in some of the largest banks," and the combination of the two exercises would be "very helpful" for the insurance industry as well.

Justine Handelman (Blue Cross Blue Shield Association) didn't provide attendees with a list of scary things about the health insurance market, because everything in that market is scary these days. "The Affordable Care Act has caused changes in every market," she said, noting that the individual market was "completely overhauled" in 2014.

The bad start to the government's health-care website, coupled with the change to the Act to allow older plans to be grandfathered in, meant that much of the work companies put into preparing for the new system went for naught. "The risk pool is a little worse than many of us expected," Handelman said, noting that the grandfathered plans kept many healthy people out of the system. "We expected there to be pent-up demand in the initial years, so

["Safe Harbor" continues on page 24]

Receiverships, Regulatory

Photos by Kenneth L. Bullock

facing the health industry, many of them stemming from changes caused by the ACA. He echoed Long's comments about working with CMS ("there can sometimes be tension between the private market and the government") and predicted that future CO-OP failures, even if the companies are not member insurers, will test the system. "Will an explanation that the company was set up in a way that precluded it from being a member of the association make sense to people?" he asked "Or will they think we're somehow ducking our obligations?"

In closing, Douglass noted that a laundry list of challenges, no matter how daunting, is nothing new for the guaranty system. "Challenges have always brought out the best in our system, and I know that will hold true in the future," he said, calling on the associations to "turn a critical eye on ourselves, consider critiques from FIO and other organizations, and do everything we can to make an already great system even better."

"I Knew the States Were Going To Own This"

Former NY Insurance Superintendent Eric Dinallo discusses AIG's rescue and how effective state regulation can be in the new economic landscape

Eric Dinallo is a Partner in Debevoise & Plimpton's New York office and a member of the Financial Institutions Group. He served as the New York State Superintendent of Insurance (2007–2009), where under his leadership the department became a national model on insurance regulation and a respected voice on the industry's role in the financial system. Mr. Dinallo worked with the United States Treasury Department, the Federal Reserve Bank of New York, and others in the restructuring of financial services giant AIG, for which he was named a "Dealmaker of the Year" by **The American Lawyer** *in 2009. He earned national acclaim for leading successful negotiations between developers and insurance companies over the World Trade Center site, and in 2008 he received the "Esprit de Corps Award" from the National Association of Insurance Commissioners for accomplishments as an "ambassador for state-based insurance regulation."*

The following is an edited transcript of our conversation at NOLHGA's 32nd Annual Meeting in October 2015.—Peter G. Gallanis

Gallanis: *You worked in the insurance field and on insurance cases before you were the Superintendent in New York. What's your reaction when you hear bodies like the Financial Stability Oversight Council (FSOC) or the Financial Stability Board (FSB) reach the conclusion that an insurance group can pose a threat to the stability of the financial system, to the global economy, and therefore designate these groups as SIFIs in the United States, or as G-SIIs internationally? Does it make sense to you that an insurance group would deserve that sort of designation?*

Dinallo: Having read the designation of Prudential and the dissents, and thinking about my experience through the financial crisis—during which the industry performed fabulously, and it doesn't get enough credit for that—I just don't think of insurance having a systemically significant impact that could theoretically undermine the financial system and people's confidence in it.

If you have not read the Prudential designation by FSOC and the dissents, you have to read it. It's like our *Marbury vs. Madison*.

In part, that's because I think people don't buy insurance as a liquidity instrument where they expect immediate liquidity. Even during the worst times, when we've had to manage insolvencies and rehabilitations, people didn't flee from the product and the industry, which to me shows that they're not assuming immediate liquidity.

Now, there are places that are potentially more complex, that have other financial instruments involved. And we could discuss that. But just insurance *qua* insurance? I was surprised that there was a rush to designate that.

Gallanis: *One wonders how much of that was technical analysis or financial analysis and how much of it was political. When we think back to the scariest part of the financial crisis—starting Friday, September 12, 2008, going into what I think a lot of people refer to as Lehman Brothers Weekend—there were attempts all that weekend to rescue Lehman. Those attempts failed, and while leading financial regulators and policymakers were working around the clock thinking that the major issue was the rescue of Lehman, all of a sudden it began to dawn on people that there was a problem that may have been even bigger: AIG. What were you doing while that weekend was unspooling?*

Dinallo: The story that's been told, which is true, is that I was driving my family up to my weekend house on Friday the 12th. The phone rang—this is before rules against texting and driving or talking—and I took the call. I believe the first speaker was Anastasia Kelly from AIG, their General Counsel. She said "I need to talk with you. It's very important. Do you have a minute?" I said yes, and she asked, "Are you sitting down?" I said I'm driving, and she said, "Okay, well, you better pull over."

So I pulled over, and she and the CFO got on the phone, and they described a liquidity issue that they were hoping could be fixed. The number then was $10 billion. They already had an idea of somehow uplifting a lot of the excess surplus from at least the New York and maybe the Pennsylvania big, healthy property companies to deal with this liquidity issue.

I said "I'll think about it." I went up to the house—I didn't turn around that night because it was too late—and I called my senior staff. I got everyone on the phone late that night. Michael Moriarty, my Deputy for Property and Casualty, kind of explained to me what she was proposing. I could tell he was mortified. He was completely shocked by the enormity of it.

By noon the next day—and I'm sort of proud of this part—we were down at AIG with about seven or eight representatives of the department. We had Hampton Finer, many of you remember him as our economist, John Kenny, and others. We were crunching the numbers that were coming in, and they were pretty bleak. Even at that point, there was already kind of a "Who's Who" of financial services people circling around: capital providers, investment bankers, investors. Chris Flowers famously was there with a plan that would possibly have been successful, but the numbers kept ramping up almost hourly. By Sunday, it was up to, I think, $45 billion.

This shows you the level of preparedness we had. My cell phone rings—I think it was Sunday morning—and I answer it and hear, "Could you please hold for President Geithner?" And he said, "Hey Eric, it's Tim. You may have heard that I'm dealing with Lehman. I'm kind of busy right now. I hear you're down at AIG, and I hear you're being very helpful." Which in Federal Reserve–speak means we were willing to lend money out of the insurance companies to fix the problem. It wasn't my great legal mind he was thankful for.

I said, "We're trying. We definitely think we could find a path." We talked a little more, and he conveyed the message that there's no rescue, no access to the window from his end. And he says, "OK, so this is what I'm going to report. I've got Lehman. You've got AIG. Thanks a lot." And he hung up.

It was like we were playing pick-up basketball or something. You know, you cover her, I'll cover him. It was unbelievable.

Gallanis: *Your office played a very important role in the overall regulation and supervision of the AIG entities. And some of us have seen the AIG organization chart that looks like a schematic diagram for some kind of a complicated computer chip—thousands of entities. In terms of the principal insurance entities or within the holding company structure, what was the New York regulatory role?*

Dinallo: I don't know if I can name them all. We had the big New York property insurer that later became Chartis, a smallish life insurance company, and a couple of other property companies. That's my recollection. And we were also the lead regulator in a NAIC task force that was bringing down the securities lending pool exposure, which I'm sure we'll talk about to some degree. Several years before, Michael Moriarity had started this task force and they were, not unwinding, but changing the lending pool mix.

Gallanis: *You've already touched on something that I think came out in the press—a story that the Governor in New York was supporting a proposal under which there was supposed to be some sort of recapitalization that would make liquid assets or cash available from regulated insurance companies to prop up the holding company. How did that story rise and fall?*

Dinallo: I think that it rose and fell on the enormity of the need that was mostly created by the Financial Products Division. So you had holding company obligations that had reached, at this point, at least $40 to $50 billion to the counterparty banks that had used the Financial Products Division to insure their books of CDOs through credit default swaps that the Financial Products Division was writing. But it did not have a lot of capital compared to an insurance company that would have been writing that business in a regulated context. So the holding company had very little liquidity that could have gone to help that. The irony was, you had a trillion-dollar balance sheet with a lot of capital in all the operating companies, but very little access to it, if any at all, by the holding company.

I saw extremely sophisticated financial services managing directors and regulators looking really ashen and shaken. Like they thought we were headed for a complete credit seizure, where ATM machines wouldn't spit money out and you wouldn't be able to roll over store credit and stores wouldn't have anything on the shelves.

Gallanis: *So it was natural for Tim Geithner to look at the cash.*

Dinallo: Oh yeah, there's no doubt. The holding company regulation with insurance groups is inverted—the money goes in, but there's generally no way for the holding company to go in and get it when it has a liquidity need or wants to move the capital around or make investments. So the regulators, the counterparties, and even the executives were frustrated. They could have otherwise reached in, and they probably could have somehow scraped together over time an amount that might have satisfied the counterparties.

The plan was that we were going to put up upward of $20 billion from these two very, very healthy property companies, and get paid back from eventual sales of private line companies. The Governor announced this, and it kind of froze the market, so to speak, for a little while—in a good way.

That was also important, because when I was in the room with these people—eventually the meetings moved over to the Fed—I saw extremely sophisticated financial services managing directors and regulators looking really ashen and shaken. Like they thought we were headed for a complete credit seizure, where ATM machines wouldn't spit money out and you wouldn't be able to roll over store credit and stores wouldn't have anything on the shelves. So I think the Governor made the right call to signal that New York State, at least, was willing to step in and do what it reasonably could. That was somewhat ameliorative.

I was not at the press conference. My phone rang that Monday morning, and Tim Geithner said, "Can you come to a meeting? I need you to explain this crazy thing called insurance regulation." I'm really not making that up. The first time I explained statutory accounting to him, I think he thought I was talking about the Mayan calendar system or something. The governor said, "You should go. It's more important." So I went down and participated in these, we'll call them the

"rescue meetings." Two or three days later, they resulted in the $85 billion infusion.

Gallanis: *What I'm taking away is that the idea of an insurance company–supported assistance package might have happened, but for the fact that the size of the hole grew so large that it just wasn't financially feasible.*
Dinallo: I think so. I think if the number had stayed reasonable, however many billions of dollars that means, we could have had kind of a self-financed rescue. But the numbers just got completely out of control.

Photos by Kenneth L. Bullock

Gallanis: *One thing many of us wonder is how so much risk, especially the risk in the credit default swaps portfolio at AIG Financial Products, could build up within a single corporate group without regulators intervening at an earlier point to address the problem.*
Dinallo: This is a bipartisan criticism on my part. I'm not taking any political shots. But I think the wrecking of the economy really started with the Commodity Futures Modernization Act in 2000. Congress deregulated derivatives very forcefully in that Act. The states had started to question whether some of these things were insurance products, like when you were buying a credit default swap in a covered context when you actually held the debt. Others were buying it, as you know, to speculate. In my mind, that's like a future. And they completely deregulated those two activities. I think it was Senator Dorgan who made this big statement on the floor, this incredibly Cassandra-like prediction of what was going to happen. And by the end of just a few years, it went to $63 trillion of derivatives in assets—completely and intentionally unregulated.

All of the sudden, you were permitting Wall Street to engage in financial products activity for which the regulatory community knew what the right capital set-asides were—i.e., insurance—or even speculative instruments. And something like the Financial Products Division, officially unregulated, could write upwards of $2.7 trillion in exposure without anyone saying, "How much capital do you have behind those bets, and what's your liquidity?"

The irony is that they wrote some pretty good risk. It's just that they didn't have the liquidity to stay in their bets long enough. Indeed, they did in fact write CDSs on some fairly old CDOs that eventually did pay off.

Gallanis: *And part of the problem, as I understand it, was that not only did they make promises to stand behind credits, if credit events took place. They also made promises to post increasing amounts of collateral.*
Dinallo: Right. They also wrote something that you generally wouldn't let people write in insurance. At the time we showed up, there had been almost no defaults on any of these CDOs for which the CDS would require payment as an insurance instrument. But it wasn't regulated as an insurance instrument. I remember Henny Sender in the *Financial Times* wrote a very cogent piece that pointed out that there were two aspects. As the CDOs went down in value they were supposed to pay and post up. I don't know what that's called, but it's not an insurance contract. And then there was this posting of hardcore collateral as the ratings went down. And so you ended up with a tremendous amount of money having to go out against no claim, actually.

That would be the final straw and kind of undermine confidence in insurance, which had otherwise held up pretty well. And of course, if there had been an official default by the Financial Products Division, the counterparty banks, which were largely international in their failure to write down the exposure in this marketplace, would have had huge holes in their balance sheets overnight.

There's a theory that Tim did all this to get money to Goldman Sachs and J.P. Morgan. I don't buy into that. I saw some of what was really going on, and I thought he was concerned about international exposure even more, as well as a kind of crisis in confidence in the United States when it came to our contractual obligations through these major institutions. So they just got very comfortable with the idea they were going to open the window for AIG and do this very usurious loan, and the turnaround was dramatic.

So I had one job. And before I explain it, I should say that I really tried as the New York Superintendent to be a colleague with other states and get very involved. New York had for years sometimes been somewhat of a lone wolf, and I really tried to get out there and learn from my colleagues.

And that mattered because I got a call—true story—from Rodge Cohen, and he said, "I'm calling on behalf of the White House and here's the question." This is the scariest question I've ever had to answer. "We understand that you're working with all the states to prevent any one of them from seizing an AIG operating company before the Fed and the Treasury have made the final decision on the bailout." Because we were all waiting to see if they were going to cough up $85 billion or not. And he said, "I think I believe in you. I think you're doing the right job. And I've got to ask you this question. Here are the choices. We can let you do what you're doing and hope you can keep working the phones and keep everyone in line. Because Texas is ready to seize its company. Or, the President could call a bunch of governors and tell them to tell their insurance commissioners to stand down."

And I said, 'Rodge, I'll do my best. I can't make any prom-

Gallanis: *Without there ever being a default.*
Dinallo: Right.

Gallanis: *We talked about what happened that Friday and over the weekend, and what happened early Monday morning when Lehman filed Chapter 11 because no one was able to put together a rescue package. There was a clear decision on the part of the involved federal financial authorities that they either would not or could not rescue Lehman. And you had already been told by Tim Geithner that no way, no how was there going to be a rescue of AIG. But sometime between the Lehman filing on Monday morning and Tuesday, later in the day, the polarities reversed. The federal government made a decision that it was going to step in and rescue AIG. I guess the general question is: Why was there no rescue of Lehman, and then a rescue of AIG?*
Dinallo: Tim Geithner was clear all through Monday: "There will be no rescue. Go off and do your math. See if 15 banks can put in $5 billion, because you're all basically on the hook here one way or the other, having hooked your trading books to these credit default swaps through AIG."

By Tuesday, it was pretty clear what the Lehman filing was causing. What they really would have done for AIG was some kind of debtor-in-possession bankruptcy, and you could see that people were already starting to worry. One of the reasons I was there was to answer questions: "If the holding company files, do the insurance regulators seize the operating companies? Would someone have the discretion to do that?"

ises. But that second idea is a really bad idea, because there are some elected insurance commissioners out there. And some of them aren't even in the same party as their governor. In fact, they want the governor's job. So that phone call is not going to go very well. I can't do the calculus right now to tell you which ones they are, but I'm sure out of the 10 calls you're going to have to make, one of them is going to end badly." And he said, "Thank you. That's very sound advice."

I just kept calling and begging and pleading, because I knew somehow the states were going to own this—unfairly, but to a large extent they were doing to own it. I just thought that if one state seized its insurance company, we would end up on a financial precipice in a matter of minutes.

Gallanis: *When people talk about the financial crisis and the need to regulate insurance more carefully, some defend a federal oversight role by saying, "AIG was an insurance company." One response commonly offered by insurance regulators and people in the insurance industry is, "Of course AIG historically has been a great insurance franchise, but the 2008 problems at AIG were really problems of these credit default swaps, which were written within a non-regulated, non-insurance subsidiary, AIG Financial Products." Many of us have found that to be a pretty compelling comeback.*

There is a scholar, Hester Peirce, who was just nominated for a vacancy at the Securities Exchange Commission this week. She published a paper in which she contends that the securities lending problems on the balance sheets of the AIG insurance subsidiaries, especially the life companies, were as bad as or worse than the problems that were posed by the CDS book at AIG Financial Products. As she views it, AIG really was as much a problem of inadequate insurance regulation as it was a problem of inadequate regulation (or non-existent regulation) of credit default swaps. Do you have a reaction to that contention?

Dinallo: I've read parts of the paper. It's a good paper, and I think the problems in the securities lending business have been overlooked to some degree. But I don't think it was a driver. I think that the problems at Securities Lending became a problem in part because the counterparty banks that were kind of privy to where AIG was on a liquidity basis were then going over to the pool and trying to pull out all their cash. You know, right after this happened, we sent what we call 308 Letters, or Letters of Inquiry, to the other 25 property domestics in New York, and none of them were having a securities lending issue. However, having said that, I'll say a couple of things. She's got some quotes in her paper that I stand behind.

I think the pooling of all of the life business was not a good idea. I thought it did a few things. It created a regulatory gap. It undermined the benefit of our "clunky" insurance regulatory system. What's great about the insurance regulatory system is that there's no way one regulator can make a wrong decision and we all go marching off the cliff together. And I think the idea of these operating companies that are kind of like castles unto themselves with a regulatory moat around them is, largely, why the industry survived the crisis so well. So I think that was a problem.

And I think what she misses, although she's not wrong in her numbers, was that when I testified in front of Congress twice, the insurance companies were still solvent. The securities lending had not caused an insolvency. But as many of you know, even if the companies had dipped low, the difference between their problems and the Financial Products Division's problems is we could have just engaged in regulatory forbearance and let them be insolvent for a little while, knowing that the numbers were going to pop back up. On the other side, you had true contractual commitments of mind-bending amounts the banks had a right to be paid on.

But there is one thing she could have attacked me on. Once I got through helping the rescue of the monolines—MBIA, Ambac—I really should have stopped and said, "Wait a minute. That Financial Products Division is really basically an unlicensed monoline. They're basically doing what MBIA, Ambac, and others are doing, but they're attached to an insurance company or financial services company. The whole point of New York Insurance Law Article 69 was to separate that activity because it was just too dangerous, it could become too big. And they're doing it without nearly the capital that you would set aside if you were regulated." To some degree, I've kicked myself for that. But remember, if I had made that call—say in January 2008—the Governor would have laughed at me and said, "Oh yeah, we're going to go after the most profitable division of AIG."

I think the wrecking of the economy really started with the Commodity Futures Modernization Act in 2000. Congress deregulated derivatives very forcefully in that Act.

Gallanis: *Hindsight is always great at telling us what we should have done, but we never think about the push back. To follow up on a thread you just exposed, you are on record to the effect that, had the federal government not rescued AIG the day after Lehman filed, the insurance entities could have met their obligations to insurance policyholders. How do you reach that conclusion?*

Dinallo: I really believed the companies were solvent enough to meet their obligations. I actually had to be prepared at length in case I had to testify in the Greenberg-Starr lawsuits. And that quote was strictly about policyholder obligations—I do think many of the companies would have gone into run-off, with basically either quick sales or no sales at all. But from our calculus and everything that we saw, I never had any lack of confidence that the operating companies *qua* operating companies could meet their individual operations.

I did make statements that were designed to keep confidence up. I went out there on a limb because I didn't want there to be a lack of a broker and agent network, because they would just flee. But I meant what I said. In my heart, I still think they would have been able to pay on their obligations.

> **You're at the epicenter of this debate. It basically opens and closes on the guarantee funds and the unfunded aspect, and they give no credit to the concept of cooperation between regulators and the successful history we've been able to manage through rehabilitations and insolvencies.**

Gallanis: *I'm going to finish with one last question, and it's kind of a catchall. Regulation of financial institutions of all sorts has changed in a lot of important ways since 2008. At the federal level we've seen the Dodd-Frank Act. At the state level, at least in insurance, we've seen through the NAIC's Solvency Modernization Initiative and other efforts by insurance commissioners an attempt to try to open the lens and see more than they were able to see going into 2008. It's been described as a "walls and windows" approach to preserving capital within operating entities while also taking a closer look at what's happening group-wide. How do you feel today about the ability of the insurance regulatory system to spot and deal with potential systemic problems at large insurance groups so that the sort of risks that erupted within AIG in 2008 will not recur?*

Dinallo: I'm still a proponent of the insurance regulatory system. I thought it did a great job during the crisis. So I would not point to them and say, "What have you learned?" I think actually a lot of financial services regulation could learn from the insurance regulatory system. I do think we've learned to look at the more complex institutions and ask whether there is activity going on there that really is insurance.

When you look at financial commitments and products and place them in different buckets—I wrote an article in the *Financial Times* where I boil it down to this: there's banking instruments, there's insurance instruments, and there's speculative instruments like futures. You've got those three. Those have to be money good. When an event occurs, there has to be sufficient capital to pay. That's what confidence is about—sufficient capital. And then there are investments—stocks and bonds—which are more regulated through transparency and not necessarily all the time core capital set-aside. There are just four buckets.

With derivatives, we thought we had invented a fifth bucket, like through alchemy. It's funny, because if you listen to the word—derivative—it's derivative of something else, right? So it's really operating as a banking instrument, an insurance instrument, a speculative instrument, or an investment. We let derivatives ruin our concept of basic regulatory capital requirements for those four buckets.

So I think the insurance regime is in very good shape. One thing I want to say about the politics on this is that I was shocked that, after AIG, there was not all of a sudden an optional federal charter or federal regulation of insurance.

I think through the Financial Crisis Inquiry Commission and in other ways, Congress really dug in and understood, more or less, what happened at AIG and did not lay it at the door of insurance *qua* insurance or insurance regulators. What I think they're trying to get at, though, and they've been open about this—they would love to put back Glass-Steagall. There's no doubt about that. They're willing to use their powers to try to get people out of the dual financial services businesses of banking and insurance.

Audience Question: *Eric, you mentioned the Greenberg vs. AIG lawsuit. I read the decision of that lawsuit and the judge's statement that AIG was the only large financial company that got federal assistance—you called it a "usurious loan"—and, as the judge said, "Paid with its life." What does that say about our regulatory structure and how our regulatory system can work and play in this new world going forward?*

Dinallo: I'm a fan of having a holding company supervisor for these companies. I never thought that was a bad idea. In fact, I think that it's probably essential and should be taken more seriously. But you do not want a regime where it's kind of "pick your regulator." One of the issues for AIG, as you know, was that the Office of Thrift Supervision got put in charge of everything at the holding company level and they were ill-prepared for credit default swaps. Maybe an insurance regulator at the top would have said, "Wait a minute." When I diagrammed this for a class I teach, I had someone up high looking down and saying, "You're doing this activity, and you're holding X amount of capital for this. But over here—same activity—no capital set aside." You know, you just wake up.

This is coming from someone who was a general counsel at Willis, but I'm still a big fan of the concept of operating company supervision. I think it really did serve the industry and the regulatory system very well. It's the best way to determine true exposure and whether there's adequate capital behind the commitments. But I think they could consider occasionally having an insurance regulator as supervisor. It would have been helpful with AIG, to be sure.

I think that's an approach that still needs to be worked out. The one thing I would recommend to this particular audience: If you have not read the Prudential designation by FSOC and the dissents, you have to read it. It's like our *Marbury vs. Madison*.

You've got to read it because you're at the epicenter of this debate. It basically opens and closes on the guarantee funds and the unfunded aspect, and they give no credit to the

concept of cooperation between regulators and the successful history we've been able to manage through rehabilitations and insolvencies. It is really interesting to me that the core question of resolution ended up being one of the strong tenets of that contested designation, at least between the dissent and the majority.

I think it's kind of remarkable and historical, and it doesn't really necessarily give enough credit to the good work you've done and your history of success when it mattered. It didn't recognize that even when we couldn't do a resolution perfectly, it didn't cause a financial crisis and completely undermine our financial insurance system. ✯

I'm still a proponent of the insurance regulatory system. I thought it did a great job during the crisis.

Resolving SIFIs: The FDIC's New Authorities

The FDIC's Art Murton discusses orderly liquidations, living wills, and how the FDIC is like the Maytag repairman

Arthur J. Murton is the Director of the Office of Complex Financial Institutions (OCFI), where he oversees the FDIC's resolution planning efforts associated with implementation of Title I and Title II of the Dodd-Frank Act. In this capacity, he leads a multidisciplinary team responsible for reviewing and providing feedback on the "living wills" prepared by the largest systemically important financial companies. These plans detail how a firm could be resolved under the Bankruptcy Code without causing financial distress to the U.S. economy. Mr. Murton is also responsible for developing a range of resolution strategies the FDIC could use if the preferred strategy of resolution through bankruptcy is not feasible. He also provides strategic leadership in support of the FDIC's international outreach and coordination efforts regarding the resolution of global systemically important financial institutions.

The following is an edited transcript of our conversation at NOLHGA's 2015 Legal Seminar on July 24.—Peter G. Gallanis

Gallanis: *To begin, could you tell us about the mission of the FDIC's Office of Complex Financial Institutions and the team that you've been assembling in that office?*

Murton: Let me start with the FDIC overall. You know that the FDIC was created in the Great Depression as the first federal deposit insurance system. The FDIC has three roles in the financial system. First, we supervise banks; we're the direct supervisor of some banks in the country, largely community banks. So of the 6,000 banks in the country, we supervise directly about 4,000 of them. That's the majority of the banks, but they're smaller, so in terms of the assets of the industry, it's less than 20%.

We're also responsible for deposit insurance for banks (and thrifts); we protect insured deposits in a bank failure. We make sure people get their money, and we've been very fortunate to be able to do that. So when a bank closes on Friday and opens on Monday, people have access to their money. Typically, they even have access if the banks have Saturday hours. We have a Deposit Insurance Fund that we maintain, and we charge banks for deposit insurance based on risk.

And then finally there's the resolution authority, which is tied to deposit insurance and which we've had over the years. It's been for banks, and what Dodd-Frank did was to extend that resolution authority to nonbank financial companies and to bank holding companies.

One of the things that happened in the last crisis was that policymakers faced two very unattractive choices when confronted with the potential failure of a very large financial firm. On the one hand, they could allow it to go through the bankruptcy process, which wasn't well suited to the problem and would likely have resulted in significant further disruption to the financial system and the broader economy. On the other hand, they could provide public support—putting taxpayers at risk and creating moral hazard.

The idea of Dodd-Frank was to provide the authorities with new tools, new options. So if they faced that situation again, they'd have a better choice than bailout or bankruptcy. And so the FDIC created the Office of Complex Financial Institutions to implement those new authorities.

Gallanis: *So am I right that under these new authorities that were conferred upon the FDIC by Dodd-Frank, the FDIC would be centrally involved on behalf of the federal government if a SIFI that included a major insurance group were to become significantly at risk of failure?*

Murton: That's a good question. As you know, Dodd-Frank created the Financial Stability Oversight Council, or FSOC as it's called. It has the ability to designate firms as systemically important financial institutions (SIFIs), and it has designated some insurance companies as such.

As a result, these companies are subject to oversight by the Federal Reserve and are required to submit resolution plans, or living wills. We are involved in reviewing those plans. Having said that, whether a firm has been designated or not doesn't determine whether we would be involved in their resolution. That decision is made at the time that situation exists, where a large financial firm is troubled. And under the Dodd-Frank framework, bankruptcy or the normal insolvency regime is the first option. It's only if policymakers judge that that option would be too disruptive to the financial system that we would get involved and use what is called our Title II Authority—the Orderly Liquidation Authority.

Whether a firm has been designated or not doesn't determine whether we would be involved in their resolution. That decision is made at the time that situation exists, where a large financial firm is troubled.

We have policymakers who make that decision—what is called the "three keys." If the company is largely a bank holding company but might also have an insurance company, the three keys would be the Federal Reserve Board and the FDIC Board making a recommendation to the Secretary of Treasury, who, in consultation with the President, would make the decision to place the firm into a Title II receivership.

If the firm is largely an insurance company, instead of the FDIC as a key turner, the Federal Insurance Office (FIO) would serve as a key turner. And just to be clear, a firm that has not been designated by FSOC could still be put into this Title II process.

Gallanis: *So if you had an insurance group—a SIFI holding company with subsidiary insurance companies—what I take from your answer is that the FDIC would be involved if those three keys were turned.*

Murton: That's correct, but I should elaborate. As you all know better than I, not all the entities within that group are insurance companies. So the parent may not be an insurance company. And so whether we would get involved in the actual resolution of the insurance companies within the group is a separate question from whether we might get involved at the parent level.

Gallanis: *Let's assume you've got an insurance group that has not been designated as a SIFI, but it may be an entity that nonetheless is supervised by the Federal Reserve at the holding company level because there is a thrift or a bank somewhere in the structure. Is it the same answer? That, as with a SIFI, you would not automatically be involved, but Title II permits a review of whether it could threaten the overall financial system? And if so, and if those three keys were turned with respect to this non-SIFI insurance group, you would have a role at that point in a Title II resolution?*

Murton: Yes, if that firm needed a Title II resolution, we would be involved in that resolution. Now, it's likely we would come in at the parent level and deal with the separate subsidiaries, whether banking or insurance, in whatever manner seems appropriate at the time and is consistent with the normal insolvency priorities for that subsidiary.

Photos by Kenneth L. Bullock

Gallanis: *And can you envision an insurance group that might not be either a SIFI or supervised by the Federal Reserve at the holding company level, where at least in theory, a determination might be made that the failure of that group could pose a risk to the financial economy that again could result in the three keys being turned and the FDIC having a role?*
Murton: The statute provides for that, so hypothetically that could be the case. There could be a firm that had not been designated by the FSOC, but at the time of its failure could be determined to pose systemic consequences, and therefore a Title II would be necessary.

Now that presents a challenge for us, because part of the framework is that firms that are likely to be systemic in resolution have to submit these resolution plans or living wills. While the wills outline how a firm would be wound down in bankruptcy, they also provide a roadmap so that we, in advance, can do some thinking and preparing for their failure.

While the living wills outline how a firm would be wound down in bankruptcy, they also provide a roadmap so that we, in advance, can do some thinking and preparing for their failure.

Gallanis: *For non-SIFIs that are supervised by the Federal Reserve at the holding company level—they've got insurance, maybe other types of subsidiaries—are they required to prepare living wills?*
Murton: The law says that bank holding companies that have more than $50 billion in assets are required to submit living wills. There are some foreign operations where, if the foreign entity is of a certain size, their operations here may be subject to the requirement for a resolution plan.

Gallanis: *And again, of interest to those of us in this audience—a bunch of insurance geeks—what I think you've said to us is that, if the Federal Reserve supervises a group that has assets in excess of $50 billion, and they happen to have insurance operations within their group, they're required to prepare a living will.*
Murton: Correct.

Gallanis: *What do you envision or understand to be the role of the FDIC if you're confronted with a global systemically important insurer—a G-SII, as they're sometimes called—or a global systemically important bank (G-SIB) that is based outside the U.S. but has some operations within the U.S.? If that kind of entity got in trouble, does your office under Title II conceivably have a role?*
Murton: Possibly. And particularly on the banking side, we have worked since the passage of Dodd-Frank very closely with jurisdictions in Europe and Japan to try to coordinate how we might approach resolution of these—whether it was one of our firms with operations abroad or one of their firms with operations here.

The thinking is that, to the extent possible for most of these firms, the resolution would be conducted by the home authority. And you would want to try to keep the key operations functioning through resolution until the firm can be wound down and liquidated. That would require some coordination through the U.S. authorities—the FDIC, the Federal Reserve, and possibly others.

But if it were the case that the support from the home jurisdiction was insufficient or wasn't forthcoming for whatever reason, it could be that the operations here would need to be dealt with in some fashion. And it could be that the three keys could be turned on the U.S. operations. So if they had a subsidiary here, it could be that they would have their own Title II Orderly Liquidation. But our preferred outcome would be that the home authority handle it smoothly and without disruption.

Gallanis: *I've already confessed that we in this group are a bunch of insurance geeks. And insurance is something that hasn't really been front and center at the FDIC. So with all of these new authorities and responsibilities under Title II, could you tell us a little about how the Office of Complex Financial Institutions has sought to build out and develop expertise on insurance groups, insurance regulation, and insurer resolutions? And how would you characterize your progress on those fronts?*
Murton: I think it's a work in progress. As you point out, the insurance industry was essentially a new field for the FDIC, and so as a member of the FSOC, even before the firms were designated, we had a role and our chairman had to vote on

whether to designate. So we had people doing the analysis with other agencies about whether firms should be designated.

So the FDIC has people—bank supervisors who are in the largest firms—and my office works very closely with them to understand each of the firms that is under our purview. There's a group in supervision at the FDIC who are basically our OCFI counterparts. They have onsite people, and they have people doing off-site analysis. We work closely with them, and we have the units organized by the types of firms. In my group and in supervision, there are units that are dedicated to nonbank firms. They've been looking at the insurance companies, working with the Federal Reserve as they start their oversight of these firms, and reviewing the resolution plans that were submitted. We're building our knowledge. I won't tell you that we're as expert as many in this room, but we're definitely moving up the learning curve.

These firms face the world through their business lines, but resolution—whether through bankruptcy or under Title II—takes place on a legal entity basis. To the extent there's a mismatch, it makes a resolution more difficult.

Gallanis: *We've already discussed Title II resolutions for SIFIs and non-SIFIs and how they might come into play. More generally, at least from the perspective of the FDIC, is a Title II Orderly Liquidation a preferred course, or is it viewed more as a last resort?*

Murton: It's the latter. It's a backstop. The way the Dodd-Frank framework is set up, bankruptcy or another insolvency regime, such as that for insurance, is the first resort. That's how we expect these firms to be resolved.

The Orderly Liquidation Authority under Title II is provided as a backstop for those circumstances where those three key policymakers judge that bankruptcy or the normal insolvency regime would result in disruption to the financial system and the economy.

Gallanis: *So you wouldn't be depressed if your office were like the Maytag repairman?*

Murton: That would be ideal.

Gallanis: *Let's come back to the topic of living wills. Can you give us a high-level description of how you view the relationship between living wills and either avoiding or administering a Title II Orderly Liquidation?*

Murton: I think they're very much related. The standard for the resolution plans under Title I is that the firms need to demonstrate that they could be resolved under bankruptcy without disruption to the financial system. So that's the standard; not resolution under Title II, but resolution under bankruptcy.

Let me talk about the largest banking firms that went through the Title I process, because we're a little further along there. They submitted their first plans in 2012. We did not judge the first plans under the standard, but provided general feedback on common areas for improvement.

We reviewed the second plans under the standard; the FDIC and the Federal Reserve. The resolution plan authority is a joint authority with the Federal Reserve. So the FDIC Board and the Federal Reserve Board both have a role.

Last August, the two agencies sent letters to the first 11 firms with our findings on their plans. We were pretty frank in those letters, and in the press release that we put out on August 5. We found that the plans had shortcomings that the firms needed to address; they had also used unrealistic assumptions to overcome some of the obstacles to an orderly resolution.

So our boards directed the firms to address several key areas. And the changes that we're requiring the firms to make, while they would help resolvability under bankruptcy, would also help them become more resolvable under a Title II resolution.

These are things like ensuring the continuity of critical

operations during resolution; making sure that capital and liquidity are available to support critical operations; and making sure that foreign authorities would not resort to destructive ring fencing. We've asked them to rationalize their legal entity structure and their business lines because, as you know, these are very complicated firms. They face the world through their business lines, but resolution—whether through bankruptcy or under Title II—takes place on a legal entity basis. To the extent there's a mismatch, it makes a resolution more difficult. And we've asked them to address that.

We're working to build and strengthen our relationship with both FIO and the states.

Gallanis: *In past conversations like this with both Bryan Marsal and the late Harvey Miller, we discussed some of the challenges of the resolution of Lehman Brothers. And each told us that one of the biggest challenges was the misalignment of the business lines on the one hand and the legal entities on the other. So it's a major issue.*

Murton: Absolutely. These firms are built without thought being given to what it would mean for resolution; they organize for tax purposes, for regulatory purposes. What is happening now is that they're being forced to think about the implications for resolution of the way they're structured.

Gallanis: *Continuing with the idea of how you plan for at least a theoretical administration of a Title II resolution, early on in the build-out of Dodd-Frank, there was some discussion—much of it from the FDIC—about the possibility of pursuing a resolution strategy that followed what was called a single-point-of-entry (SPOE) approach. At a high level, could you give us a sense of what's contemplated by a SPOE strategy, and how you think it might work in a resolution?*

Murton: Sure, and I'll try to be brief. Most if not all of the large U.S. banking firms are organized with a holding company on top that is largely nonoperational, with the key subsidiaries below: an insured bank, possibly a broker-dealer, and so forth.

The idea is that, in a Title II resolution, we would place the top-tier holding company into the Title II receivership and create a new bridge financial holding company. Dodd-Frank gives us the authority to do that. We'd transfer the assets of the failed parent—largely the investments in those key subsidiaries—into this new bridge entity.

The idea would be to liquidate the parent by putting it into receivership but keep the operating subsidiaries open and operating to minimize disruption and provide continuity of services, at least as a transition to get through resolution weekend and the early days of the resolution. Eventually, the firms would be broken up, wound down, and liquidated.

Gallanis: *How have you thought about the applicability of a SPOE strategy in the context of a group that is largely focused on insurance?*

Murton: When we developed SPOE early on, it was a strategy that seemed well-suited, given the existing structure of these large firms—come in at the top. These firms have so many interconnections among their various subsidiaries that it's hard to disentangle them in resolutions.

So the idea of keeping them all going to minimize disruption made a lot of sense. What we're doing through the Title I process is telling these firms they have to focus on separability of key operations, so that if one part of the organization gets into trouble, it could be dealt with without necessarily having negative implications for the rest of it.

So while SPOE is an option, we can picture that there could be other resolution approaches once these firms make the type of changes that we're pushing for. That is background. For the insurance companies, at least the ones that have been designated SIFIs, the parent companies are not insurance companies, but we could picture coming in at the top in the parent, and possibly placing the parent into a Title II receivership, and similarly trying to keep the solvent insurance companies open and operating.

Or, if one of them is insolvent, hopefully it can go through its normal insolvency procedure without disruption to other parts.

Gallanis: *Let's talk about that specific point. One of the aspects of Dodd-Frank that people have looked at—it was mentioned in the IMF FSAP technical note on resolution that was recently released—is that if you have the failure of an entity where a Title II resolution is pursued, what Title II seems to contemplate is that the holding company, the systemic part of the entity, is resolved through the FDIC. But if any subsidiary insurance companies need to be resolved, their resolutions would continue to be managed through state processes. In other words, state insurance receivership and consumer protection through the state guaranty associations.*

Murton: That's our objective.

Gallanis: *So if the Maytag repairman gets the phone call and we actually have to get involved in one of those Title II liquidations that does involve operating insurance subsidiaries, how do you envision the need and the process for cooperation among your team handling the noninsurance parts of the resolution with the*

state regulators who may end up becoming receivers of these insurance subsidiaries? And with the guaranty associations that may be triggered to do their job of providing a financial safety net for the consumers?

Murton: I think we would certainly have to have close cooperation. Any time we're doing a resolution of any kind, we have to be in close contact with the relevant regulators and authorities. And this introduces a new thing; it's not just supervisors of these other parts, but the actual resolution authorities for these different parts.

So we'd very much have to coordinate it, and just as we're reaching out to the foreign jurisdictions for our large banks, we are building an understanding with the states. And I think we've made some progress there; we have more work to do, but absolutely, we would have to be coordinating in a resolution.

Gallanis: *How does the notion of regulatory capital requirements relate to what types of resolution are possible? When SPOE was first being discussed, there was speculation in the trade and financial press that it was highly dependent on the availability of fairly high levels of capital at the parent company. I wonder, based on what you've said here, if through the living will process we're driving toward more flexibility in terms of permissible or possible or workable resolution strategies; does that have implications for the amount of capital that would be required, and where it would be required to be held?*

Murton: Well, let's divide capital into equity and other forms and particularly long-term debt. Because when I mentioned a SPOE strategy, part of what's needed to make that work is that, when we go into resolution, there's something there to absorb losses and provide needed capital.

Our experience with banks is that typically there's not much equity, if any, when we get to a resolution. So we've been thinking that we'd have to take some of the long-term debt the firm has and use that; convert that into equity to absorb losses and provide capital.

There has been an effort internationally, something called TLAC—Total Loss Absorbing Capacity. And the Financial Stability Board—an international organization primarily composed of treasuries, central banks, and supervisors—put out a consultative paper last fall talking about minimum standards for global SIFIs with respect to loss-absorbing capacity. So that is a critical part of it, and we're expecting that the Federal Reserve will issue a rule to implement TLAC domestically. That will be forthcoming.

Gallanis: *Just in terms of the New World Order at the level of federal entities involved in financial services regulation, how much does your team, or the FDIC in general, interact with counterparts at the Federal Reserve or at the Federal Insurance Office? Or for that matter, with the involved state regulators for insurance entities? What sort of formal or informal systems of relationships, interaction, or consultation are out there?*

Murton: Let me start with the Federal Reserve first. That relationship is probably the deepest, partly because the living will authority is a joint authority with the Federal Reserve. So in terms of the resolution plan reviews, we are in constant contact with the Federal Reserve. We have a standing weekly call with them, but we're talking to them pretty much every day on these things.

And we've had a long-standing relationship with the Federal Reserve on other bank supervision and deposit insurance issues. In terms of FIO, we have been in discussions with them; they are part of the FSOC, and the FSOC has some role in the Title I process, so there's communication as a result.

And then with the states, we have engaged with the state commissioners. We have engaged with them in discussions of our Title II authorities and how they might work. And then on the living wills, we've had engagement there.

So I think it's fair to say because of the longstanding history, we have a deeper relationship with the Federal Reserve. I think we're working to build and strengthen our relationship with both FIO and the states.

Gallanis: *When you think about your Title II responsibilities, and particularly as they relate to entities that have insurance subsidiaries involved in the picture, what keeps you up at night worrying?*

Murton: Well, what keeps me up is the idea that we would have to do one of these. In terms of doing one with an insurance company, as I said before, these are new animals for us. There are things that could pop up that we aren't aware of, that we don't have any experience with. That's obviously a challenge for us. We want to build the relationships and build our understanding so that the chances of that happening are less and less over time. ✯

["Fearless Predictions" continues from page 1]

have come true—federal/international discussions and debates have not abated, and the NAIC and its state regulator members are devoting more and more time to the new reality. Plus, while capital standards and group supervision monopolized 2015, resolution is bubbling to the top and will inevitably get more air time moving forward.

Predictions

At the IAIR Forum during the last NAIC meeting in Washington in November 2015, we were asked to make some predictions about what to expect from a Democrat or Republican President in 2017.

On the Democrat side of predicting, we refer everyone to Hillary Clinton's 2016 economic plan: https://www.hillaryclinton.com/issues/plan-raise-american-incomes/. That plan embraces and strengthens the Dodd-Frank Act (DFA) structure.

Republican predictions are more difficult. Congress, now in the hands of Republicans, is watching every DFA move by the federal agencies with skepticism. They lie in wait for a Republican President in 2017 who could lead a charge to nip, tuck, or slash the DFA. Here's what we predict would happen if we had a Republican Congress *and* a Republican President.

SIFI Designations: Any expansion of the systemically important financial institution (SIFI) designation list—which now includes insurance companies AIG, Prudential, and MetLife—is likely to stop. That process is driven by political appointees, so it can be directly affected by a new administration skeptical that insurance companies can even be systemic.

FIO's Philosophy: The Federal Insurance Office (FIO) and its parent, the U.S. Treasury Department, would likely be a little more respectful of state regulation and skeptical of growing federal influence over insurance, at least in the short run.

CFPB Interest in Insurance: The Consumer Financial Protection Bureau (CFPB) has been wandering over into insurance consumer protection issues. That would almost certainly stop. The activities of the CFPB could be restricted, in general, and an aggressive march over to insurance would likely not happen.

The Dodd-Frank Reform Agenda: DFA "reform" means legislation, and the reformers can't get much reform through the Congress right now. A Republican President doesn't necessarily change that. That means FIO, FSOC, and all the rest are still around doing their Dodd-Frank jobs.

International Standard Setting: The international agenda probably isn't affected, at least at first. That is driven by the independent Federal Reserve and FDIC. In any event, that train may have left the station, and it's hard to reverse quickly—international standard setting is already affecting regulation, and that isn't going to stop.

Federal Reserve Authority: Between the statutory independence and the "train has left the station" effect, Federal Reserve influence over insurance regulation and capital should continue to grow.

In November 2015, the Republican majority on the House Financial Services Committee passed six insurance bills touching on some of the above issues. The NAIC's Policyholder Protection Act even became law through the year-end omnibus appropriation.

FIO remains active, where Director Michael McRaith has kicked off the process toward a reinsurance covered agreement that screams state regulation preemption and strikes terror in the heart of some in the NAIC. See the summary below, and please also read pages 63–65 of FIO's 2015 Annual Report, which addresses resolutions.

Affordable Care Act: Digging deep on the implications for the Patient Protection and Affordable Care Act (ACA) deserves its own treatment. But suffice it to say, Obamacare without Obama makes for a different landscape. Legislative action on Obamacare continued last year, including opponents finally passing a substantial repeal bill through the Senate. That action is symbolic with an Obama White House, but it would be a different story under Republican leadership. That story would center on whether Republicans would match their talking points and fully repeal the ACA.

Short of that, they would likely repeal large pieces of the law, including lessening the individual and business mandates; repealing, rather than delaying, the so-called Cadillac tax; and making permanent the budget neutrality of the risk corridors that support health insurers in the exchanges. And even absent full or partial repeal, regulatory implementation and enforcement (or lack thereof) under a Republican President would, yet again, change the healthcare landscape in fundamental ways.

Covered Agreement

In short, insurance conversations no longer stop at our shores, even when the subject is the U.S. insolvency safety net.

There is no better example of that than what is happening on the reinsurance collateral reform front—the "covered agreement" process that kicked off last November under the leadership of FIO.

Much has been written, said, and shouted about reinsurance collateral requirements through the years. In 2011, the NAIC passed amendments to its "Credit for Reinsurance Models" that, once implemented by a state, will allow certified reinsurers to post significantly less than 100% collateral for U.S. claims.

Thirty-two states have passed legislation to implement the revised NAIC Credit for Reinsurance Models, representing more than 66% of direct insurance premium written in the United States across all lines of business. An additional five states have indicated plans to take up the model law in the near future, which would raise the total market coverage to 93%.

Individual reinsurers are certified based on criteria that include, but are not limited to, financial strength, timely claims, payment history, and the requirement

that a reinsurer be domiciled and licensed in a "qualified jurisdiction."

But what U.S. regulators do on the subject is now not the end of the story. That's because on November 20, 2015, FIO Director Michael McRaith, through the U.S. Department of the Treasury and the Office of the U.S. Trade Representative (USTR), announced the group's intention to begin negotiating a covered agreement with the European Union. Under the FIO Act, the Secretary of the Treasury, FIO, and the USTR are authorized jointly to negotiate a covered agreement with one or more foreign governments, authorities, or regulatory entities.

A covered agreement is an agreement between the United States and one or more foreign governments, authorities, or regulatory entities regarding prudential measures with respect to insurance or reinsurance. Treasury publicly called for a covered agreement in FIO's 2013 Report, *How to Modernize and Improve the System of Insurance Regulation in the United States*.

In the covered agreement negotiations, Treasury and the USTR will seek recognition of certain prudential measures, including reinsurance collateral, to ensure a more level playing field for U.S. firms. The process will also negotiate potential standards on group supervision and confidentiality.

"Negotiating a covered agreement with the European Union is a critical step toward leveling the playing field for American insurers and reinsurers," said Director McRaith in his November 20 announcement. "As we begin negotiations with our European counterparts, I look forward to consultation and engagement with Congress, state regulators, and other stake holders so that we can pursue a covered agreement that provides tangible benefits for the U.S. insurance industry and consumers."

The start of the covered agreement process is a big deal. Key Congressional committees will be involved, and both Treasury and the USTR have said they intend to engage meaningfully with stakeholders, including state insurance regulators, throughout the covered agreement negotiations.

So here's what happens next. FIO and the USTR's steps in November were just that—initial steps. By the terms of the DFA's Title V, getting to a covered agreement will proceed in the following stages:

Step 1—Consultation: Before and during covered agreement negotiations, Treasury and the USTR must consult with four key Congressional committees. The consultation must include at least:

- The nature of the agreement
- How and to what extent such an agreement will achieve the purposes of Title V of the DFA
- The implementation of the agreement and its effect on state laws

Step 2—Agreement: Treasury and the USTR agree in principle with foreign authorities (here the European Union) to terms of the covered agreement.

Step 3—Submission: Treasury and the USTR jointly submit the proposed agreement to the Congressional committees on a session day.

Step 4—Layover: Ninety calendar days after submission, the covered agreement is effective. No Congressional approval is needed; just lack of adverse action.

Note that preemption of a state regulation by a covered agreement requires further consultation, procedures, and opportunity for judicial review.

One last observation on the covered agreement world: The effects of the covered agreement process are direct and immediate, but also potentially far reaching. A final covered agreement will directly affect reinsurance collateral and group supervision. The full weight of that direct impact will only be known when the actual negotiation process is complete. But the process has larger implications for insurance regulation as well. For the first time, FIO will have a hand in establishing national prudential standards for U.S. insurers—not aspirational international standards, not white papers, not moogy/foogy, but rather legally binding rules that U.S. insurance companies and state insurance commissioners will live by. Speculation about the direction of the federal role in insurance is still speculation, but it now gets sharper. Will the covered agreement process expand to more topics and/or more countries? Will the covered agreement process redefine the federal role so fundamentally that further involvement meets less resistance? Or will opponents of federal "encroachment" galvanize now that this shoe has dropped, leaving FIO its "one off" but drawing the line there?

The Resolution Debate

On top of this will be the insurance company resolution debates that will necessarily touch what the guaranty system does, what it's capable of doing under stress, and what it offers the consumers it protects and the industry it supports.

The reality is that state and federal regulators, along with the industry, have been focused the past 24 months on group supervision and capital standards. That focus will continue in 2016, but at some point, resolution/safety net issues will get on the discussion agenda, perhaps even near the top.

For example, 2016 begins with a consultation underway on a Financial Stability Board insurance resolution paper. The guaranty system has to be ready to describe, demonstrate, and document its capabilities under a variety of economic, operational, and legal scenarios and challenges. In short, we need to be ready to explain ourselves clearly to—and support the role of the guaranty system in this post/Dodd-Frank world in front of—all relevant constituencies.

There you have it. A Washington update to start the year off right. Next year's version will tell you what to expect from a new President and a new Congress—and the height of Donald Trump's Mexico-U.S. wall. ✯

Charles T. Richardson and Patrick D. Hughes are Partners with Faegre Baker Daniels.

["Grace Under Pressure" continues from page 3]

We in this room are engaged in tough work, whether it's within the industry, in the guaranty system, as regulators, or receivers. It's very challenging work, and often, no matter how well we do our jobs, some people are never going to be fully satisfied.

To me, that implies two conclusions we need to reach if we're going to do our jobs and hope for any inner peace in the process.

The first conclusion is that if we can satisfy our own consciences that we've done the best we can possibly do under tough circumstances, then it doesn't matter what the critics say.

The second conclusion is that, to a great extent, we're all in this together: regulators, receivers, the individual guaranty associations and their teams, and NOLHGA as the agency of the associations. In the vast majority of cases, if any of us fail, we all fail. So let's treat as generously as we would wish to be treated the good faith, diligent efforts of our counterparts—our teammates—in this shared, difficult enterprise in which we are all engaged.

It has been a pleasure and an honor to serve this great organization for another year, and I look forward to working with all of you in the year to come. Thank you very, very much. ✯

Peter G. Gallanis is President of NOLHGA.

["Safe Harbor" continues from page 7]

we fully expected higher utilization early on." The individual mandate, which will be increasing, could help alleviate this problem. "I'm hopeful that stick will entice people to sign up."

That's not the only challenge insurers face. Handelman pointed out that there are currently 33 special enrollment periods to sign up for health insurance. "We really believe this is resulting in some gaming of the system," she said. "You don't want to create an environment where people can jump in and out." The problem is exacerbated by the 90-day grace period to pay premiums, which could allow people to obtain services and then exit the system without paying for them. She also noted that the push for Medicare payment reform, with its move away from fee-for-service to a focus on patient outcomes, will bring more challenges. "It's going to drive tremendous change in health care."

Handelman touched briefly on the recent failure of a number of consumer-operated and oriented plans (CO-OPs), which were established by the Affordable Care Act. "That was a challenge from the get-go," she said, adding that a number of plans under-priced their policies. Changes to the risk corridor programs, which were designed to funnel money to these new insurance companies, played a role in many of the failures as well, she said, adding that "there's a lot of uncertainty" over how many CO-OPs will make it through 2016.

Eye on the Economy

Dr. Laurence Ball (Johns Hopkins Krieger School of Arts & Sciences) also looked ahead to 2016, saying "we absolutely should worry a lot about decades of Japan-like zero interest rates." He added that the Fed should raise rates, but not just yet (this was in October 2015). One reason rates need to go up eventually, he added, is that "economic history teaches us there will be shocks to the economy" in the future, and the Fed will need the leeway to lower rates. It's difficult to go lower than zero.

Dr. Ball predicted that "we're going to bump along around zero for a long time" and suggested that "we could have greater growth if only the Fed would allow unemployment to fall under 5%. A more dovish interest rate policy would really have long-term benefits for putting people back to work." ✯

Sean M. McKenna is NOLHGA's Director of Communications.

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