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The Thirteenth Annual A.A. Sommer, Jr. Lecture on Corporate, Securities & Financial Law at the Fordham Corporate Law Center

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Cover Page Footnote

Benjamin M. Lawsky is the Superintendent of the New York State Department of Financial Services.

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LECTURE

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REGULATING IN AN EVOLVING FINANCIAL LANDSCAPE

WELCOME & INTRODUCTORY REMARKS
Sean J. Griffith
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LECTURER
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LECTURE

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WELCOME AND INTRODUCTORY REMARKS

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† The Lecture was held at Fordham University School of Law on April 18, 2013. The remarks of Benjamin M. Lawsky are published as prepared for delivery. The Welcome & Introductory Remarks of Sean J. Griffith and Ben A. Indek were edited to remove minor cadences of speech that appear awkward in writing. The Lecture was edited to provide sources and references to other explanatory materials where the editors deemed appropriate.

* Sean J. Griffith is the T.J. Maloney Chair in Business Law at Fordham University School of Law and Director of the Fordham Corporate Law Center. Sean J. Griffith—Biography, http://law.fordham.edu/faculty/seanjgriffith.htm.

** Ben A. Indek is a Partner at Morgan, Lewis & Bockius LLP.

*** Benjamin M. Lawsky is the Superintendent of the New York State Department of Financial Services.

WELCOME AND INTRODUCTORY REMARKS

PROFESSOR GRIFFITH: Welcome. Good evening. My name is Sean Griffith. I am the T.J. Maloney Chair and Professor of Law here at Fordham Law School. And I am also Director of the Fordham Corporate Law Center.

I am delighted to welcome you all to the 13th Annual A.A. Sommer, Jr. Lecture. Our speaker tonight is Benjamin M. Lawsky, Superintendent of the New York State Department of Financial Services. His topic tonight is "Regulating in an Evolving Financial Landscape." In a few minutes, Ben Indek, Partner at Morgan, Lewis & Bockius will introduce Superintendent Lawsky.

But first I have the privilege of welcoming you and making a few introductory remarks, first about the Sommer Lecture itself. The Sommer Lecture is co-sponsored by Morgan Lewis and the Corporate Law Center, and it honors the legacy of former SEC Commissioner and former securities law practitioner Al Sommer. Mr. Sommer was a guiding light on the Commission, an outstanding lawyer, and a mentor to many scholars and practitioners of securities law. The annual Sommer Lecture is the Corporate Law Center's longest running tradition here at Fordham Law School. And at the 2007 Sommer Lecture, our speaker, SEC Commissioner Paul Atkins, remarked that the Sommer Lecture has become a prominent feature in the ongoing dialogue among security regulators, practitioners, and the regulated community, and I know that the lecture will continue that tradition tonight.

The Sommer Lecture is hosted by the Fordham Corporate Law Center, and I will just mention what we do at the Corporate Law Center—we serve as the Law School's nexus for discourse on issues of business law and policy. We like to call the Center the platform from which the Law School launches its graduates on a business law trajectory and from which it launches its faculty members on their scholarly endeavors. The Center has three principle target audiences and three target interests. First, public lectures like this one seek to bring headline speakers to the Law School to speak to a community of alumni, faculty, friends, and students. Second, we focus on our academic events. We bring scholars from around the country and around the world to the Law School. Thirdly, we bring friends and alumni back for our students, to provide them with networking opportunities and opportunities to learn how to get there from here.

The Corporate Law Center is especially excited about its new initiative in the area of Corporate Compliance. This summer, the Corporate Law Center is going to start the first annual meeting of the Corporate Compliance Institute, a three-week intensive training program to "retool" lawyers in the area of corporate compliance. We hope to launch an LL.M. program in the area of Corporate Compliance soon after that. We see that as a growth area for us and for Fordham Law School.

Before I turn the podium over to Ben, I just want to thank and acknowledge a number of people here tonight. First of all, John Peloso, who is Of Counsel at the Morgan Lewis firm and was the driving force behind the creation of both the Corporate Law Center and the Sommer Lecture. We are very grateful to John for the many contributions that he has made to the Law School and the partnership that he had helped us forge with the Morgan Lewis firm and now with Ben Indek. We also want to thank the SEC Historical Society for being a part of this event and the Executive Director of that Society, Carla Rosati, who is here tonight. The Society shares, preserves, and advances the knowledge and the history of financial regulation through its virtual museum and an archive available online at www.sechistorical.org. The Society recently celebrated its tenth anniversary. Also, I want to acknowledge the members of the Sommer family who are here with us tonight: Mrs. Starr Sommer, her daughter Susan Futter, and her son-in-law Jeff Futter. They traveled here to join us for the Sommer lecture as they often do, and their presence underscores the special relationship that Fordham had and has with Al Sommer, and the memory of Al Sommer. We are grateful also obviously to the members of the New York State Department of Financial Services who are here with us tonight accompanying Superintendent Lawsky. This event was going to take place on November 1st, and intervening events, a little annoying visit from someone named Sandy, got in the way of that event. We are very pleased that you were able to make time and reschedule the program for us tonight. I also want to thank my colleagues in the audience for attending tonight.

Now, it is my pleasure to turn the microphone over to Ben Indek from Morgan Lewis.

BEN A. INDEK: Good evening everybody. On behalf of Morgan Lewis, I would also like to welcome you to the 13th Annual A.A. Sommer Jr. Lecture.

More than 30 years ago, Al Sommer started the Morgan Lewis Securities Practice and as a way to honor his role, we created this lecture series. As Sean was mentioning, Al was a Morgan Lewis partner from 1979 until 1994. He then became Counsel to the firm. Al was an outstanding public servant. He was an SEC Commissioner from 1973 to 1976. He also served as Chairman of the Public Oversight Board and as a public member of the AICPA. In private practice, he was a trusted boardroom lawyer, a prolific author, and an expert commentator on a wide range of securities law topics. With the assistance of many other lawyers, several of whom regularly participate in this event, Al strengthened and expanded our securities law practice.

Today we have more than 100 lawyers in about a dozen cities around the world devoted to providing advice regarding the securities law to financial institutions and public companies. The Morgan Lewis Securities Group now mirrors the structure of the SEC. We practice in the securities enforcement and litigation areas, trading and markets, investment management and corporate finance. Al participated in the first two lectures we held at Fordham Law School. Some of you may remember him quizzing the lecturer on particular parts of their remarks. Sadly, Al passed away in 2002. Nevertheless, we are delighted that his family, as Sean mentioned, continues their close relationship with Morgan Lewis and Fordham. We are also thankful to the SEC Historical Society as Sean mentioned.

Like Al, our speaker tonight, Superintendent Benjamin M. Lawsky is also committed to public service. And I am confident that Al would have heartily complimented Mr. Lawsky for his dedication to government service. Prior to helping to create and lead the New York State Department of Financial Services, Mr. Lawsky served as Chief Counsel to Senator Charles Schumer on the Senate Judiciary Committee, as an Assistant United States Attorney in the Southern District of New York, as Deputy Counselor and Special Assistant to then-Attorney General Andrew Cuomo and as Governor Cuomo's Chief of Staff. Finally, in addition to leading the Department of Financial Services, his day job, in the aftermath of Hurricane Sandy, Mr. Lawsky was tapped by Governor Cuomo as co-chair of the Moreland Commission, which has been charged with investigating the preparation of and response by New York's power companies to Sandy and Hurricane Irene. And we appreciate Mr. Lawsky coming tonight after our original date in November was postponed due to Sandy.

Although separated by a generation, it was also clear to me that Mr. Lawsky and Al had a common view on the role of government regulation. After being nominated by Governor Cuomo to serve as the Superintendent of Financial Services in 2011, Mr. Lawsky articulated several objectives for the new department. Remarkably, certain of Mr. Lawsky's goals were consistent with those articulated by Al as an SEC Commissioner in the mid 1970s. For example, Mr. Lawsky has stated that one of the more important goals of the Department of Financial Services is to make sure that it is "right-sized and wisely structured" and that it needed to focus on "eliminating redundancies and waste." In a speech he delivered while on the Commission called "The Delicate Balance of Regulation and Competition," Al commented, and I am quoting here, that "it is imperative that every effort be made by the SEC to eliminate duplication" in its rules and regulations.[1]

As another example, in creating the Department of Financial Services, Mr. Lawsky was mindful that a regulator must be "nimble" and one that didn't "stifle innovation."[2] By doing so, the Department could contribute in a positive way to New York's economic future. In the same speech just quoted from Al 40 years ago, Al suggested that where it could responsibly do so, the SEC should foster competition, rather than regulation.

Finally, as regulators, Mr. Lawky and Al understood that it is critical to forcefully enforce the law against wrongdoers. Mr. Lawsky said, ". . . we must remain vigilant against fraud in our markets and against consumers."[3] Al himself could have written those words. In fact, he put it a bit more colorfully in a 1974 speech when he said ". . . our enforcement efforts must be strengthened and promoted vigorously. There is other than education, nothing that can serve the public better than ferreting out the frauds and putting them out of business, throwing sand in their schemes, making the risk too heavy, as compared to the potential gains."[4]

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1. *See* A.A. Sommer, Jr., Commissioner, SEC, Address at North American Securities Administrators Association 58th Annual Conference (Sept. 8, 1975).

2. Benjamin M. Lawsky, Testimony Before the New York Senate Committees on Insurance and Banking (May 18, 2011), *available at* http://www.dfs.ny.gov/about/speeches_testimony/t110518.htm.

3. *Id.*

4. A.A. Sommer, Jr., Commissioner, SEC, Address to North American Securities Administrators (Sept. 24, 1974).

Those who paid attention last summer to the Department of Financial Services' pursuit of charges against an international bank regarding processing transactions on behalf of Iranian customers would have little doubt that Mr. Lawsky would have agreed with Al's view. In turn, I know that Al would have been keenly interested to hear Mr. Lawsky's lecture this evening. At Morgan Lewis, we are proud of Al Sommers' affiliation with the firm and delighted to sponsor this annual lecture in his honor.

I am pleased to turn the podium over to our speaker tonight, Superintendent of the New York State Department of Financial Services, Benjamin Lawsky.

LECTURE: REGULATING IN AN EVOLVING FINANCIAL LANDSCAPE

BENJAMIN M. LAWSKY: The theme of what I want to talk with you about today, "Regulating in an Evolving Financial Landscape," speaks to a unique set of challenges that we now face together as financial regulators and as a country.

In the wake of a devastating financial crisis, lawmakers, regulators, the financial industry, consumer advocates, and a wide range of other stakeholders are building the new architecture of a reformed Wall Street.

That's a dynamic, ongoing process.

As you well know, it didn't end the day—three years ago, on July 21, 2010—when the President signed Dodd-Frank into law.

Through Dodd-Frank, the President and Congress provided regulators in Washington with a robust framework for reform. But they left the specific contours of those new rules of the road up to a set of federal agencies writing regulations on matters as diverse as the Volcker Rule, living wills, orderly liquidation authority, risk retention, qualified residential mortgages—and a whole long list of other terms and acronyms that were foreign to us only a few short years ago.

While regulators in Washington have made important progress implementing those critical reforms—the rules of the road are still not yet fully written.

And, of course, even when the ink is dry on every last regulation, there will remain—as there always is—a constant push and pull between regulators and the financial industry as market participants adjust to the new rules of the road.

Regulators need to remain vigilant. Because there is a constant danger that putting a thumb in the dyke in one part of the financial system will cause a leak to spring somewhere else.

A danger that well-intentioned reforms could push risk to ever-darker corners of the financial system. To financial products not yet envisioned by even the most far-sighted of regulators.

The lure of potential profits is too great. And the dynamism of the global economy is too strong for the financial system to stand frozen in time.

This is not to say—as some suggest—that the art of financial regulation is a futile endeavor. That we should resign ourselves to a financial system that forever careens from crisis to crisis.

Far from it.

It just means that we should approach the constantly evolving landscape of the financial sector with a deep sense of humility about the capacity of any one set of reforms or safeguards to permanently preserve the stability of our kinetic, frenetic global financial system.

And this deep sense of humility shouldn't fade with the passage of time—when the 2008-09 financial crisis becomes a page in the history books rather than a fresh wound.

To be sure, Dodd-Frank represents the most far-reaching set of reforms to our financial system since the Great Depression.

But we can't become complacent.

And one critical part of avoiding that fate—avoiding complacency—is what I will call "healthy competition in financial regulation."

A dose of healthy competition among regulators is helpful and necessary to safeguarding the stability of our nation's financial system. Not just today – but for the long term.

HEALTHY COMPETITION IN FINANCIAL REGULATION

So what do I mean by healthy competition in financial regulation?

It's not so dissimilar to what economists talk about when they discuss healthy competition in the broader economy.

Or what Supreme Court Justice Louis Brandeis meant when he called the states "laboratories" of democracy during the Progressive Era.[5]

The New York State Department of Financial Services—or DFS as we like to call it—was recently created through the merger of two existing state agencies with long histories: the New York State Banking Department (which was founded in 1851) and the New York State Insurance Department (which was established in 1859).

However, DFS—in its current, unified structure—is only about 18 months old. So, in many ways, we're the new regulator on the block.

The Federal Reserve has been around for about a century. The Federal Deposit Insurance Corporation ("FDIC") has been protecting depositors since the Great Depression. And the U.S. Treasury Department has served a vital role in managing our nation's finances since the founding of our republic.

At DFS, we're fortunate to work with federal partners who have a deep well of institutional knowledge and expertise—which complements our own.

We've collaborated with our federal partners closely and cooperatively on a number of issues of common interest.

Moreover, at DFS, like our other regulatory partners, we have a commitment to thorough, thoughtful, diligent work.

But we also have another key attribute at DFS.

We're nimble. And we're agile. And we're able to take a fresh look at issues across the financial industry—both new and old.

Sometimes financial regulators find that moving in a new direction is akin to turning a battleship in a bathtub. Institutional inertia can stymie even the most well-intentioned of watchdogs.

But as a newly created regulator, DFS isn't necessarily wedded to existing ways of doing business.

Indeed, similar to the example of the broader economy, when there's a new entrant into the marketplace, it often spurs others to reexamine existing processes and practices. To innovate.

At DFS, we can shine a spotlight wherever we think it needs shining.

When banks are engaging in practices that threaten our country's financial stability and national security – we can take swift action.

5. New State Ice Co. v. Liebmann, 285 U.S. 262, 387 (1932) (Brandeis, J., dissenting).

When consumers are being abused – we can move rapidly to right those wrongs.

Sometimes, that means DFS may be out in the lead on a particular issue.

But I think that's healthy. Not only for the financial regulatory community, but for the long-term strength of the financial industry and our nation's economy.

Problems with Unhealthy Competition

Indeed, it may also be helpful to define healthy competition in opposition to the type of *unhealthy* competition that we saw during the lead up to the financial crisis.

When the system turned on its head and the debate turned to who could *water down standards the most*.

Who could provide the "lightest touch" regulation at the firms they oversaw.

In many ways, this created a race to the bottom in which both regulators and Wall Street firms were willing participants.

At DFS, we hope our activism at the state level will at least sometimes do the reverse and spur a race to the top.

Now, some people claim that being a strong and independent regulator is at odds with the goals of promoting economic growth and job creation.

That you have to be a laid back or passive regulator to be pro-growth and pro-business.

We fundamentally disagree.

When Governor Cuomo—who himself played a vital role as a financial watchdog when he was Attorney General—proposed creating DFS, he gave us a clear mission.

He wanted the industries DFS regulates—banking and insurance—to thrive. He wanted to keep New York the financial capital of the world.

And he also wanted to protect consumers and investors better than ever before by using all the tools in our tool-belt.

Those two goals can fit together. They are not mutually exclusive.

When consumers, entrepreneurs, and investors have confidence in the integrity—the safety and the soundness—of their banks and insurers. When they know they're getting a fair deal. They'll do more business here.

That's better for the long-term health of the financial industry and our economy. And it is certainly better for the long-term health of our system to prevent future crises through smart and active regulation.

And it's certainly not pro-business to regulate so lightly that we run the risk of another meltdown.

With that in mind, I wanted to discuss a couple recent examples of DFS actions that we hope will play an important, constructive role in strengthening the long-term health of the financial system: first, a corner of the insurance industry called "force-placed insurance," and second, anti-money laundering enforcement.

Additionally, I wanted to highlight a few other areas in financial regulation that DFS is taking a hard look at right now—where healthy competition may play a vital role going forward. Those include: (1) conflicts of interest in the consulting industry; and (2) the troubling role private equity firms are playing in insurance markets.

FORCE-PLACED INSURANCE

Let's start with force-placed insurance.

In October 2011, the New York State Department of Financial Services launched an investigation into the force-placed insurance industry.

Force-placed insurance is insurance taken out by a bank—on behalf of the homeowner—when a homeowner does not maintain the insurance required by the terms of a mortgage.

This occurs most frequently when a homeowner allows their policy to lapse—usually due to financial hardship.

So, these are folks who are already teetering on the edge of financial disaster.

And, as the name implies, the insurance is forced upon them.

Now, in certain circumstances, this makes sense because the mortgage holder has a right to protect their collateral (In this case, the house).

But when we conducted our investigation, we found that there was very little competition and very high rates in the force-placed insurance industry.

Sometimes when a homeowner who was already in financial trouble got "force-placed" into an insurance policy their rate jumped two to ten times higher—despite the fact that force-placed insurance provides far less protection for homeowners than voluntary insurance.

Our investigation looked at why this was happening.

Normally, you'd expect that the bank would do what any of us would do when they shop something. That they'd look for the best product at the lowest price.

What we found is that the banks and the insurers had set up what is essentially a form of reverse competition.

Banks were looking for high prices and high premiums. And they were happy to pay them. Why? Because a good portion of the premiums were being funneled back to the banks in the form of commissions.

All of this, mind you, at the expense of homeowners and investors, who ultimately got stuck with the bill.

In May, we held public hearings where we brought the industry and homeowners to testify. And that hearing—along with our broader investigation—really tore the cover off this issue.

DFS's investigation has already produced a recent, major settlement with the country's largest force-placed insurer: Assurant.

Assurant controls seventy percent of the market in New York.

That settlement includes restitution for homeowners who were harmed, a $14 million penalty paid to the State of New York, and industry-leading reforms that will save homeowners, taxpayers, and investors millions of dollars going forward through lower rates.

Indeed, through those reforms, we're banning the type of practices that drove premiums sky- high.

We're kicking the kick-backs out of this industry.

Today, we announced an additional settlement with the nation's second-largest force-placed insurer, QBE, that includes a $10 million penalty, restitution for homeowners, and New York's industry-leading reforms. Now, companies representing more than 90 percent of this market in New York have signed onto our reforms.

When DFS began its investigation, force-placed insurance wasn't an area to which many regulators were paying close attention.

It was essentially a dirty little secret in the insurance industry.

But that's started to change—at least in part—because DFS has pushed very hard on this issue. Soon after DFS announced its settlement with Assurant, the Federal Housing Finance Agency, which regulates mortgage giants Fannie Mae and Freddie Mac, followed our actions by filing a notice to ban the lucrative fees and commissions paid by insurers to banks on force-placed insurance.

To spur further action, DFS also recently urged other state regulators to use our settlement with Assurant as a national model. Every regulator should be asking, "[i]f you can clean up things in New York, why can't you clean it up nationwide?"

We've received a good response from a number of states so far. But the proof will be in the pudding.

If other states follow through, it will help end the kickback culture that has pervaded this industry and hurt far too many homeowners and investors.

ANTI-MONEY LAUNDERING ENFORCEMENT

Another area where I think DFS has begun to play an important and constructive role is anti- money laundering—which is so vital to our country's national security.

This was an area where we felt that, at times, the industry and our regulatory structures had gotten used to a certain playing field. A certain silently acknowledged level of consequences tied to a certain quantum of illegal and immoral behavior.

And we felt that this was serious, serious conduct justifying more potent action. And we wanted the banking industry to take it a lot more seriously given the threat it posed not only to our financial system, but to our national security.

Banks were sometimes effectively serving as financial conduits for terrorists, other enemies of our country, and perpetrators of some of the most vile human rights abuses anywhere on earth.

DFS took action against a particular bank last summer.

We felt like it was the right thing to do.

And we did it based on the facts and the law.

Our investigation uncovered that the bank had hidden from U.S. and other regulators roughly 60,000 secret transactions involving at least $250 billion—reaping the company hundreds of millions of dollars in fees.

This conduct had left the U.S. financial system vulnerable and deprived law enforcement investigators of crucial information used to track all manner of criminal activity, including terrorism.

New York ended up securing a $340 million settlement and a set of reforms to help put a stop to this behavior.

Initially, there was what we believed to be a misplaced focus on the fact that DFS had acted more quickly, more robustly, and more independently than some people were used to from a state banking regulator.

That focus was misplaced because it distracted everyone from the very real issues at stake when it comes to international money laundering on a massive scale for nations like Iran.

Ultimately, though, we certainly stimulated a debate nationally and internationally on this issue.

And, more importantly, I think we started an alteration or, better yet, a recalibration of the regulatory playing field going forward in this area.

Now, you're seeing more robust action taken – at both the state and federal level – to root out this type of illegal money-laundering

That's good for our national security. And it's good for the integrity—and the safety and soundness—of the broader financial industry.

And it was driven in part by the sort of healthy competition I mentioned earlier.

CONSULTING

Now, let me turn to a new set of issues on which DFS is very focused right now. And where we hope, again, to play an essential role in the weeks and months ahead.

The independence and integrity of monitors and independent consultants is another area of vital concern to DFS.

These consultants are installed at banks and other companies usually after an institution has committed serious regulatory violations or broken the law. The intent is that monitors assist companies in improving controls and ensuring that violations do not reoccur.

All too often, however, the outcome of a monitorship is disappointing, as we recently saw in the context of the national mortgage reviews. This can be blamed on a number of factors, but it is worth considering that our current system significantly undermines the independence of the monitors—the monitors are hired by the banks, they're embedded physically at the banks, they are paid by the banks, and they depend on the banks for future business.

If the monitors or consultants are simply puppets of the big banks that pay their fees—rather than independent voices—then their work-product can hardly be deemed reliable.

There is also insufficient communication between monitors and regulators. Frequently, monitors never hear from regulators once they are put in place at a bank. This is a problem we can and must fix.

It's largely about "managing the monitors" and that is up to regulators. There need to be regular meetings between regulators and monitors. Expectations must be set. Weekly updates on progress should be happening.

A good monitor can truly improve a troubled company when there is a problem, but an ineffective monitor can make the situation much worse by creating a false sense of security in the regulator and the public.

At DFS, we have already instituted a more robust process in the selection of monitors, and we will be pushing more broadly for change in the dynamics between regulators, monitors and institutions.

You will likely be seeing some innovative initiatives from DFS in this area in the coming weeks and months. And we expect that those actions will help propel reform at both the state and federal levels.

One very important question we all need to be asking is when monitors or consultants perform poorly or, worse, when they intentionally obscure problems at banks: what should the consequences be? Because if we allow intentional conduct aimed at quietly sweeping problems at banks under the rug, we are truly undermining our whole system of prudential regulation. At some point, we must take action that has real consequences or the problems in our system will continue to be perpetuated rather than deterred.

PRIVATE EQUITY BUYING ANNUITY COMPANIES

I'd now like to turn to an emerging trend in the insurance industry that DFS has become concerned about.

Private equity firms are becoming active in the acquisition of insurance companies. In the last few years, private equity firms have been targeting fixed and indexed annuity writers.

For those who are unfamiliar with annuity companies—they sell insurance products that essentially promise a certain payment every year or month (whatever the terms of the policy may be) over a particular period of time.

If you look at the deals completed or announced to date, private equity-controlled insurers now account for nearly thirty percent of the indexed annuity market (up from seven percent a year ago) and fifteen percent of the total fixed annuity market (up from four percent a year ago).

These are large numbers, and they indicate a very rapid growth in market share. As you may expect, that's driving DFS to take a close look at these transactions and these firms—to ensure that the safety and soundness of these companies and consumers both remain protected.

Now, as you probably know, annuities are very popular products that a significant number of Americans rely on to help finance their retirements.

The risk that we're concerned about at DFS is whether these private equity firms are more short- term focused—when this is a business that's all about the long haul.

That their focus is on maximizing their immediate financial returns, rather than ensuring that promised retirement benefits are there at the end of the day for policyholders.

And—because of their potential short-term focus—here is a risk that these companies may not be delivering the level of compliance and customer service that we'd expect of them given the importance of this product to so many seniors on fixed incomes.

There can be exceptions, but generally private equity firms follow a model of aggressive risk- taking and high leverage, typically making high-risk investments. If just a few of these investments work out, then the firm can be very successful—and the failed ventures are just viewed as a cost of doing business.

This type of business model isn't necessarily a natural fit for the insurance business, where a failure can put policyholders at significant risk.

Private equity firms typically manage their investments with a much shorter time horizon—for example, three to five years—than is typically required for prudent insurance company management. They may not be long-term players in the insurance industry and their short-term focus may result in an incentive to increase investment risk and leverage in order to boost short-term returns.

Now, at DFS, we regulate both banks and insurance companies. And the differences between these two industries are quite striking when it comes to private equity investments.

Private equity firms rarely acquire control of banks, not because they are prohibited from doing so, but because the regulatory requirements associated with such acquisitions are more stringent than a private equity firm may like. These regulatory requirements in the banking industry are designed—in part—to encourage a long-term outlook and ensure that the person controlling the company has real skin in the game.

The long-term nature of the life insurance business raises similar issues, yet under current regulations it is less burdensome for a private equity firm to acquire an insurer than a bank.

We need to ask ourselves whether we need to modernize our regulations to deal with this emerging trend to protect retirees and to protect the financial system.

This is an area that not too many regulators are looking at. But it's one where DFS is moving to ramp up its activity.

And we hope that other regulators will soon follow suit.

SHADOW INSURANCE

Another area that we're hard at work on relates to the use of what are called captive insurance companies, used to quietly off-load risk and increase leverage at some of the world's largest financial firms.

In July 2012, the New York State Department of Financial Services initiated a serious investigation into this somewhat obscure area that—we believe—could put insurance policyholders and taxpayers at greater risk.

Insurance companies use these captives to shift blocks of insurance policy claims to special entities—often in states outside where the companies are based, or else offshore (e.g., the Cayman Islands) —in order to take advantage of looser reserve and oversight requirements. (Reserves are funds that insurers set aside to pay policyholder claims.)

In a typical transaction, an insurance company creates a "captive" insurance subsidiary, which is essentially a shell company owned by the insurer's parent. The company then "reinsures" a block of existing policy claims through the shell company—and diverts the reserves that it had previously set aside to pay policyholders to other purposes, since the reserve requirements for the captive shell company are typically lower. (Sometimes the parent company even effectively pays a commission to itself from the shell company when the transaction is complete.)

However, this financial alchemy, let's call it "shadow insurance," does not actually transfer the risk for those insurance policies off the parent company's books because, in many instances, the parent company is ultimately still on the hook for paying claims if the shell company's weaker reserves are exhausted ("a parental guarantee").

That means that when the time finally comes for a policyholder to collect their promised benefits after years of paying premiums—such as when there is a death in their family—there is a smaller reserve buffer available at the insurance company to ensure that the policyholders receive the benefits to which they are legally entitled.

We believe that shadow insurance also puts the stability of the broader financial system at greater risk. Indeed, in a number of ways, shadow insurance is reminiscent of certain practices used in the run-up to the financial crisis, such as issuing subprime mortgage-backed securities ("MBS") through structured investment vehicles ("SIVs") and writing credit default swaps on higher-risk MBS. Those practices were used to water down capital buffers, as well as temporarily boost quarterly profits and stock prices at numerous financial institutions. And ultimately, those practices left those very same companies on the hook for hundreds of billions of dollars in losses from risks hidden in the shadows and led to a multi-trillion dollar taxpayer bailout.

Similarly, shadow insurance could leave insurance companies less able to deal with losses. The events at AIG's Financial Products unit in the lead up to the financial crisis demonstrate that regulators must remain vigilant about potential threats lurking in unexpected business lines and at more weakly capitalized subsidiaries within a holding company system.

We are hard at work on our continuing investigation into shadow insurance. And we hope to shed light on and further stimulate a national debate on this important issue to our financial system.

CONCLUSION

Now, I've highlighted a number of areas where DFS has taken a leadership role and sought to push reform.

But the role of state regulators can and should vary based on the particular context.

It really comes down to a question of federalism—the relationship between the states and the federal government.

What I will call collaborative or cooperative federalism is usually the best kind of federalism. When we work closely and together and symbiotically with our federal partners.

A great example of this is what DFS has been doing to partner with the Consumer Financial Protection Bureau ("CFPB") in the areas of debt collectors and payday lending.

In other areas, where there has been less focus on a particular issue at the federal level, a form of persuasive federalism sometimes emerges—where the state tries to lead by example and stimulate national reform. DFS's work in the force-placed insurance industry is a great example.

On the far end of the spectrum is what I'll call, for lack of a better term, coercive federalism. Coercive federalism should be rare. But sometimes it's necessary. Sometimes a state must act alone to change the rules of the game. DFS's work on anti-money-laundering enforcement is a good example here.

Now, I listed three types of federalism. But if I had to give them an overarching label, I would call DFS's overall approach going forward catalytic federalism.

We will continue to evaluate the appropriate role of the state regulator on an issue-by-issue basis, depending on the context.

As I noted at the beginning of the speech, we inhabit a constantly evolving financial ecosystem. And we will remain nimble and agile as we attempt to affect change wherever our ever-changing markets need that stimulus.

Change is good. And a robust marketplace of ideas among financial regulators is a key strength of our system.

Indeed, our federal regulators are leading on a number of important issues.

Today, the Federal Reserve and Treasury—for example—are leading the charge on two areas of vital concern to long-term financial stability: money market reform and addressing potential sources of risk in the tri-party repo market.

The SEC—together with its law enforcement partners—has fought hard to crack down on insider trading. And the SEC is also working to modernize investor disclosures in an era of Twitter, Facebook, and other social media products that didn't even exist a decade ago.

The Commodity Futures Trading Commission has taken a leadership role in cracking down on past abuses in LIBOR and proposing future reforms so that they don't happen again.

The CFPB—led by Richard Cordray, who is just one of the bright, shining stars of the Obama Administration – has staked out new ground in the fight to arm families with the clear, concise information they need to make the financial choices that are best for them.

In recent years, the FDIC has really been ahead of the curve on the issues of providing relief to struggling homeowners and ensuring banks have the capital they need to withstand unexpected financial shocks and losses.

The critical point is that through healthy competition—in this marketplace of ideas—the best ideas will hopefully rise to the top.

That the ideas that withstand the informed scrutiny of fellow regulators, the media, the public and other stakeholders will one day win out. (Even if it's not today.) And that those ideas come out better for being battle tested.

I think our financial system, our economy, and our country will ultimately be better for it. When regulators speak their mind, say their peace and engage in a vigorous debate through healthy competition.

Thank you. And I look forward to taking your questions.