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The Authority of the FSOC and the FSB to Designate SIFIs: Implications for the Regulation of Insurers in the United States after the Prudential Decision

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Abstract: The Financial Stability Oversight Council (FSOC), established by the Dodd-Frank Act, has the extraordinary authority to designate financial firms as systemically important financial institutions (SIFIs). Firms so designated are then turned over to the Fed for "stringent" regulation. FSOC's recent designation of Prudential Financial as a SIFI shows that the agency is unlikely to set any standards that might limit its own discretion, raising the possibility that other insurers will also be designated in the future. Moreover, the US Treasury and the Federal Reserve are both members of an international regulatory group, the Financial Stability Board (FSB) that has been empowered by the G20 leaders to reform the international financial system in the wake of the 2008 financial crisis. The FSB has also taken it upon itself to designate global SIFIs, including three US insurers—AIG, Prudential and MetLife—and has done so with the concurrence of the US Treasury and the Fed. The FSOC just followed the FSB's lead. This, together with the absence of any standards for what constitutes a SIFI, suggests that if the FSB continues to designate other insurers in the future the FSOC will follow suit. This will have major effects on competition in the insurance industry in the future.

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In September 2013, the Financial Stability Oversight Council (FSOC) determined that Prudential Financial, Inc., one of the country's largest insurers, was a systemically important financial institution, or SIFI. Under the Dodd-Frank Act, then, Prudential was turned over to the Federal Reserve for what the act calls "stringent" regulation. This paper will review the FSOC's decision and its implications for both the insurance industry and the financial services industry as a whole. The FSOC is a creation of the Dodd-Frank Act, and is a uniquely powerful body within the Executive Branch of the US government. It consists of 15 members, of which 10, with one exception, are the chairs of other federal financial regulatory agencies, and five are non-voting members.[1] The secretary of the Treasury is the chairman and has an effective veto over any major FSOC action because his affirmative vote is required by the act. The fact that the voting members are largely specific individuals—that is, the chairs or directors of regulatory agencies rather than the agencies themselves—allows them to follow the lead of the administration in power and not necessarily the institutional views of their respective agencies. Thus far, they seem to follow the lead of the Treasury Secretary.

Insurance is regulated at the state level in the United States, so there is no head of a federal agency with expertise in insurance. For this reason, the Dodd-Frank Act authorizes the president to appoint (with the consent of the Senate) one voting member of the FSOC who is called the Independent Member having Insurance Expertise. Two nonvoting members have a connection with insurance—a representative of the state insurance supervisors and the director of the Federal Insurance Office, an office within the Treasury Department also created by Dodd-Frank.

The Prudential decision was the second decision of the FSOC involving an insurance-related firm. In July 2013, the agency had designated American International Group (AIG) as a SIFI. That decision was expected, perhaps even politically compelled; AIG had famously been bailed out by the Treasury and the Federal Reserve during the financial crisis. Moreover, the chairman of AIG had welcomed the SIFI designation because he believed, with some justification, that the designation carried with it the implication that the firm would not be allowed to fail; this he saw as a government "seal of approval,"[2] which would provide competitive advantages for an insurance company. The Prudential decision was the first to designate a nonbank financial institution as a SIFI when that firm had not suffered any significant financial distress during the financial crisis.

[1] The voting members are the Secretary of the Treasury, who is also the chair of the FSOC, the Chairman of the Board of Governors of the Federal Reserve, the Comptroller of the Currency, the Director of the Consumer Financial Protection Bureau, the Chairman of the Securities and Exchange Commission, the Chair of the Federal Deposit Insurance Corporation, the Chair of the Commodity Futures Trading Commission, the Director of the Federal Housing Financial Agency, the Chair of the National Credit Union Administration Board, and an Independent Person Having Insurance Expertise. The nonvoting members are the Director of the Office of Financial Research, the Director of the Federal Insurance Office, a State insurance commissioner, a State banking supervisor, and a State securities commissioner.

[2] Leslie Scism, "AIG's Benmosche and Miller on Villains, Turnarounds and Those Bonuses," The *Wall Street Journal*, September 23, 2013, http://blogs.wsj.com/moneybeat/2013/09/23/aigs-benmosche-and-miller-on-villains-turnarounds-and-those-bonuses/tab/print/.

Dodd-Frank enjoins the FSOC to "identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large interconnected bank holding companies or non-bank financial companies." (Sec 112). The decision to designate Prudential as a SIFI was made under Section 113, which authorizes the FSOC to designate a nonbank financial firm as a SIFI if "the Council determines that material financial distress at the US nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. financial company, could pose a threat to the financial stability of the United States."

The first thing to be said about this language is that it is a remarkable grant of authority, and essentially permits the FSOC to determine the scope of its own jurisdiction. Although the courts frown on this when it is called to their attention, it is difficult to see how this will ever occur; regulated firms, fearing retaliation, are very reluctant to challenge the legal authority of their regulators. Indeed, Prudential initially suggested that it would challenge the FSOC's decision, but after going through a pro forma administrative appeal process decided not to engage.

Thus, because the key terms the FSOC must apply in order to take jurisdiction over any particular firm—"financial distress" and "market instability"—have no clear meaning, and because both involve predictions about the future, they amount to an enormous grant of discretionary power.

Discretionary power, where judicial intervention is unlikely, can result in arbitrary, capricious and politically-based administrative decisions. This can be rectified if an agency develops and applies standards that limit its own discretion, provides a roadmap for compliance by affected companies, and allows the basis of its decisions to later be judged. This the FSOC has not done, although the International Association of Insurance Supervisors (IAIS), an international group of insurance supervisors, has shown that it is possible. The IAIS, of which the state-based National Association of Insurance Supervisors (NAIS) and FIO are members, has developed a methodology for judging the systemic importance of insurance firms. The methodology sets priorities and standards that would somewhat limit the discretion of an agency that is authorized to determine whether an insurance firm is systemically important.

The IAIS's methodology was an important element in a process through which the Financial Stability Board (FSB) recently designated nine large internationally active insurance firms as "global systemically important insurers" (G-SIIs). This process began in 2010, when the G-20 leaders endorsed an FSB framework for reducing the risks to the financial system associated with large financial institutions. The FSB is an international group of financial supervisors and central banks of which the Treasury and the Federal Reserve are members. It initially focused on banking organizations, but noted that "as experience is gained, the FSB will review how to extend the framework to cover a wider group of SIFIs, including financial market infrastructure, insurance companies and other non-bank financial institutions that are not part of a banking group structure."[3]

The first group of 29 "global systemically important banks" (G-SIBs) were named at a meeting of the G-20 leaders at a meeting in November 2011, at which time the G-20 also requested that IAIS complete its methodology for assessing the risks associated with G-SIIs. The test for G-SIIs, as for banks and other SIFIs, is whether they are "institutions of such size, market importance, and global interconnectedness that their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries."

This language is not materially different from Dodd-Frank's reference to "instability in the US financial system." The final IAIS methodology places percentage weights on five different elements of risk—size, global activity, interconnectedness, non-traditional insurance and non-insurance activities, and substitutability. The weights are important for understanding the mindset of the insurance supervisors that created the methodology and for comparing the IAIS methodology to the FSOC's analysis. In the IAIS methodology, size has the lowest importance (five percent), global activity (five percent), interconnectedness (40 percent), nontraditional or bank-like activities for insurance firms (45 percent) and substitutability (5 percent). Clearly, for the IAIS, interconnectedness and nontraditional activities were the major factors in determining whether an insurer was likely to fall into the category of G-SII. Interconnectedness will be discussed at length below, because it was cited by the FSOC as a specific element of its Prudential findings. Nontraditional activities, according to the IAIS, were defined to include such things as participation in the credit default swap market, short-term borrowing, selling financial or mortgage guarantee insurance, offering variable annuities, backing intra-group commitments, and offering liabilities that can be surrendered within three months without penalty. For the moment, the important point is not whether the IAIS was correct in its assessments of where the risk of large financial institutions actually lies, but rather that the IAIS limited its own discretion by developing a methodology by which an assessment of risk can be made for individual firms.

Here, however, is where the process stopped. Although a methodology had been developed, and the FSB said its decision was based on the methodology, there is no indication that the FSB actually applied it to individual firms in making its designations. In July 2013, nine large internationally active insurers, including the US-based insurers AIG, Prudential and MetLife, were designated as G-SIIs.[4] Obviously, a methodology is useless and lacks any credibility without showing how it was applied to each insurance firm, and the FSB—if it used any judgment at all—has not provided any explanation. Unsurprisingly, the designations were not

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[3] See http://www.financialstabilityboard.org/publications/r_101111a.pdf.

[4] The nine insurers were Allianz SE, American International Group, Inc., Assicurazioni Generali, S.p.A., Aviva plc, Axa S.A., MetLife, Inc. Ping An Insurance (Group) Company of China, Ltd., Prudential Financial, Inc., and Prudential plc

accepted as valid by many of the firms named as G-SIIs.[5] In other words, the FSB—the ultimate decider in a process begun by the G-20 leaders—preserved its own discretionary authority to make these decisions, without providing any roadmap to other insurers for how designation might be avoided in the future.

It is important to note at this point that all of the participants in this process—the G-20 leaders, the IAIS, the FSB, the FSOC, the Fed, the NAIC, and others active in the banking or insurance field, are all government or regulatory organizations. They all have an interest in increasing their regulatory authority over the financial system, including the insurance industry, and particularly over the largest and most influential insurers. There are many incentives for the FSB to be expansive in its range of coverage and few reasons to exercise restraint. The financial crisis has in many ways changed the rules that formerly confined the regulators to a limited field. Prudential bank-like regulation was previously approved for federal regulators only where government support such as deposit insurance threatened to create moral hazard. However, the narrative that came out of the 2008 financial crisis was that any large financial institution could cause another financial crisis if it failed. This provided the authority for the FSOC and the FSB to adopt prudential regulatory standards for the largest financial institutions—not just banks—because any one of them could, under the prevailing theory, cause a financial crisis if not carefully and stringently regulated. For this reason, the FSOC, as empowered by the Dodd-Frank Act, and the FSB, empowered by the G-20, focus on specific institutions, and not on general rules. The FSB, indeed, has already outlined an aggressive program that could eventually result in the designation of SIFIs in many other financial fields, including securities firms, finance companies, mutual funds and hedge funds.[6]

The Dodd-Frank Act authorizes the FSOC to designate, and the Fed to regulate, banks and non-bank financial institutions that are deemed to be a threat to the stability of the US financial system, but the act does not authorize the FSOC, the Fed or the Treasury Department to enter into international agreements that designate specific US firms as SIFIs. Yet the evidence thus far suggests that the FSOC is coordinating its activities with the FSB. For example, the FSB has recommended that if money market mutual funds do not adopt a floating net asset value (NAV), they should be subject to capital requirements like banks.[7] FSOC has pressured the SEC to adopt similar rules for money market funds (MMFs). The FSB has indicated that all asset managers with assets of more than $100 billion may be subject to prudential regulation, [8] and the Office of

[5] Stuart Collins, The Geneva Association, "Enhanced regulation of nine named GSIIs receives cool reception," July 26, 2013, https://www.genevaassociation.org/media/624404/26072013_commercialriskeurope_gsifis.pdf.

[6] Financial Stability Board, "Progress and Next Steps Towards Ending 'Too- Big-to-Fail' (TBTF)," Report of the Financial Stability Board to the G-20, August 30, 2013. http://www.financialstabilityboard.org/publications/r_130902.pdf.

[7] Financial Stability Board, "Overview of Progress in the implementation of the G20 Recommendations for Strengthening Financial Stability" September 5, 2013, p24

[8] FSB, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High Level Framework and Specific Methodologies," *Consultative Document,* January 8, 2014.

Financial Research (OFR), another agency created by Dodd-Frank, has produced two reports at the request of the FSOC to the effect that large asset managers should be designated as SIFIs. The FSB has designated three US insurance firms as SIFIs—AIG, Prudential and MetLife—and the FSOC has already designated AIG and Prudential as SIFIs and is currently investigating MetLife for a possible SIFI designation.

The fact that the FSB, the FSOC and the Fed are coordinating their activities is clear. As members of the FSB, the Treasury and the Fed know well in advance what the agency is going to do. They could stop it if they were so inclined. The fact that Prudential was designated as a SIFI in July 2013 made the FSOC's decision in September a foregone conclusion. The Treasury and the Fed had already voted for it. And this is how it can happen indefinitely; the FSB can make designations and the FSOC will simply follow suit; the FSB's determination will be treated as sufficient evidence for the FSOC's purposes. This raises questions about the objectivity of the investigative and analytical work that the FSOC is supposed to do before declaring US firms to be SIFIs under the Dodd-Frank Act—a concern that is fully validated by the kind of analysis the FSOC did in the Prudential case.

The Prudential Decision

Although, as discussed below, the IAIS methodology allocates far too much importance to interconnectedness, it at least attempts to create a set of standards that could—if effectively applied to individual firms—limit the discretionary authority of the FSB in designating individual insurers as G-SIIs. In the FSOC's analysis of the Prudential case, there was no similar effort on the part of the FSOC to establish a set of standards for when an insurer would be deemed a SIFI. That explains why the two members of the FSOC who had insurance expertise (and were not employees of the Treasury Department) dissented from the FSOC's decision, and why the banking regulators—who have no experience or knowledge in this area—all voted for it.

The dissent by Roy Woodall, the presidentially-appointed Independent Member having Insurance Expertise, was particularly stinging:

In making its Final Determination, the Council has adopted the analysis contained in the Basis. Key aspects of said analysis are not supported by the record or actual experience; and, therefore, are not persuasive. The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems. As presented, therefore, the analysis makes it impossible for me to concur because the grounds for the Final Determination are simply not reasonable or defensible, and provide no basis for me to concur. [9]

Dodd-Frank sets out the standards that the FSOC is required to use in determining whether a non-bank financial institution is a threat to the stability of the US financial system. There are close to a dozen factors that can be taken into account, but the key ones are these:

- Leverage;
- Off-balance sheet exposures;
- Transactions and relationships with other significant bank and non-bank financial firms;
- The nature, scope, size, scale concentration, interconnectedness, and mix of activities;
- The degree to which the company is already regulated;
- Reliance on short-term funding.

Whether any or all of these applied to Prudential can be only be guessed at by reading the FSOC document entitled "Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc" (Basis paper). In that document, the FSOC summarized its decision as follows:

Prudential is a significant participant in financial markets and the U.S. economy and is significantly interconnected to insurance companies and other financial firms through its products and capital markets activities. Because of Prudential's interconnectedness, size, certain characteristics of its liabilities and products, … material financial distress at Prudential could lead to an impairment of financial intermediation or of market functioning that would be sufficiently severe to inflict significant damage on the broader economy.[10]

This summary allows us to determine that the key elements forming the basis of the FSOC's decision were its size ("Prudential is a significant participant in financial markets"), interconnectedness (which probably also includes "transactions and relationships with other significant bank and non-bank financial firms"), and mix of activities ("certain characteristics of its liabilities and products…"). We can also exclude the other considerations outlined above—leverage, off-balance sheet exposures, degree of regulation and reliance on short-term funding. Although the Basis paper mentions these desiderata in passing, it never gives them any content, and in some instances indicates that they don't apply in Prudential's case. For example, on page 8, it points out that "Prudential does not substantially depend on short-term funding..."

[9] Roy Woodall, "Views of the Council's Independent Member having Insurance Expertise," p1, http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf

[10] Financial Stability Oversight Council, "Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc.," September 19, 2013, p. 2.

Among the remaining considerations—size, interconnectedness and activities—it appears that the FSOC is relying on size alone as the foundation for designating Prudential as a SIFI. This is demonstrated by considering in detail how the Basis paper addresses the other arguments—the mix of activities and interconnectedness.

The FSOC organized its discussion of how Prudential might cause financial instability in the US market under two key channels, called Asset Liquidation and Exposure. These are addressed below.

The Asset Liquidation Channel

As a life insurer, the FSOC points out, “Prudential’s U.S. life insurance policies are subject to early withdrawal and include a significant cash surrender value.” If policy holders choose to terminate their relationships with the company in sufficient numbers, or seek the cash surrender value of their policies, this could cause Prudential to “liquidate a substantial portion of its general account assets to meet redemption and withdrawal requests.” This in turn “could cause significant disruptions in key markets including asset-backed and securities markets particularly during periods of overall stress in the financial services industry and in a weak macroeconomic environment, when liquidity dries up and price swings can be magnified.”[11]

Here, the FSOC is outlining a scenario that could occur if a substantial number of policyholders chose to terminate their relationship with Prudential or sought the cash value of their policies. If this is a plausible scenario, the result could be disruptive to the markets. But is there any substantial likelihood that policyholders will run from Prudential even in adverse market conditions? On this question, Independent Member Roy Woodall again dissented, arguing that

While there have in fact been liquidity runs on life insurance companies, no historical, quantitative or qualitative evidence exists in the record which supports a run of the scale and speed posited, or to support a rapidly spreading sector-wide run. The asset liquidation analysis appears to assume a contemporaneous run against the general and separate accounts *by millions* of life insurance policyholders and a significant number of annuity and other contract holders of products with cash surrender value—a scale for which there is no precedent, and for which the likelihood is believed by most experts to be extraordinarily low.[12] [emphasis in the original]

The implausibility of the scenario the FSOC has painted in this instance is suggested by the fact that it made no effort to show in the Basis paper that Prudential relied on leverage or short-term funding. Without either unusual leverage or major short-term funding, it is highly unlikely that policyholders would run in the event of a financial downturn, even a severe one. The 2008 financial crisis was driven by the losses suffered by banks and investment banks that were reliant on short-term funding to carry long-term assets. When those assets—mostly mortgages and

[11] FSOC, Basis, pp. 2-3.
[12] Woodall dissent, p. 3.

mortgage-backed securities—declined in value, the firms suffered substantial losses in paying off their short-term liabilities as these came due. Prudential, on the other hand, as implicitly admitted by the FSOC, relies on long-term funding which it matches with its long-term assets. If those assets decline in value, there is no particular pressure on Prudential because the assets are supported by long-term debt. Without this pressure, there are likely to be few, if any, policyholder runs. In that case, the rest of the FSOC scenario falls apart; there is no plausible reason for Prudential to dump assets on the market to meet redemption and withdrawal requests.

It is also important to note that the FSOC makes no effort to quantify the pressures that would be placed on the markets if Prudential were to suffer a run of the kind the FSOC has posited. The Woodall dissent suggested that millions of policyholders would have to run before the effects in the FSOC's scenario would be felt, but the FSOC made no effort to quantify the effect of a run of any size. What if two million policyholders ran from Prudential—how much cash would that require the firm to produce, and if they had to sell assets in order to raise that cash, what effect would that have had on the prices of the assets that Prudential was selling? The absence of any calculations or projections of this kind casts doubt on the seriousness of the FSOC's analysis and the plausibility of its scenario. The word "significant" is used 47 times in the 12 page Basis document—mostly to describe the effect that a Prudential failure might have on the markets and on counterparties—but the FSOC makes no effort to support its characterizations with the kind of numerical data that would give its conclusions credibility. The only useful numbers in the Basis paper are page numbers.

The Exposure Channel and Interconnectedness

The IAIS methodology put the greatest weight (45 percent) on non-insurance or bank-like activities, both as sources of financial distress for insurance companies and as an important way that this distress is communicated to the markets. But the FSOC does not make any effort to quantify the degree to which Prudential might be a threat to the stability of the financial system. The following is virtually its complete statement on the subject:

The financial system is exposed to Prudential through the capital markets, including as derivatives counterparties, creditors, debt and equity investors, and securities lending and repurchase agreement counterparties. …Prudential also uses derivatives to hedge various exposures related to its assets and liabilities. Prudential's derivatives counterparties include several large financial firms, which are significant participants in the global debt and derivatives markets…Prudential's off-balance sheet exposures could serve as a mechanism by which material financial distress at Prudential could be transmitted to banks and to financial markets more broadly. For example, Prudential's total off-balance sheet exposure due to derivatives counterparty and credit facilities commitments with large global banks is significant.[13]

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[13] Basis, p. 8.

As in many other portions of the Basis paper, the FSOC simply says that Prudential's activities are "significant" but does not define what that means either for Prudential or for its counterparties. Without that, it is impossible to determine what FSOC considered "significant" or sufficient to cause financial instability in the market as a whole. The FSB seems to have done roughly the same thing, suggesting that it was basing its designation of nine insurance firms—including the US companies AIG, Prudential and MetLife—on the IAIS methodology, but then giving no hint how this methodology was applied to each firm. Without that, the methodology is nothing more than window dressing, seriously undermining the FSB's credibility.

The same is true of the FSOC's interconnectedness argument. The interconnectedness idea posits that when a large financial institution fails, its interconnections with others will have knock-on effects, causing others to weaken or fail. The notion that interconnectedness among large financial institutions is a source of danger to the financial system is at the heart of the Dodd-Frank Act. The reason for designating certain bank and non-bank financial firms as SIFIs, and subjecting them to stringent regulation by the Fed, was to prevent them from failing and then, supposedly, dragging down others. It is also the reason for setting up a special "orderly liquidation authority" (OLA) to be administered by the FDIC; the OLA is supposed to prevent the disorderly collapse of a large institution which was claimed, after Lehman, to have caused the financial crisis.

As discussed below, interconnectedness had no role in the financial crisis. However, it is catnip for regulators because it provides a basis for more comprehensive regulation of financial institutions, something they arguably know how to do. Thus, the Dodd-Frank Act assumes that by stringently regulating large financial institutions such as Prudential, these institutions can be kept from failing and bringing down other firms with which they are "interconnected." For example, the Basis paper states with reference to Prudential:

Certain of Prudential's activities have a high degree of interconnectedness. The financial system is exposed to Prudential through the capital markets, including as derivatives counterparties, creditors, debt and equity investors, and securities lending and repurchase agreement counterparties. Material financial distress at Prudential could affect third parties that hold Prudential's debt, including other insurance companies that hold a significant portion of the company's long-term debt.[14]

The theory that interconnectedness between large financial institutions was a cause of the financial crisis has also captured the imagination of European regulators such as the IAIS and the FSB. The IAIS methodology assigns a 40 percent weight to interconnectedness. I don't know the circumstances in Europe, but there is no evidence at all in the US that interconnectedness had any role in the US portion of the financial crisis. Indeed, there is important evidence to the

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[14] Basis, p. 8.

contrary.[15] For example, the Lehman Brothers bankruptcy, announced on September 15, 2008, created chaos in the financial markets, but no major (or even minor) financial institution failed as a result. This was true, even though Lehman was one of the largest financial firms in the US, was active in the credit default swap market, and the financial markets were in the midst of an unprecedented panic so great that banks were refusing to lend to one another, even overnight.[16] The only serious knock-on effect of the Lehman bankruptcy was the inability of a single money market mutual fund, the Reserve Primary Fund, to maintain the value of its shares at $1 per share. The fund had continued to hold Lehman commercial paper (probably expecting that Lehman, like Bear Stearns, would be bailed out by the government) and its potential losses in the bankruptcy were great enough to reduce its net asset value to less than $1 if the Lehman paper was uncollectible. In the midst of a panicky market, this produced what has been called a "run" on the fund, but in the end the losses to Reserve Fund shareholders were minimal, about one or two percent. Whatever might be said about the Reserve Fund's "breaking the buck," it was not akin to a firm being dragged into bankruptcy by the failure of a counterparty; it is simply a firm encountering an unexpected loss. It is also occasionally argued that AIG is an example of the dangers of interconnectedness, but this idea also fails any serious examination. First, AIG had virtually no exposure to Lehman. In addition, despite a lot of speculation in the media about the Fed's reasons for rescuing AIG two days after Lehman was allowed to fail, the officials involved at the Treasury and Fed have never said anything other than that they stepped in to rescue AIG because it was so large that its bankruptcy—in the midst of the post-Lehman panic—would have caused a complete meltdown of the financial system. It is not a case of interconnectedness, but of the Treasury and Fed's view of market psychology at a time of particular market turmoil.

The reason for the invalidity of the interconnections theory is that large firms, by their nature, do not become significantly exposed to other large firms. The failure of one might cause a loss to others, but does not drag them into bankruptcy or insolvency. Accordingly, the FSOC's use of the interconnectedness idea in its Prudential decision would not have been persuasive unless Prudential's counterparties and creditors could be shown to have unusually large exposures to Prudential. But the FSOC doesn't even attempt to demonstrate this. Instead, it specifically discounts this idea and modifies the interconnectedness theory so that it would apply to any large firm:

[I]ndividual exposures to Prudential may be small relative to the capital of its counterparties. In the aggregate, however, the exposures across multiple markets and financial products are significant enough that material financial distress at Prudential could aggravate losses to large,

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[15] Hal S. Scott of Harvard Law School has done comprehensive work on this subject. See Hal S. Scott, Interconnectedness and Contagion, November 20, 2012.

[16] For further discussion of this issue, and the effect of the Lehman bankruptcy, see Peter J. Wallison, "Magical Thinking: The Latest Regulation from the Financial Stability Oversight Council, *Financial Services Outlook*, October-November 2011. http://www.aei.org/outlook/economics/financial-services/magical-thinking-the-latest-regulation-from-the-financial-stability-oversight-council/.

leveraged financial firms, which could contribute to a material impairment in the functioning of key financial markets or the provision of financial services by Prudential's counterparties.[17]

This analysis essentially takes the essence of the interconnectedness theory off the table. Not only were Prudential's interconnections not threatening to the financial health of its counterparties and creditors—the original theory for including interconnectedness among the standards FSOC should consider —but the only effect of its financial distress would be an aggregated effect on the whole market simply because Prudential is large.

Size as the FSOC's only standard

In this close examination of the FSOC's designation of Prudential as a SIFI, then, we are left only with size as the principal determining factor. Assuming that what the FSOC did in the Prudential matter was a real analysis—not just a perfunctory effort—Prudential, apparently, is to be regulated stringently by the Fed because it is large. This is somewhat ironic, in light of the fact that the IAIS methodology treats size as one of the least important reasons for designating an insurer as a G-SII and gives it only five percent weight in the IAIS methodology. The reason for this is explained by the IAIS as follows:

Insurance is founded on the law of large numbers, which basically states that the aggregation of a large number of idiosyncratic risks ultimately results in a normal curve of distribution. It is therefore fair to say that the business model of insurance is based upon the assumption of a large number of ideally uncorrelated risks from policyholders to build up and maintain a well-diversified portfolio. In practice, this means that with an increasing portfolio there is less opportunity for unexpected results and a lower probability of very large losses (in relation to the entire portfolio). The risk profile of an insurer becomes less risky the more risks are assumed, i.e. the larger it is and the more diversified its business is (the more lines of business it writes).[18]

In other words, the larger an insurer becomes the less likely it is to encounter financial distress or failure. The FSOC's exclusive focus on size, accordingly, is entirely misplaced. This focus, however, has some troubling implications. Neither the FSOC nor the FSB ever suggests exactly what size would constitute an insurance firm as a G-SII. The Dodd-Frank Act itself determines that a bank holding company with more than $50 billion in assets should automatically be considered and regulated as a SIFI. This is a precedent that the FSOC could easily use in the future, determining that an insurance company with more than $50 billion in assets is large enough to cause instability in the US market if it should suffer financial distress or fail. There were 26 US insurance companies with more than $50 billion in assets at the end of 2011.[19] Given

[17] Basis, p. 8.
[18] International Association of Insurance Supervisors, "Global Systemically Important Insurers: Initial Assessment Methodology," July 18, 2013. http://www.iaisweb.org/view/element_href.cfm?src=1/19151.pdf.
[19] http://www.relbanks.com/top-insurance-companies/usa.

the lack of clear standards in the Prudential decision, it would not be hard for the FSOC to say that the market's exposure to every one of those 26 firms is "significant."

However, it is difficult to escape the conclusion that the FSOC's Prudential decision was simply perfunctory. For reasons outlined earlier, the agency must conform to the FSB's designations of firms that are deemed to be G-SIIs; the Treasury and the Fed had already concurred in that judgment. Moreover, as a body of regulators, the FSOC has powerful incentives to endorse conclusions that extend their power. Finally, with little likelihood that its decisions will ever be challenged in court, the FSOC does not want to reduce the scope of its discretion by setting out standards that will enable prospective designees to challenge its conclusions. Indeed, to maintain the flexibility to conform its decisions to the FSB's conclusions, it must adopt this course.

Four Major Outstanding Issues

In light of the FSOC's Prudential decision, four major problems loom for the insurance industry, in ascending order of uncertainty. First, there is great uncertainty about how many insurance firms will eventually be considered SIFIs and turned over to the Fed for stringent regulation. If the FSOC can continue to make its SIFI designations solely on the basis of size, many more insurers—like bank holding companies—may be swept into the SIFI category simply on this account, especially if the FSB decides to go in this direction in the future. Second, is the scope and nature of the Fed's "stringent" regulation—what changes it might entail in traditional insurance regulation. Third, is the effect of SIFI designations on competition in the US insurance market? Finally, there is a great deal of uncertainty associated with the future decisions of the FSB. If these result in additional designations of US insurers as G-SIIs, US insurers may not be able to operate abroad if they are not subject to prudential regulation at the national level in the US, particularly regulation by the Fed. The size issue has already been addressed above. The scope and nature of the Fed's regulation and the potential effect of international regulatory standards will be discussed below.

The Fed's regulation of insurance

In July 2013 testimony before Congress, Fed Governor Daniel Tarullo referred to the regulation of insurance firms that have been designated as SIFIs with the following remark: "We remain committed to applying a supervisory and regulatory framework to [insurance] firms that is tailored to their business mix, risk profile, and systemic footprint." Then he added, "Consistent with the Collins Amendment and other legal requirements under the Dodd-Frank Act."[20] In other words, the Fed hasn't decided what it will do.

The Collins Amendment is embodied in Section 171 of Dodd-Frank and provides, in pertinent part, that "the appropriate federal banking agencies shall establish minimum leverage capital

[20] Governor Daniel K. Tarullo, "Dodd-Frank Implementation," Remarks before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 11, 2013, p7.

requirements [and minimum risk-based capital requirements] on a consolidated basis for insured depository institutions, depository institution holding companies, and nonbank financial companies supervised by the Board of Governors" (Sec 171(b)(1) and (2)). In other words, the language is fairly clear that Congress expected the Fed to impose leverage and risk-based capital requirements—bank regulatory concepts—on non-bank financial firms, such as insurance companies, regulated by the Fed. Congress had gone over this language fairly carefully during the legislative process and had modified it from the original proposal advanced by the FDIC, but no one seemed to think that it was a peculiar idea to impose bank-like capital requirements on insurance firms. Although the Fed officials have said that they intend to "tailor" these requirements somehow for insurers, they haven't indicated how this would be done. This is a serious conceptual problem for a simple reason: the principal risks of banks reside in their assets; the principal risks of insurers reside in their liabilities. There is no such thing as risk-based liabilities in bank capital regulation, and the Fed is apparently having a very difficult time trying to figure out how it can comply with what seems a clear congressional directive.

Beyond the Collins Amendment, and the possibility of bank-centric regulation it suggests, there is no assurance that the Fed has, or can develop within any reasonable period of time, sufficient competence in insurance accounting and regulation to carry out the role of an insurance regulator, let alone one that is imposing regulations on SIFI insurers (both life and property and casualty) that are more "stringent" than the regulations normally imposed on insurers by their state supervisors. (Sec 115(a)(1)(A)). The FSOC's decision on Prudential means that two operating firms (Prudential and AIG) are now subject to Fed regulation, and as yet there has been no statement by the Fed about how they will be regulated.

Effect on competition in the US

The Fed's regulation of the largest insurers, whether it remains at its current level or comes to include more large insurance firms, will almost certainly result in a different regulatory regime for these firms than for those that continue to be regulated at the state level. As noted earlier, the Dodd-Frank Act requires that the Fed regulate SIFIs more "stringently" than their competitors are regulated, which perhaps will include bank-like capital requirements. This could have two effects. The additional stringent regulation may be significantly more costly than the regulation of their non-SIFI competitors. This would put the SIFI firms at a competitive disadvantage and contribute to their weakening and eventual failure—ironically, the very outcome the more stringent regulation was intended to prevent. In addition, if there are different capital or reserve requirements imposed on the larger firms, these could subject them to disadvantages that cannot be foreseen at this point. Finally, the fact that these large firms have been designated as SIFIs might be a huge competitive boon. They would be able to tell potential customers that, because they are systemically important, they will not be allowed to fail, making them safer bets for creditors and preferred insurers for traditional life and P&C risks. This might allow them to outcompete their smaller competitors and come to dominate the industry in the way that too-big-to-fail banks have come to dominate banking. Robert Benmosche, the head of AIG welcomed the

SIFI designation for his firm for just this reason; it is, as noted earlier, a governmental "seal of approval." This is the most probable outcome of the SIFI designations authorized by Dodd-Frank.

At this point, it is impossible to predict how all these regulatory changes will work out in a competitive market, but it is certain that the additional net regulatory costs that will be imposed on the SIFI firms will not be exactly matched by the competitive benefits. One or the other will come to dominate, and that will substantially change competitive conditions in the insurance market in the future.

The relevance of international regulatory standards

As troubling as the FSOC's Prudential decision is, it is not the only potential problem for U.S. insurers. As discussed above, the IAIS has developed a methodology that was intended to apply to G-SIIs, but it could also apply to insurance regulation generally. The IAIS methodology placed 45 percent of its weight for determining when a firm is a G-SII on whether the firm is engaged in non-insurance or bank-like activities. Size is not a significant factor. It could come to be regarded as best practices for insurance firms to be regulated differentially, and more stringently, if they engage in non-insurance or bank-like activities. More importantly, it is necessary to recall that in 2002 the European Parliament adopted a measure that required any foreign securities firm operating in the EU to have a consolidated home country regulator by 2005. At that point, the parent companies of the largest US securities firms—Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers and Bear Stearns—were all unregulated holding companies with broker-dealer subsidiaries regulated by the SEC. Their securities subsidiaries would have been barred from operating in the EU if the SEC had not agreed to be the consolidated regulator of the holding companies. It is not farfetched to suggest that the same idea will eventually be applied to insurance, with the EU requiring that since EU insurance regulation has now conformed to a single standard, no insurance firm should be allowed to operate in the EU unless it or its parent company is regulated on a consolidated basis by a home country regulator. This would force the US to adopt a national regulator for insurers and their parent firms, or to turn the regulation of all internationally active insurance companies over to the Fed, even if these firms have not by that time been designated as SIFIs.

Further, by analogy to the Basel Accords on bank capital standards, US regulators in all financial areas might be required to sign on to an agreed set of international regulatory standards that have not been approved by Congress or the states. It is important to recall that these agreed standards, whatever their value in restraining excessive risk-taking, can have anti-competitive consequences; like all regulation, they stifle innovation, increase costs and prevent the formation or growth of new competitive firms. In addition, by reducing regulatory competition—called "regulatory arbitrage" by regulators—they increase the power of home country or state regulators by reducing the choices of regulated firms.

Conclusion

The FSOC's analysis of Prudential does not provide much confidence that the FSOC will be swayed by facts in making its decisions in the future, or that it will ever set up any standards that would limit its discretion in designating insurance companies as SIFIs. Unfortunately, it has authority from Congress to determine whether any firm's financial distress could cause financial instability in the US, and it is likely to follow the lead of the FSB in how far its regulatory reach extends into the insurance industry. Unless Congress steps in to limit the FSOC's authority, it is plausible—perhaps even likely—that insurance firms with more than $50 billion under management could in the future be designated as SIFI simply on the basis of their size.

Another problem for Congress is the process by which international regulators, and particularly the FSB, are gradually developing rules for insurance, asset management, securities trading and other non-bank financial activities. Over time, these could become *de facto* standards imposed on US firms by international agreement of regulators.