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"Oversight of the Financial Stability Oversight Council: Due Process and Transparency in Non-Bank SIFI Designations"

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Background

I am the Sam Harris Professor of Corporate Law, Corporate Finance, and Securities Law at Yale University, and a Professor in the Yale School of Management. He is the author or co-author of several books on corporate governance and banking laws, including *Macey on Corporation Laws, Corporations: Including Partnerships and Limited Liability Companies*, and *Banking Law and Regulation.* His work on risk includes "Regulation and Disaster: Some Observations in the Context of Systemic Risk," 1998 Brookings-Wharton Papers on Financial Services 405 (with M. Wayne Marr and S. David Young), and "The Glass-Steagall Act and the Riskiness of Financial Intermediaries," 14 Research in Law and Economics 19 (1991). Section 113 of the Dodd-Frank Act is a risk-regulation statute. It directs the Financial Stability Oversight Council ("FSOC") to assess two particular form of risk to "the financial stability of the United States." 12 U.S.C. § 5323(a)(1). The FSOC's actions thus far fail to take account of widely accepted principles of risk regulation that are relevant to its analysis.

Testimony

There are significant fairness and process concerns associated with the process by which non-bank financial institutions are designated as systemically important (SIFIs) by the FSOC. Among the most significant are: (a) the subjective nature of the designation process; (b) the ad hoc and idiosyncratic nature of the regulations that are imposed on SIFIs by the Fed after FSOC makes its designation.

The basic goal of due process, which is to support the rule of law by requiring that like case be treated alike and that rules be applied evenly and not on an individualized idiosyncratic basis is not being achieved by FSOC's rulemaking. At a minimum, regulators should be required to state clearly and uniformly what criteria will lead to a SIFI designation. Further, once a company

has received a SIFI designation, the Fed should be required to negotiate an exit strategy, which would articulate what the firm must do to shed itself of the designation.

I. The FSOC's Analysis Does Not Consider Whether its Risk Scenarios Are Plausible

A. Basic principles of risk regulation require distinguishing plausible risks from implausible ones.

Every accepted form of risk regulation requires an assessment of not only the *consequences* of a possible contingency, but also its *likelihood*. There is much more to risk regulation than simply assuming that everything that *can* go wrong *will* go wrong, simultaneously, and treating that worst-case scenario as the baseline for regulation. Rather, an essential part of risk regulation is an objective assessment of *which risks to regulate*, based on empirical evidence and not just on the limits of the pessimist's imagination. The mere fact that a risk is hypothetically conceivable is not enough.

Context matters in assessing whether a particular risk is more than a speculative possibility. Just because flooding is a real risk in some circumstances does not mean it is a real possibility atop a mountain in the desert.

Even some risks that are *conceivable* are not conceivable *together*. For instance, some doomsday scenarios are simply inconsistent with one another. Equipment is not going to face extreme heat and extreme cold *simultaneously*.

Indeed, risk regulation could not be carried out without at least *some* consideration of probabilities. Part of risk regulation is assessing whether safety measures are adequate. That task becomes impossible if the inquiry includes the assuming that each and every safety measure will fail.

For these common-sense reasons, every accepted concept of risk regulation includes a component of risk *assessment*—including the risk-regulation concepts followed within the Executive Branch itself. According to the Office of Management and Budget, risk regulation entails risk assessment, risk management, and risk communication. In particular, risk assessment is a "useful tool for estimating the likelihood and severity of risks . . . and for informing decisions about how to manage those risks." Proposed Risk Assessment Bulletin, 71 Fed. Reg. 2,600 (Jan. 17, 2006). Similarly, as early as 1997, the Federal Reserve Board emphasized the importance of risk assessment in the context of regulating "large complex institutions." Fed. Reserve Sys., Framework for Risk-Focused Supervision of Large Complex Institutions 1 (1997). Specifically, the Board noted, risk assessment should "[c]onsider the relationship between the likelihood of an adverse event and the potential impact on an institution." Id. at 25.

By definition, risk is about probability, and assessing the likelihood of any given risk is an essential element of risk regulation.

B. The FSOC Has Refused to Distinguish Plausible Risks from Implausible Ones

The FSOC's analysis thus far has been inconsistent with this basic principle of risk regulation. For example, in its assessment of whether MetLife is a Systemically Important Financial Institution (SIFI) the FSOC overtly *refused* to give any consideration to whether its scenarios were even remotely likely to occur—whether to MetLife specifically, to an insurance company more generally, or to anyone. Fin. Stability Oversight Council, *Explanation of the Basis of the Financial Stability Oversight Council's Final Determination that Material Financial Distress at MetLife Could Pose a Threat to U.S. Financial Stability and that MetLife Should be Supervised by the Board of Governors of the Federal Reserve System and Be Subject to Prudential Standards* 27 (Dec. 18, 2014) ("Final Basis"). The FSOC asserted that because the statute does not expressly incorporate a standard of likelihood, the FSOC may assess harm to the financial stability of the United States based on risks that lack even basic plausibility in the relevant context.

That contention gets the matter precisely backwards. Because distinguishing between plausible and implausible risks is such an essential part of any coherent system of risk regulation, there was no need for the statute to use the word "probable" or "likely"; the mere omission of such terms certainly does not require the FSOC obstinately to ignore reality. *See* Mem. of Points and Authorities In Support of Pl. MetLife, Inc.'s Cross-Mot. for Summary Judgment and In Opposition to Def.'s Mot. to Dismiss, or, In the Alternative, For Summary Judgment (Dkt. No. 40) at 27 ("MetLife Br."). The statute, after all, requires the FSOC to examine "material financial distress *at* the U.S. nonbank financial company." 12 U.S.C. § 5323(a)(1). Examining material financial distress *as it could plausibly occur at such a company* is thus required by the statutory text—just as one would expect in light of the background principles of risk regulation.

The FSOC's decision to untether its analysis from reality led it to use highly unlikely scenarios to conclude that material financial distress *could* pose a threat to U.S. financial stability. For instance, the FSOC's analysis placed a strong emphasis on the "run-on-the-bank" scenario. The FSOC suggested that "[b]eyond the direct effect of MetLife's asset liquidation on the financial markets, a run on MetLife necessitating significant asset liquidations could spark a loss of confidence in the broader insurance industry, potentially leading to runs at other major insurers." Final Basis at 145. The FSOC expressed the same concerns in its determination regarding American International Group and Prudential Financial. *See, e.g.*, Fin. Stability Oversight Council, *Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.* 7 (July 8, 2013).

But the "run-on-the-bank" scenario is wholly improbable in the context of an insurance company like MetLife, because of several important aspects of the insurance industry, discussed in more detail below. *See infra* at 6–14. The FSOC's insistence that it can just assume that a "run-on-the-bank" scenario *will* occur in this context skips this crucial aspect of risk regulation—and renders its analysis fundamentally incoherent.

Another problem with the FSOC's analysis is that it does not account for the significant difference between runs on life insurers and runs on banks. In the United States, state regulators deal with a run on an insurer by seizing control of the insurer and freezing outflows. Because policyholders in insurance companies are not relying on money due to them for short-term liquidity needs, and because policyholders do not have the same immediate liquidity rights as do counter-parties to repurchase agreements and depositors in banks, regulators have more options in dealing with those runs that do occur and runs can be managed by state regulators in a more orderly way.

The FSOC's rejection of risk assessment also caused it to ignore or minimize certain important protections, such as the use of collateral to mitigate risk. Risk regulators universally treat obligations secured by collateral as less risky than unsecured obligations; indeed, the quality of collateral *itself* may be a factor in risk assessment, as is the extent to which the collateral secures the obligation. Those well-accepted principles would simply evaporate in a regime where the regulator simply assumes that everything that can go wrong, will—*e.g.*, that good collateral will provide no more protection than bad collateral, or none. Accordingly, adherence to sound principles of risk regulation takes into account such risk-mitigation measures as collateral.

II. **The FSOC's Analysis Failed to Rationally Consider the Relevant Aspects of MetLife's Insurance Business**.

A. **Assessing The Risk of a Systemic Threat Akin to a Bank Run Requires an Understanding of Maturity Mismatch.**

Principles of risk regulation seek to understand the phenomenon of bank runs and to ascertain what causes or prevents them. Applying those principles requires an understanding of the concept of maturity mismatch.

Maturity mismatch refers to the difference between the maturities of a company's assets and liabilities. Liquidity risk refers to the risk that a company may not have sufficient funding to satisfy its short-term needs. Liquidity risk and maturity mismatch are closely related. Maturity mismatch "affects a company's ability to survive a period of stress that may limit its access to funding and to

withstand shocks in the yield curve." Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637, 21,659 (Apr. 11, 2012). Hence, maturity mismatch may result in liquidity risk. See, e.g., Final Basis at 15. When the financial system encounters liquidity problems, companies are forced to sell their assets at an illiquidity discount (a price cheaper than would be available under conditions of liquidity), often referred to as a fire sale. In turn, lower asset prices lead to losses that deplete capital, further compromising liquidity. Franklin Allen & Douglas Gale, Financial Intermediaries and Markets, 72 Econometrica 1023 (2004). The result is a feedback mechanism.

Economists have found that maturity mismatch causes self-fulfilling panics among bank depositors. That happens in the banking context because of the very nature of banks, which engage in maturity transformation, turning short-term liabilities into longer-term assets. Put another way, a bank gives its demand depositors almost instant access to their funds, but it receives repayment of loans from consumers and businesses over a longer period of time. In this sense, the risk of maturity mismatch inheres in banks' business model.

This results in two equilibria. First, "[i]f confidence is maintained, there can be efficient risk-sharing, because in that equilibrium a withdrawal will indicate that a depositor should withdraw under optimal risk-sharing. [Second, i]f agents panic, there is a bank run and incentives are distorted. In that equilibrium, everyone rushes in to withdraw their deposits before the bank gives out all of its assets. The bank must liquidate all its assets, even if not all depositors withdraw, because liquidated assets are sold at a loss." Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 J. Political Econ. 401, 403 (1983). Thus, "[i]lliquidity of [banks'] assets provides the rationale both for the existence of banks and for their vulnerability to runs." *Id*.

In the financial sector, maturity mismatch is often measured by asset-liability duration and gap analysis. Put simply, duration analysis involves the calculation of the "time-weighted" maturity for each asset and liability of a company. In turn, gap analysis involves the estimation of differences

between the duration of those assets and liabilities. Thus, to measure maturity mismatch, one needs to examine a company's balance sheet closely. With life insurers, by contrast, it is not primarily their ability to do gap analysis and asset-liability management that makes them less susceptible to liquidity risk. Rather, the primary factors are: the fundamental structure of such companies' liabilities, particularly the relative stability of such liabilities; their long-term nature; and the reluctance of policyholders to liquidate due to surrender penalties, taxes, and other restrictions.

B. <u>The FSOC's Analysis Fails to Consider Important Aspects of the Insurance Industry</u>

In contrast to the business model of banks, however, maturity mismatch does not inhere in the business model of insurance companies, which are better positioned to pursue asset-liability management. Insurance companies operate by pooling and managing risk. While the structure of their balance sheet varies significantly by the type of insurance product, insurance companies tend to have long-term liabilities. In turn, insurance companies are well-positioned to estimate the duration of their liabilities and assign probability to payouts. Thus, MetLife describes itself as a "liability-driven business with long-term, predictable cash flows." Final Basis at 284. In principle, this allows insurance companies to buy assets with maturities that correspond to their liabilities and hold such assets to maturity. Moreover, unlike bank depositors, insurance policyholders have greater disincentives to early withdrawal, such as contractual penalties and loss of tax benefits, and thus are less likely to run on a moment's notice.

The differences in the business models of banks and insurance companies have three primary consequences. First, insurance companies can manage maturity mismatch significantly better than banks, and it is in the insurance companies' interest to do so. Unlike banks, maturity mismatch is not an inherent feature of insurance companies' business model. In fact, insurance companies pursue asset-liability management by matching the terms of their asset profile with those of their liability

profile. See Final Basis at 284. Therefore, even large insurance companies like MetLife are less likely to suffer from maturity mismatch.

Second, the insurance industry has far greater resilience against liquidity risk than other financial firms because their liabilities tend to be illiquid. The illiquid liabilities give them the opportunity to invest in longer-term assets. This characteristic of insurance not only reduces risk, it has a huge societal benefit in light of the great social value in having investors with longer-term time horizons. That benefit may be lost by treating insurance companies as if they were no different from banks.

Third, insurance companies are less susceptible to liquidity problems through their management of maturity mismatch. To begin with, insurance policyholders have greater disincentives to early withdrawal than bank depositors, including "federal income tax liability, federal income tax penalties, surrender penalties, and the loss of guarantees." Fin. Stability Oversight Council, View of Director John Huff, the State Insurance Commissioner Representative 2 (Sept. 19, 2013). Moreover, insurance companies, especially life insurance companies, "are generally buy-and-hold investors, with the goal of generating predictable and stable income in the long run, and having sufficient funds available to pay claims when due." National Association of Insurance Commissioners, Capital Markets Bureau, Securities Investment Strategies and Return on Invested Assets, available at http://www.naic.org/capital_markets_archive/140911.htm (last visited May 18, 2015).

In other words, insurance companies, given the nature of their business model, are less likely to face an immediate need for liquidity. MetLife, for instance, manages $458 billion in its general account investment portfolio; over 20 percent of the portfolio's securities are held in "[c]ash, short-term investments, U.S. Treasury securities, agencies, and agency RMBS." Final Basis at 284. Thus, "liquidity risk is negligible in the insurance sector." Guillaume Plantin & Jean-Charles Rochet, WHEN INSURERS GO BUST: AN ECONOMIC ANALYSIS OF THE ROLE AND DESIGN OF

PRUDENTIAL REGULATION 92 (2007) [hereinafter WHEN INSURERS GO BUST]. The dissenting and minority views on MetLife's designation voiced the same concern about the FSOC's reliance on speculative scenarios. S. Roy Woodall, the independent member with insurance expertise, stated that the FSOC's analysis under the Asset Liquidation Transmission Channel "relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity." Fin. Stability Oversight Council, Views of the Council's Independent Member Having Insurance Expertise 2 (Dec. 18, 2014). Adam Hamm, the State Insurance Commissioner Representative, noted that "the Basis implicitly assumes material financial distress at all insurance entities at the same time, yet the Basis cites no historical examples of that having ever occurred." Fin. Stability Oversight Council, View of Adam Hamm, the State Insurance Commissioner Representative 10 (Dec. 18, 2014).

B. Even On Its Own Terms, The FSOC's Analysis of Mismatch Fails to Comport With the Applicable Professional Standards.

In its Final Rule and Interpretive Guidance, the FSOC proposed a number of sample metrics to assess liquidity and maturity mismatch. See 77 Fed. Reg. at 21,660. These metrics help determine a nonbank financial company's vulnerability to financial distress. For instance, "[s]hort-term debt as a percentage of total debt and as a percentage of total assets . . . indicates a nonbank financial company's reliance on short-term debt markets." Id. In addition, the FSOC acknowledged that "[a]sset-liability duration and gap analysis . . . indicate[s] how well a nonbank financial company is matching the re-pricing and maturity of the nonbank financial company's assets and liabilities." Id.

The FSOC, however, failed to apply its own metrics in assessing MetLife. It glossed over the fact that MetLife's short-term debt is only 0.27 percent of its assets. See Final Basis at 286. It did not seriously engage in asset-liability duration and gap analysis.

Going a step further, a proper analysis of maturity mismatch should consider the likelihood that maturity mismatch would pose a systemic threat to the financial system. Even if there are

differences in the maturities of a company's assets and liabilities, such a risk can be mitigated by the liquidity of the company's assets. Thus, the FSOC proposed to consider such metrics as liquid asset ratios and the ratio of unencumbered and highly liquid assets to the net cash outflows and callable debt. See 77 Fed. Reg. at 21,660. To the contrary, analyzing MetLife, the FSOC simply glossed over the fact that "MetLife has a substantial portfolio of highly liquid assets." See Final Basis at 17. Not only did the FSOC fail to measure the degree of MetLife's maturity mismatch, but it also failed to measure the actual risk that MetLife's maturity mismatch poses to the financial system.

To be sure, the sample metrics listed in the Final Rule and Interpretive Guidance "are representative, not exhaustive, and may not apply to all nonbank financial companies under evaluation." 77 Fed. Reg. at 21,658. In this case, however, the sample metrics, such as asset- liability duration and gap analysis, were entirely applicable, as MetLife's "asset-liability profile differs fundamentally from the typical financial intermediary profile described in the Interpretive Guidance." Final Basis at 284. Still, the FSOC refused to apply its own sample metrics to MetLife.

C. The FSOC Refuses to Apply the Well-Established Principle That Collateral Is a Valid Hedge Against Risk

The FSOC in its Metlife decision heavily focused on maturity mismatch and liquidity risk stemming from MetLife's securities lending program. That focus fails to take account of the fact that the program's transactions are heavily collateralized—as the FSOC itself admitted.

The FSOC recognized that "[a]pproximately 88 percent of the securities lent by MetLife are U.S. government and agency securities, whose liquidity helps to protect counterparties." Final Basis at 156. And the FSOC even noted that "MetLife invested $6.6 billion of the cash collateral in U.S. Treasury and agency securities, which would be sold to satisfy any cash requirements due to the termination of securities lending agreements." *Id*. at 157. However, this did not prevent the FSOC from speculating that MetLife "could transmit material financial distress to other market participants as a result of a rapid liquidation of invested collateral to produce the necessary liquidity to return

cash collateral to its securities lending counterparties." *Id*. Thus, in its final determination, the FSOC failed to consider MetLife's access to liquid assets.

That is reasoning that has no stopping point and cannot be squared with general principles of risk regulation. Under the FSOC's analysis, material financial distress at any large, interconnected financial company with a securities lending program of any size would pose a threat to U.S. financial stability, regardless of the liquidity of the company's assets.

E. Some Financial Firms, Such As Insurance Companies Are Less Interconnected With One Another and With the Financial System

Banks are institutionally interconnected. They extend loans to one another through the interbank lending market and transact in over-the-counter derivatives. Therefore, the financial system is susceptible to systemic risk arising from banks. Financial distress at a large bank can impact the financial system at large and pose a threat to U.S. financial stability.

In particular, banks routinely encounter counterparty risk that stems from their trading partners, including other banks. Counterparty risk comes in various forms, such as default risk, replacement risk, and settlement risk. Moreover, the magnitude of counterparty risk increases with the degree of interconnectedness of the trading partners. During the 2008 financial crisis, "increased counterparty risk contributed to" the unfolding of the financial market turmoil. John B. Taylor & John C. Williams, *A Black Swan in the Money Market*, 1 AM. ECON. J.: MACROECONOMICS 58, 58 (2009).

In contrast, insurance companies lack the banking system's interconnectedness in two distinct ways. First, insurance companies are less interconnected with one another than banks are. There exists no "insurance system" comparable to the banking system. Insurance companies are not directly linked to one another through their balance sheets. While insurance companies cede some of their risks through reinsurance agreements, reinsurers only take up portions of the

primary risks of insurers, acting as a backstop. Second, insurance companies are not as interconnected with the rest of the financial system as banks are. On the one hand, insurance companies act as financial intermediaries and invest in financial markets. However, "the degree to which insurance companies are interconnected with other financial institutions is generally less significant than the interconnection among banks and brokerage firms." National Association of Insurance Commissioners, Capital Markets Bureau, *U.S. Insurance Industry's Investment Exposure to the Financial Sector, available at* http://www.naic.org/capital_markets_archive/130405.htm (last visited May 18, 2015). Insurance companies, for instance, may participate in securities lending as a low-risk investment strategy, but they do not participate in interbank lending. *See* National Association of Insurance Commissioners, Capital Markets Bureau, *Securities Lending in the Insurance Industry*, http://www.naic.org/capital_markets_archive/110708.htm (last visited May 18, 2015).

Because insurance companies are less interconnected with one another and with the financial system than banks, their exposure to the financial system is more limited. Moreover, insurance companies do not impose the same level of counterparty risk on the financial system as banks do. Indeed, empirical studies point toward lack of "any evidence in favor of contagion of failures in insurance." WHEN INSURERS GO BUST at 92. In sum, insurance companies are less interconnected, and thus less likely to pose a threat to U.S. financial stability than banks.

III. Cost-Benefit Analysis Allows for a More Transparent and Prudential Regulation of the Insurance Industry.

One sensible and often-followed approach to risk regulation seeks to measure whether taking a particular precaution is worth the cost. Under cost-benefit analysis, "all potential gains and losses from a proposal are identified, converted into monetary units, and compared on the basis of decision rules to determine if the proposal is desirable from society's standpoint." Tevfik F. Nas, COST-BENEFIT ANALYSIS: THEORY AND APPLICATION 1-2 (1996). Thus, the analyst "must

painstakingly identify all relevant costs and benefits and measure their true resource values under alternative policy and economic environments." Id. at 5-6. By applying cost-benefit analysis, the FSOC could have avoided the problems in its analyses. To the contrary, the FSOC rejected cost-benefit analysis as "not required . . . in connection with this rulemaking." 77 Fed. Reg. at 21,651.

In 1993, President Clinton issued Executive Order 12,866, which established guiding principles for regulation by federal agencies. See Exec. Order No. 12,866, 3 C.F.R. § 638 (1994). The Order noted that the "American people deserve a regulatory system that . . . improves the performance of the economy without imposing unacceptable or unreasonable costs on society." Id. Thus, it mandated federal agencies to "assess all costs and benefits of available regulatory alternatives, including the alternative of not regulating." Id. at § 1(a). Furthermore, federal agencies must "consider, to the extent reasonable, the degree and nature of the risks posed by various substances or activities within [their] jurisdiction." Id. at § 1(b)(4).

Within the context of financial regulation, cost-benefit analysis is based on the idea that "regulation is desirable only if the costs of regulation are smaller than the benefits from mitigating a market failure." WHEN INSURERS GO BUST at 74. For instance, under cost-benefit analysis, the FSOC would have considered whether the marginal benefits of federal supervision of MetLife outweigh its marginal costs. In particular, the higher the level of existing regulatory scrutiny, the lower the marginal benefits of additional regulation will be.

As another example, under cost-benefit analysis, the FSOC would have considered the likelihood or probability of MetLife's failure. Given that the FSOC aims to "address any potential risks to U.S. financial stability posed by" nonbank financial companies, 77 Fed. Reg. at 21,637 (emphasis added), the marginal benefits of regulating nonbank financial companies should be discounted by the probability of such risks. Thus, the FSOC would have relied less on such analyses as "run-on-the-bank" scenario, which may pose a great threat to U.S. financial stability but is not likely to materialize.

Cost-benefit analysis also places a premium on transparency: the methodology is employed right out in the open. Indeed, cost-benefit analysis "can be understood as . . . a method for ensuring that the consequences of regulation are not shrouded in mystery but are instead made available for public inspection and review." Cass R. Sunstein, The Cost-Benefit State 4, The Univ. of Chi. Law & Economics, Olin Working Paper No. 39 (May 1996).

Therefore, although cost-benefit analysis may not be the only rational approach in every situation, it is a sound set of principles that in this case would have helped the FSOC to avoid the problems in its analyses identified above. And if the FSOC publicly followed the well-established cost-benefit methodology, companies would be better able to understand and respond to the FSOC's determination process, and the public would be better able to scrutinize the FSOC's determination standards. The FSOC would have created a genuine justification for its actions that the public could review and critique or accept. Instead, the FSOC's insistence that "a determination decision can[not] be reduced to a formula," 77 Fed. Reg. at 21,642, resulted in a failure of risk regulation and a failure of transparency.

CONCLUSION

The FSOC's analysis thus far as failed to consider important characteristics of the company under consideration for SIFI as well as the nature of the industry (insurance, for example) in which the company operates. Its analysis overemphasizes the size and purported interconnectedness of the firm under consideration to the exclusion of relevant factors, such as substitutability, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The FSOC's analysis also has relied on speculative scenarios that failed to consider important aspects of insurance companies, which are less interconnected and better positioned to manage maturity mismatch and liquidity problems than banks.