INTERNATIONAL FINANCIAL REGULATION: THE ROLE OF NONBANKS AND THE FED

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THE PROBLEM

- The Financial Stability Board, a global network of regulators, promulgates an annual list of systemically important insurers. From the announcement:

G-SIIs will be subject to the following internationally agreed standards:

- *Higher loss absorbency (HLA),* the initial development of which was published by the IAIS in October 2015.[2] The HLA requirements, which will be revised to reflect further work by the IAIS on the G-SII assessment methodology, are scheduled to be applied starting from January 2019 to those G-SIIs identified in November 2017.
- *Enhanced group-wide supervision,* including for the group-wide supervisor to have direct powers over holding companies and to oversee the development and implementation of a Systemic Risk Management Plan and a Liquidity Management Plan.
- *Group-wide recovery and resolution planning and regular resolvability assessments*. The resolvability of each G-SII is also reviewed in a high-level FSB Resolvability Assessment Process (RAP) by senior regulators within the institution's Crisis Management Group.[3]

THE PROBLEM

- The list of institutions includes three American insurers:

G-SIIs identified as a result of the 2016 G-SII assessment exercise

Aegon N.V.

Allianz SE

American International Group, Inc.

Aviva plc

Axa S.A.

MetLife, Inc.

Ping An Insurance (Group) Company of China, Ltd.

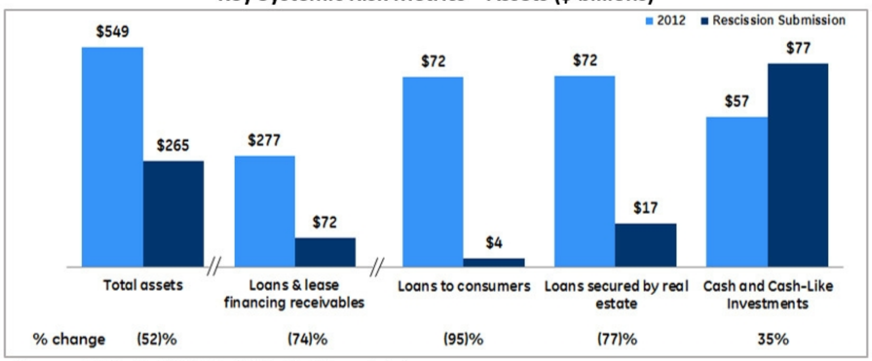
Prudential Financial, Inc.

Prudential plc

THE PROBLEM

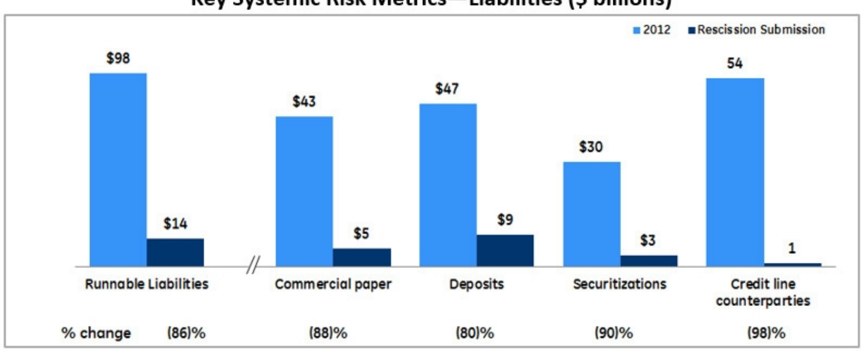
American regulators now can require non-bank financial companies to be subject to bank-like supervision, and firms will take great steps to avoid it.

Key Systemic Risk Metrics—Assets ($ billions)



Source: GE Capital FR Y-9C; GE Capital internal data.

Key Systemic Risk Metrics—Liabilities ($ billions)

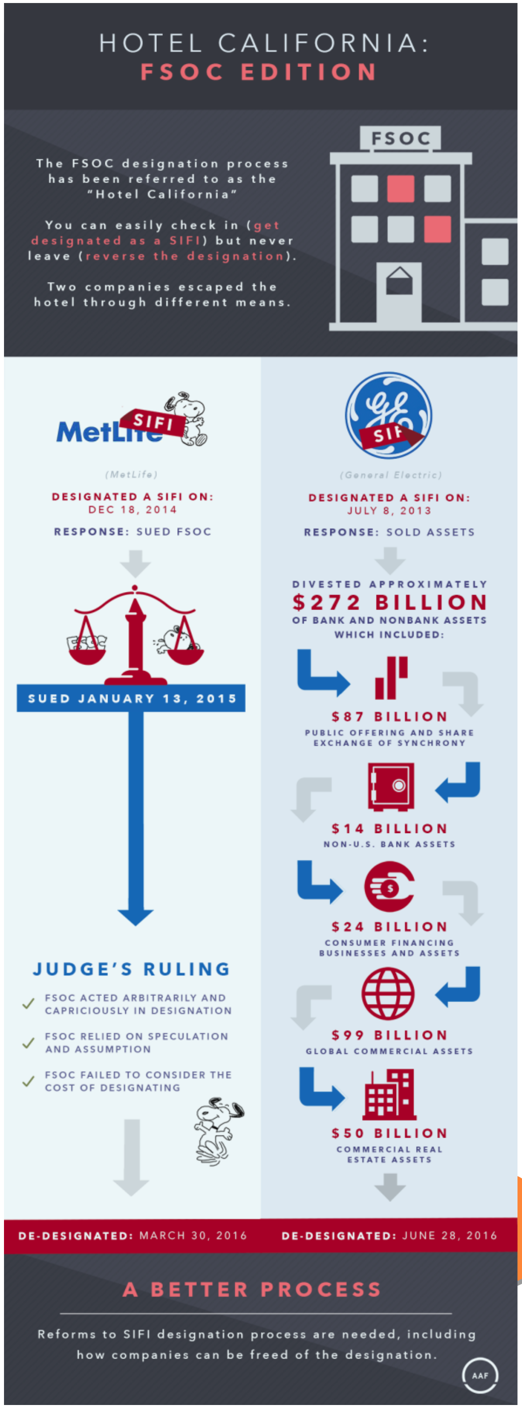


Source: GE Capital FR Y-9C; GE Capital internal data.

- GE Capital transformed itself
  - MetLife Sued

FSOC'S CRITICS

- The chair of the Senate Banking Committee has wondered whether the council's designation decisions are "sufficiently open, objective, data driven, and free from the influence of outside organizations."
- The Republican Party's presidential platforms in both 2012 and 2016 have committed the party to revoking the council's powers.
- And one court has reversed the council's designation of the country's largest life insurer as an arbitrary and capricious exercise of its authority. Metlife, Inc. v. Fin. Stability Oversight Council, No. CV 15-0045 (RMC), 2016 WL 1391569, at *17 (D.D.C. Mar. 30, 2016). That case is now on appeal.



COUNCIL DESIGNATIONS OF NONBANKS

Non-Bank SIFIs

Company Name	Category
General Electric Capital Corporation	Savings and Loan
American International Group	Insurance
MetLife	Insurance
Prudential Financial	Insurance

- Undesignated:
  - Some large insurers, e.g., Berkshire Hathaway
  - Asset managers, e.g., BlackRock, Vanguard

- Also designated:
  - Financial market utilities (FMUs) – exchanges and clearinghouses

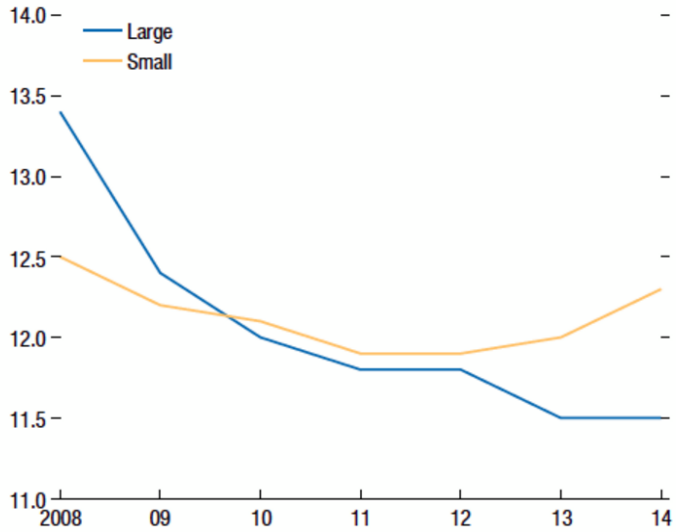
ADVANTAGES OF THE APPROACH TO SIFI DESIGNATION UNDER DODD-FRANK

- Uncertainty of systemic risk combined with the limits of regulatory foresight can incentivize nonbank firms to affirmatively seek out systemic risk.
- Malleability of FSOC Designation standard disincentivizes financial firms from seeking out systemic risk.
  - Creates only limited uncertainty due to (i) quantitative screen, and (ii) tacit non-designation of most insurers.
- FSOC Designation standard incentivizes regulators to affirmatively respond to emerging areas of concern.
  - Example: money market fund oversight by the SEC.

OTHER BENEFITS OF REGULATORY THREATS

- Efficient use of enforcement resources
- Has met with changed conduct:
  - MetLife sued … and sold its variable annuities business
  - AIG last year considered breaking itself up

Figure 2 US life insurers' higher-risk assets
(% of total assets)



REGULATION BY THREAT

- It is legitimate:
  - A legal system has never required the law to be enforced “with Prussian thoroughness as the price of being allowed to enforce them at all.” – Richard Posner
  - An “agency generally cannot act against each technical violation of the statute it is charged with enforcing.” Heckler v. Chaney, 470 U.S. 821, 831 (1985).
- Especially when uncertainty is high and downside risk extreme (Sunstein 2009)
- There are other reasons to conclude that FSOC regulates legitimately:
  - Voting
  - State members
  - International constraints
  - Political accountability through chair

THE NATURE OF THE THREAT: REGULATION BY THE FED

- Powerful in its own right
- The Fed acts independently of the legislature and executive, as exemplified by its own foreign policy:
  - Often more cosmopolitan than they would choose to be, at least statedly.
  - Sometimes an America First approach that may be inconsistent with our allies and national interests.
  - It is a very difficult problem to fix without compromising the independence of the central bank.

COSMOPOLITANISM: BIS AND BASEL

MONETARY POLICY: AMERICA FIRST

- "We're in the midst of an international currency war." Brazilian finance minister Guido Mantega
- "At what point does the domestic mandate get trumped by international responsibility? … If it never gets trumped, then let's stop talking about international responsibility." RBI Chair Ragu Rajan
- Fed Chair Ben Bernanke's response:
  - "along with economic conditions in our respective countries, our perceived interests began to diverge."
  - "Financial regulation and supervision are areas in which the Fed and other central banks should cooperate (and to an important extent already do) to reduce financial risks."

CONCLUSION

- Discretion to regulate systemically risky institutions should be protected.
- But it means that financial regulators will have the power to devise policies in conjunction with their global counterparts.
- And they have the flexibility to be inconsistent, as the Fed exemplifies.

Comments:

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