Testimony of Jeremy C. Kress
Assistant Professor of Business Law
University of Michigan Ross School of Business
Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs
Hearing on "Financial Stability Oversight Council Nonbank Designations"
March 14, 2019

Chairman Crapo, Ranking Member Brown, Members of the Committee, I am honored to appear before you to discuss the Financial Stability Oversight Council's nonbank systemically important financial institution (SIFI) designations. Nonbank SIFI designations are an essential policy tool for regulating systemic risk. I am therefore concerned that recent efforts to de-emphasize nonbank SIFI designations—or eliminate them altogether—would expose the financial system to many of the same dangers it experienced in 2008.

I will make three points in my testimony today.[1] First, nonbank SIFI designations are crucial for preventing catastrophic nonbank failures like the collapses of Bear Stearns, Lehman Brothers, and AIG. Nonbank SIFI designations protect the financial system by deterring nonbanks from becoming systemically important and by applying heightened safeguards to firms that nonetheless become excessively large, complex, or interconnected. By contrast, nonbanks' baseline regulatory regimes are generally not well suited to accomplish these goals.

Second, criticisms of nonbank SIFI designations are unpersuasive. For example, despite critics' complaints, nonbank SIFI designations do not impose bank-centric rules on nonbanks. To the contrary, the Federal Reserve has gone to great lengths to recognize the distinct regulatory issues associated with nonbank financial companies, and to tailor its approach accordingly. Moreover, to the extent that heightened regulations create an uneven playing field for designated nonbank SIFIs, this differential is a feature, not a bug. Enhanced safeguards for nonbank SIFIs ensure that companies have incentive to avoid becoming or remaining systemically important.

Third, proposals to replace nonbank SIFI designations with an activities-based approach are deeply misguided. Activities-based regulation, on its own, will not prevent systemic collapses like those we experienced in 2008. It is unrealistic to expect that regulators will identify and appropriately regulate all such activities *ex ante*, especially given financial companies' strong incentives to restructure or rename activities to avoid regulation. By contrast, policymakers are much more likely to consistently and accurately identify nonbank financial companies whose distress could threaten financial stability.

A purely or predominantly activities-based approach to nonbank systemic risk will fail for yet another reason: the U.S. regulatory framework is not configured to implement effective activities-based regulation. The U.S. regulatory system is riddled with gaps in areas like insurance, hedge funds, and fintech. Because FSOC lacks authority to implement activities-based rules directly, this pervasive jurisdictional fragmentation would undermine efforts to enact and enforce uniform, consistent activities-based rules throughout the financial system.

[1] Portions of this testimony are adapted from Jeremy C. Kress, Patricia A. McCoy, & Daniel Schwarcz, *Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk*, 92 S. CAL. L. REV. (forthcoming 2019).

To be sure, if configured appropriately, activities-based regulation could address some sources of nonbank systemic risk. As currently structured, however, the United States' regulatory framework is simply not conducive to effective activities-based nonbank regulation.

Proponents of an activities-based approach to nonbank systemic risk contend that activities-based rules would merely supplement, rather than displace, nonbank SIFI designations. But make no mistake: the procedural barriers to nonbank SIFI designations that FSOC proposed last week would make it exceedingly difficult for the Council to designate new nonbank SIFIs and for any such designation to survive judicial review. Moreover, the Council's apparent enthusiasm for activities-based nonbank regulation rings hollow given that the FSOC has not used its existing statutory authority to propose a single activities-based rule in more than two years under Secretary Mnuchin's leadership.

In sum, I am deeply concerned about recent initiatives to roll back nonbank systemic risk regulation. Efforts to marginalize the Council by diminishing its legal authority, politicizing its work, and reducing its budget collectively increase risks to the financial system and ultimately threaten the real economy.

I. Background on Nonbank SIFI Designations and Proposed Procedural Barriers

A. The Financial Crisis, Nonbank Systemic Risk, and the FSOC

The 2008 financial crisis demonstrated unequivocally that nonbank financial institutions can threaten U.S. and global financial stability. The failures of Bear Stearns, Lehman Brothers, and AIG proved that nonbanks—like banks—are capable of propagating risk throughout the financial system. Yet, traditionally, investment banks, insurance companies, and other nonbank financial companies generally have not been subject to macroprudential regulation designed to limit the risks these firms pose to the financial system and the broader economy.

After the crisis, Congress created FSOC to address the problem of nonbank systemic risk.[2] The Dodd-Frank Act gave FSOC two tools to achieve this goal. First, under section 113 of Dodd-Frank, FSOC may designate an individual nonbank SIFI for enhanced regulation if the Council determines that the firm's material financial distress or "the nature, scope, size, scale, interconnectedness or mix of [its] activities" could pose a threat to U.S. financial stability.[3] Any nonbank entity that FSOC designates as a SIFI becomes subject to consolidated supervision and regulation by the Federal Reserve, including risk-based capital, leverage, liquidity, and risk-

[2] My views about FSOC have been shaped by excellent scholarship on the Council and nonbank systemic risk. *See, e.g.*, Hilary J. Allen, *Putting the "Financial Stability" in Financial Stability Oversight Council*, 76 OHIO ST. L.J. 1087 (2015); Jeffrey N. Gordon, *"Dynamic Precaution" in Maintaining Financial Stability: The Importance of FSOC*, *in* TEN YEARS AFTER THE CRASH (Sharyn O'Halloran & Thomas Groll, eds., forthcoming 2019); Patricia A. McCoy, *Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance*, 5 U.C. IRVINE L. REV. 1389 (2015); Daniel Schwarcz & David Zaring, *Regulation by Threat: Dodd-Frank and the Nonbank Problem*, 84 U. CHI. L. REV. 1813 (2017); Christina Parajon Skinner, *Regulating Nonbanks: A Plan for SIFI Lite*, 105 GEO. L.J. 1379 (2017); Robert F. Weber, *The FSOC's Designation Program as a Case Study of the New Administrative Law of Financial Supervision*, 36 YALE J. REG. 359 (2019).

[3] 12 U.S.C. § 5323(a)(1).

management requirements.[4] This is FSOC's so-called "entity-based" approach. Second, under section 120 of Dodd-Frank, FSOC may recommend that the primary financial regulatory agencies adopt "new or heightened standards or safeguards" for any financial activity that could propagate systemic risks.[5] This is FSOC's "activities-based" approach.

B. Nonbank SIFI Designations and De-Designations

At first, FSOC embraced its SIFI designation authority. The Council promulgated, through notice-and-comment rulemaking, formal procedures for evaluating a nonbank's systemic importance.[6] Then, in 2013 and 2014, the Council designated three insurance-focused companies—Prudential, AIG, and MetLife—and General Electric's captive finance subsidiary, GE Capital, as nonbank SIFIs. FSOC concluded, through increasingly detailed analyses, that material financial distress at any of these four companies could pose a threat to U.S. financial stability and that enhanced oversight was therefore appropriate for each firm.

But now, just five years later, FSOC has reversed all of its original nonbank SIFI designations. To be sure, the Council's unanimous rescission of GE Capital's SIFI status in 2016 was well warranted. After its SIFI designation, GE Capital substantially reduced its systemic footprint, shrinking by more than half and reducing its reliance on risky short-term funding.[7] GE Capital's designation, restructuring, and consequent de-designation demonstrate that nonbank SIFI designations, when used appropriately, are effective deterrents against firms becoming and remaining systemically important.

Each of the Council's three subsequent de-designations, however, was hasty and ill-conceived. After Treasury Secretary Steven Mnuchin became Chair of the Council, FSOC rescinded AIG's SIFI status by a contested 6-3 vote. AIG's de-designation was considerably more controversial than GE Capital's, as AIG—one of the primary culprits of the financial crisis—did not appreciably reduce its systemic footprint following its designation.[8] Then, after MetLife prevailed in its lawsuit contesting its SIFI designation on procedural grounds, the Council abruptly reversed its litigation position and dropped its appeal of MetLife's case.[9]

Most troublingly, FSOC de-designated Prudential in October 2018, even though Prudential had increased in size and complexity since becoming a SIFI.[10] The Council's rescission of Prudential's

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[4] 12 U.S.C. § 5365(b)(1)(A).
[5] 12 U.S.C. § 5330(a).
[6] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637 (Apr. 11, 2012).
[7] *See* Ted Mann & Joann S. Lublin, *Why General Electric is Unwinding its Finance Arm*, WALL ST. J. (Oct. 13, 2015), https://www.wsj.com/articles/why-general-electric-is-unwinding-its-finance-arm-1444784781.
[8] *See* Gregg Gelzinis, *Deregulating AIG Was a Mistake*, CTR. FOR AM. PROGRESS (Oct. 11, 2017), https://www.americanprogress.org/issues/economy/reports/2017/10/11/440570/deregulating-aig-mistake/.
[9] Interestingly, FSOC's decision to drop its appeal in the MetLife case was supported by a majority of FSOC's voting members, rather than the two-thirds of voting members that would have been required to formally rescind MetLife's designation. *See* Press Release, Dept. of Treasury, Secretary Mnuchin Statement on the MetLife, Inc. v. Financial Stability Oversight Council Appeal (Jan. 18, 2018), https://home.treasury.gov/news/press-releases/sm0254.
[10] Prudential had grown by more than $100 billion in assets since its designation. Meanwhile, Prudential's complexity and interconnectedness with other financial companies also increased. Its notional derivatives exposures and repurchase agreements rose by more than 30 percent after its designation. *See* Jeremy Kress, *Prudential Hasn't*

SIFI status was not only unwise, it was also illegal.[11] When it de-designated Prudential, FSOC (1) violated its formal procedures by second-guessing the Council's original assessment of Prudential's systemic importance, (2) performed misleading quantitative analyses while dismissing more reliable indicators of Prudential's systemic importance, and (3) ignored its statutory mandate to consider Prudential's existing regulatory scrutiny.[12] These shortcomings substantially undermine the Council's conclusion that Prudential is not systemically important and render FSOC's action arbitrary and capricious.[13] Unfortunately, in contrast to MetLife, which had an unambiguous statutory right to contest its SIFI designation, it is unclear whether individual citizens or public interest groups have standing to sue FSOC when the Council illegally de-designates a SIFI.[14]

C. Proposed Procedural Barriers to New Nonbank SIFI Designations

These de-designations appear to be part of a concerted effort by the Trump Administration and some members of Congress to de-emphasize—or permanently eliminate—nonbank SIFI designations as a regulatory tool. In November 2017, the Treasury Department published a report deriding nonbank SIFI designations as a "blunt instrument" and proposing procedural barriers to new nonbank SIFI designations.[15] For example, the Treasury Department would require FSOC to assess a potential designee's likelihood of financial distress and perform a quantitative cost-benefit analysis of each designation. Just last week, FSOC proposed to adopt these procedural barriers through amendments to its interpretive guidance.[16]

If enacted, these new policies would substantially undermine FSOC's ability to designate nonbank SIFIs in the future. First, consider the proposed requirement that FSOC assess a company's likelihood of financial distress. As a threshold matter, this proposal directly conflicts with the text of the Dodd-Frank Act, which instructs FSOC to *assume* that a firm is in distress and analyze whether that distress could pose a threat to U.S. financial stability.[17] Even setting statutory considerations aside, however, this proposed requirement is seriously misguided. As FSOC's prior experience demonstrates, it can take years for the Council to evaluate a nonbank for potential designation, for the Federal Reserve to establish regulations appropriately tailored to a nonbank SIFI's business model, and for a designated nonbank SIFI to bring itself into compliance with those safeguards. Thus, waiting to designate a nonbank until it is vulnerable to distress could be

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Earned the Right to Shed SIFI Label, AM. BANKER (March 13, 2018), https://www.americanbanker.com/opinion/prudential-hasnt-earned-the-right-to-shed-sifi-label.

[11] *See* Jeremy C. Kress, *The Last SIFI: The Unwise and Illegal Deregulation of Prudential Financial*, 71 STANFORD L. REV. ONLINE 171 (2018).

[12] *See id.*

[13] An agency's decision is arbitrary and capricious if the agency did not rely on the factors Congress intended or the decision runs counter to the evidence before the agency. *See* Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co. 463 U.S. 29, 42-43 (1983). In addition, an agency may not "simply disregard rules that are still on the books." FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009).

[14] *See* Weber, *supra* note 2, at 425-32.

[15] U.S. DEP'T OF THE TREASURY, FINANCIAL STABILITY OVERSIGHT COUNCIL DESIGNATIONS, REPORT TO THE PRESIDENT OF THE UNITED STATES PURSUANT TO THE PRESIDENTIAL MEMORANDUM ISSUED APRIL 21, 2017.

[16] Notice of Proposed Interpretive Guidance Regarding Nonbank Financial Company Determinations (March 6, 2018), https://home.treasury.gov/system/files/261/Notice-of-Proposed-Interpretive-Guidance.pdf.

[17] 12 U.S.C. § 5323(a)(1).

too late. By the time the relevant capital, liquidity, and other safeguards associated with designation go into effect, the nonbank SIFI may already have collapsed.[18]

Subjecting nonbank SIFI designations to quantitative cost-benefit analyses would be equally unwise. Quantifying the costs and benefits of nonbank SIFI designations poses serious analytical challenges. For example, the stability-enhancing benefits of financial regulations are notoriously difficult to calculate accurately. As many scholars have recognized, quantifying the benefit of a crisis averted is nearly impossible.[19] Moreover, because of the infrequency of financial crises, financial regulatory cost-benefit analyses are highly sensitive to crude economic loss and discount rate assumptions. For these reasons, empirical cost-benefit analysis of the Council's nonbank SIFI designations would be susceptible to *ex post* second-guessing by a reviewing court, thereby creating litigation risk for the Council and deterring it from attempting to use its SIFI designation authority in the first place.

In lieu of nonbank SIFI designations, FSOC now purports to prioritize an activities-based approach to nonbank systemic risk. In its proposed interpretive guidance, the Council states that it will consider using its SIFI designation authority "only if a potential risk or threat cannot be addressed through an activities-based approach." Under this activities-based approach, the Council would coordinate with various federal and state financial regulatory agencies and encourage them to address risks arising from specific activities, either informally or through the Council's formal section 120 recommendation authority.[20]

Parallel initiatives in Congress would codify similar procedural barriers to nonbank SIFI designations and formally prioritize FSOC's activities-based approach. For example, the Financial Stability Oversight Council Improvement Act would prohibit FSOC from voting on a proposed nonbank SIFI designation unless the Council determines that a different approach would be impracticable or insufficient to mitigate the threat the company could pose to U.S. financial stability.[21] For the reasons explained below, these administrative and legislative efforts to de-emphasize nonbank SIFI designations are ill-advised and, if enacted, would recreate the same feeble approach to nonbank systemic risk that proved woefully inadequate in 2008.

II. Nonbank SIFI Designations are Critical for Preventing Systemic Nonbank Insolvencies

Retaining nonbank SIFI designations as a viable regulatory tool is necessary to prevent catastrophic nonbank failures like Bear Stearns, Lehman Brothers, and AIG. FSOC's nonbank

[18] Moreover, conditioning a firm's designation on its vulnerability could actually hasten its collapse. Any SIFI designation issued under this standard would signal that FSOC views the company as unstable, potentially triggering a run and creating the instability SIFI designations are designed to prevent.

[19] *See, e.g.*, John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882, 960–69 (2015); Jeffrey N. Gordon, *The Empty Call for Benefit-Cost Analysis in Financial Regulation*, 43. J. LEGAL STUD. S351, S373–75 (2014).

[20] Interestingly, the Council states that it will "make recommendations under section 120 of the Dodd-Frank Act only to the extent that its recommendations are consistent with the statutory mandate of the relevant primary financial regulatory agency." Notice of Proposed Interpretive Guidance Regarding Nonbank Financial Company Determinations, *supra* note 16, at 14. It is not clear how FSOC intends to address stability risks within the jurisdiction of agencies, like the Securities and Exchange Commission and state insurance regulators, that lack a statutory financial stability mandate.

[21] S. 3577, 115th Cong. (2018).

SIFI designation authority achieves two essential regulatory objectives: the threat of designation deters nonbanks from becoming systemically important, and tailored Federal Reserve regulation safeguards companies that nonetheless become excessively large, complex, or interconnected.

First, the prospect of nonbank SIFI designation serves as a powerful deterrent against nonbanks becoming systemically important. Ordinarily, a nonbank has strong incentive to expand its systemic footprint. That is because any financial company perceived as systemically important can borrow at favorable rates if the market believes that the government would bail out the firm, rather than allow it to fail.[22] FSOC's nonbank SIFI designation authority, however, counteracts this incentive. Because designation subjects a company to potentially costly regulation, the threat of designation dissuades firms from seeking to become systemically important. Thus, as Professors Daniel Schwarcz and David Zaring have written, "the FSOC designation regime incentivizes nonbanks to eschew activities and strategies that they anticipate would subject them to designation."[23] Moreover, as GE Capital's experience demonstrates, this incentive is even stronger for companies ultimately designated as nonbank SIFIs. Indeed, such firms have especially powerful motivation to simplify or shrink themselves in an effort to escape their designations.

Second, in the event that a nonbank becomes and remains systemically important, FSOC's nonbank SIFI designation authority enables the Council to subject the firm to appropriately tailored safeguards and thus protect the broader financial system. The Federal Reserve's macroprudential regulatory tools are uniquely suited to limit the risk that a designated nonbank SIFI will experience a systemic failure. For example, consolidated risk-based capital and leverage limits ensure that SIFIs maintain a sufficient capital cushion to absorb potential losses. Liquidity rules require SIFIs to hold a minimum amount of liquid assets to protect against funding runs. Stress tests simulate adverse economic conditions to ensure that SIFIs can withstand a severe downturn. Corporate governance reforms focus on improving enterprise risk management across SIFIs' operations. Finally, *ex ante* resolution planning is crucial if a systemically important nonbank must be liquidated through Dodd-Frank's Orderly Liquidation Authority.

To be clear, these macroprudential safeguards are necessary because most traditional nonbank regulatory regimes lack reliable financial stability regulatory tools. Insurance regulation is the most straightforward example. In the United States, insurance regulation has long been the responsibility of the states, with little federal involvement. But the state-based system of insurance regulation suffers from serious flaws with respect to systemic risk regulation. Most critically, the U.S. insurance regulatory system lacks well developed consolidated regulation and supervision of insurance holding companies.[24] And, in most states, the insurance commissioner is subject to a narrow regulatory mandate to protect an insurance subsidiary's policyholders, not to limit financial stability risks. In sum, absent nonbank SIFI designations and ensuing Federal Reserve oversight, some systemically important nonbanks will not be subject to consolidated, macroprudential supervision and regulation that is necessary to prevent a repeat of the 2008 crisis.

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[22] *See, e.g.*, Viral V. Acharya et al., *The End of Market Discipline? Investor Expectations of Implicit Government Guarantees* 35 (Munich Personal RePEc Archive, Working Paper No. 79700, 2016).

[23] Schwarcz & Zaring, *supra* note 2, at 1851.

[24] While the states have attempted to improve group-wide supervision of insurance holding companies since 2008, they still have not implemented consolidated capital requirements and other critical regulatory tools. Moreover, the efficacy of these state-level reforms is speculative because they largely have not been tested since the financial crisis.

III. Criticisms of Nonbank SIFI Designations are Unpersuasive

Critics of FSOC's nonbank SIFI designation authority have long complained that SIFI designations impose bank-centric rules on nonbanks, create an uneven playing field, are opaque, and are driven by international advisory bodies. None of these criticisms is convincing. Some critiques were overblown from the start; others have been addressed through reforms adopted by FSOC and the Federal Reserve. In any event, these arguments have little merit.

First, despite critics' complaints, nonbank SIFI designations do not result in the imposition of bank-centric rules on nonbanks. To the contrary, policymakers have taken several steps to tailor nonbank SIFI regulation to the distinct regulatory issues associated with designated nonbank financial companies. For example, Congress passed The Insurance Capital Standards Clarification Act of 2014, which specifically authorized the Federal Reserve to tailor its capital standards for insurers to the distinctive risks posed by each firm. And, in fact, the insurance SIFI capital standards the Federal Reserve proposed in 2016 reflect thoughtful consideration of the differences between bank and insurance company business models.[25] Moreover, the Federal Reserve has established a specialized team of insurance-focused experts to supervise nonbank SIFIs.

Second the fact that nonbank SIFI designations create an uneven playing field for designated firms is by design. Heightened capital, liquidity, and other rules help to ensure that nonbank firms have incentive to avoid being designated in the first place, and to shed their status quickly if they are so designated. Further, the costs of being designated are less unfair than critics suggest, as they help offset the funding advantages that come along with being perceived as systemically important.

Third, FSOC has taken numerous steps to enhance the transparency of the nonbank SIFI designation process. For example, it developed a formulaic quantitative test to select only a small subset of all nonbank financial firms for potential designation.[26] The Council began informing firms earlier when they were being considered for designation, and it established a formal process for reevaluating such designations.[27] FSOC also began releasing more detailed explanations for its designation decisions that provide clearer indications of how firms can achieve de-designation. Thus, while FSOC can surely further improve the transparency of its designation process, critics' concerns about opacity are overblown.

Finally, in contrast to critics' complaints, the Council's nonbank SIFI designation decisions are not driven by international advisory bodies. FSOC alone selects firms to evaluate for potential designation, and the Council makes its own, independent judgment about whether a firm meets the criteria for SIFI designation. While international advisory groups like the Financial Stability Board (FSB) have processes for evaluating financial institutions' systemic importance, their evaluations are not binding on the Council. Indeed, FSOC reversed the designations of AIG and MetLife even

[25] Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities, 81 Fed. Reg. 38,631 (June 14, 2016).

[26] Financial Stability Oversight Council Guidance for Nonbank Financial Company Determinations, 12 C.F.R. pt. 1310, app. A., § III.a (2018)

[27] *See Examining Insurance Capital Rules and FSOC Process: Hearing Before the Senate Subcomm. on Securities, Insurance, and Investments*, 114th Cong. 7–8 (2015) (testimony of Daniel Schwarcz, Professor, University of Minnesota Law School).

though the FSB considered those firms to be global systemically important insurers.[28] Thus, while the FSB and other advisory bodies facilitate global coordination, they do not detract from the independence of FSOC's nonbank SIFI designations.

In sum, criticisms of FSOC's nonbank SIFI designation authority are wholly unconvincing. Critics' complaints were either exaggerated from the outset or have been largely addressed by reforms policymakers adopted to improve the SIFI designation process. Accordingly, opponents' critiques should hold little weight in the continued debate over the appropriateness of nonbank SIFI designations.

IV. An Activities-Based Approach, On Its Own, Would Not Prevent a Recurrence of the 2008 Crisis

Recent efforts to prioritize an activities-based approach to nonbank systemic risk—by codifying a preference for activities-based regulation or erecting procedural barriers to nonbank SIFI designations—are deeply misguided. Proponents of this approach assume that by regulating systemically risky *activities*, policymakers can prevent the systemic failures of nonbank *entities*. This assumption, however, is wrong. Activities-based regulation, on its own, cannot prevent catastrophic nonbank failures like Bear Stearns, Lehman Brothers, and AIG. Instead, a purely activities-based approach would recreate the conditions that led to the last financial crisis.

Legislative and regulatory proposals to prioritize an activities-based approach are problematic for three distinct reasons. First, activities-based regulation is poorly suited to prevent systemically important nonbanks from imperiling financial stability. Second, even if activities-based regulation could work in theory, an effective activities-based approach is impossible in practice, given the current U.S. regulatory framework. Finally, prioritizing an activities-based approach would slow the process of designating nonbank SIFIs and thereby increase the likelihood of a catastrophic nonbank collapse.

A. <u>An Activities-Based Approach Will Not Prevent Systemic Nonbank Failures</u>

On its own, an activities-based approach is insufficient to stop nonbanks from propagating risks throughout the financial sector. That is because policymakers are unlikely to identify and appropriately regulate all potentially systemic activities *ex ante*. Moreover, even if regulators were to issue appropriate activities-based rules, a purely activities-based approach ignores the unique and potentially dangerous ways in which individual activities might interact when combined within a single financial institution.

First, an activities-based approach is inherently grounded in an unrealistic expectation that policymakers will identify and appropriately regulate all potentially systemic activities *ex ante*. As the 2008 crisis demonstrated, numerous known and unknown activities can create systemic risk. In the last crisis alone countless activities and products—subprime mortgages, mortgage-backed securities, collateralized debt obligations, repurchase agreements, commercial paper, and securities lending, among others—contributed to systemic risk. The prospect that policymakers

[28] FIN. STABILITY BD., 2016 LIST OF GLOBAL SYSTEMICALLY IMPORTANT INSURERS (G-SIIS) (Nov. 21, 2016), http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-insurers-G-SIIs.pdf

will identify and properly regulate all such systemic activities *ex ante* seems far-fetched. A purely activities-based approach is especially unlikely to succeed given financial companies' incentives to restructure or rename activities to avoid regulation.

The experience of the President's Working Group on Financial Markets (PWG) in the lead-up to the 2008 financial crisis exemplifies the difficulty of identifying systemically risky activities. President Reagan formed the PWG in 1988 to coordinate financial market oversight across various jurisdictions.[29] Comprised of the heads of the major U.S. regulatory agencies, the PWG was essentially a precursor to FSOC, with a mandate to address systemically risky activities.[30] While the financial sector amassed mortgage-related risks during the mid-2000s, however, the PWG focused on issues entirely unconnected to the looming crisis. Indeed, at the time, the PWG was primarily concerned with hedge funds, mutual funds, and terrorism risk insurance. It was not until March 2008 that the PWG finally recommended improved standards for mortgage origination, securitizations, and derivatives—the week before Bear Stearns failed.[31] This is not to fault the PWG for failing to anticipate the crisis—few people foresaw the market crash. But PWG's experience during the mid-2000s underscores that regulators face serious challenges in identifying the specific activities that will transmit systemic risks.

By contrast, policymakers are much more likely to consistently and accurately identify nonbank entities whose distress could threaten financial stability. As FSOC has demonstrated through its analytical framework, it is relatively straightforward to predict which nonbank entities could plausibly transmit systemic risks and which would not. Furthermore, nonbank SIFI designations need not perfectly distinguish between nonbanks that are systemically significant and those that are not. To the contrary, FSOC can deter nonbanks from seeking out systemic importance as long as the designation process is even roughly accurate. The mere prospect of being designated as a SIFI creates uncertainty, which a firm will likely seek to avoid by reducing its size and complexity.

Furthermore, even if policymakers could identify and regulate each potentially risky activity, that alone would not be enough to prevent a systemically important nonbank from failing. That is because an activities-based approach is designed to limit risks associated with individual financial activities or products, in isolation. But a financial institution's risk profile is the product of all of the firm's activities and how they interact with one another. AIG is a classic example. AIG's failure was not solely attributable to its now-infamous credit default swaps on mortgage-related assets. Instead, AIG's failure was also due to its securities lending activities, in which the firm invested collateral in mortgage-backed securities.[32] AIG's credit default swaps and securities lending activities posed highly correlated risks—the firm suffered significant losses from both activities when mortgage assets declined in value and counterparties demanded payouts. A purely activities-based approach, however, is blind to these types of interactions among all of a firm's activities.

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[29] *See* Exec. Order No. 12,631, 3 C.F.R. § 559 (1988).

[30] In contrast to FSOC, the PWG lacked authority to designate systemically risk entities for enhanced regulation or supervision.

[31] *See* THE PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, POLICY STATEMENT ON FINANCIAL MARKET DEVELOPMENTS (2008), https://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf.

[32] *See* Daniel Schwarcz & Steven L. Schwarcz, *Regulating Systemic Risk in Insurance*, 81 U. CHI. L. REV. 1569, 1585-86 (2014).

In sum, a purely or predominantly activities-based approach will not prevent a recurrence of the systemic nonbank failures the financial sector experienced in 2008. Entity-based nonbank SIFI designations, by contrast, are well suited to safeguard systemic nonbanks. Nonbank SIFI designations address the interrelationship of a firm's activities through enterprise-level safeguards like capital requirements, liquidity rules, and risk management standards. And, as noted above, policymakers are much more likely to be able to identify nonbank SIFIs, rather than trying to predict the precise activities through which such firms might transmit systemic risk. Accordingly, proposals to prioritize an activities-based approach while erecting procedural barriers to nonbank SIFI designations will weaken regulators' ability to prevent another financial crisis.

B. Effective Activities-Based Regulation is Impossible in the Current U.S. Regulatory Framework

Proposals to shift to an activities-based approach suffer from another critical drawback: even if activities-based regulation could work in theory, effective activities-based regulation is not possible in the current U.S. legal and regulatory framework. FSOC faces two significant obstacles in carrying out an activities-based approach to nonbank systemic risk.

1. *Effective Activities-Based Regulation is Impossible Because FSOC Lacks Authority to Mandate Activities-Based Rules*

First, FSOC lacks legal authority to implement activities-based reforms. Instead, the Council's section 120 activities-based power is strictly precatory. FSOC may *recommend* that an agency adopt new activities-based rules. But an agency has no legal obligation to actually implement such rules.[33] And, in fact, there are many reasons why an agency might resist implementing activities-based regulations at FSOC's urging. For example, the agency might be captured by the financial sector it regulates, or it might try to protect its regulatory turf against intrusion by the Council. Thus, it is inadvisable to rely heavily or exclusively on an activities-based approach to nonbank systemic risk because FSOC's activities-based powers are extremely weak.

The feebleness of FSOC's activities-based approach is especially concerning because the Council proposes to forfeit its one credible threat when an agency declines to adopt activities-based rules at FSOC's urging. Ordinarily, if an agency refuses an FSOC recommendation, the Council may respond by designating firms within the agency's jurisdiction as nonbank SIFIs. In fact, the Council threatened to do just that in 2012, after the SEC initially resisted enacting enhanced regulations on money market mutual funds.[34] Because agencies fear losing authority over companies within their jurisdiction, the threat of SIFI designation may encourage an agency to adopt FSOC's recommended rules.[35] Indeed, that is what happened when the SEC ultimately implemented MMMF reforms after the Council threatened to designate certain MMMFs or their advisors. Now, however, FSOC essentially proposes to take the threat of nonbank SIFI designations off the table. By enacting onerous procedural barriers, FSOC will make the threat of

[33] If an agency elects not to adopt an FSOC recommendation under section 120 of the Dodd-Frank Act, it must only "explain in writing" why it chose not to implement the rule. 12 U.S.C. § 5330(c)(2).
[34] *See* Allen, *supra* note 2, at 1118-19; Schwarcz & Zaring, *supra* note 2, at 1862-63.
[35] Schwarcz & Zaring, *supra* note 2, at 1860-64.

SIFI designations non-credible. In sum, creating new hurdles for nonbank SIFI designations further decreases the likelihood that an activities-based approach will work in practice.

2. *Jurisdictional Fragmentation in U.S. Financial Regulation Would Make an Activities-Based Approach Unworkable*

The second obstacle to effective activities-based regulation is the jurisdictional fragmentation that pervades the U.S. regulatory system. This fragmentation prevents policymakers from overseeing and regulating systemically important activities on a system-wide basis. In some cases, the regulatory system suffers from problematic gaps, where no regulatory agency has authority over particular conduct. For instance, in areas like insurance, hedge funds, and fintech, even if the Council were to recommend heightened macroprudential rules, it is not clear that any federal agency would have jurisdiction to implement those recommendations. In other cases, the U.S. regulatory system features complicated overlaps, where multiple agencies share responsibility for certain financial activities. This happens in areas like mortgages, securities, and derivatives. These overlaps would unduly complicate efforts to enact and enforce uniform, consistent activities-based rules throughout the U.S. financial system.

None of this is to say that a well-designed activities-based approach cannot help preserve financial stability. To the contrary, activities-based regulation has the potential to combat some—but not all—sources of nonbank systemic risk, *if configured appropriately*. For example, an activities-based approach is uniquely well-suited to address systemic risks that may arise from correlations across numerous different nonbanks' investment activities, risk management practices, or product features. An activities-based approach may also be better designed to address certain risks arising from complex relationships among firms that require regulators or other market actors to mediate intercompany relationships through market infrastructure, such as clearinghouses and exchanges.

As currently configured, however, the fragmented U.S. regulatory framework is not designed to realize these potential benefits of activities-based regulation. To operationalize an effective activities-based approach, Congress would need to dramatically reform the U.S. regulatory system. For example, Congress could create a single stability regulator with authority to oversee activities spanning different segments of the financial sector, similar to the regulatory structure in Australia and other "multi-peaked" systems. A regulator of this sort would obviate many of the structural problems with activities-based regulation. Absent these reforms, however, an activities-based approach to nonbank systemic risk will not succeed in the current U.S. regulatory framework.

C. <u>Prioritizing an Activities-Based Approach Would Slow the Process of Nonbank SIFI Designations</u>

Finally, proposals to prioritize an activities-based approach—and consider nonbank SIFI designations only as a last resort—could dramatically slow the process of designating a nonbank SIFI, even when conditions clearly warrant such a designation. The designation process that FSOC and some members of Congress envision would involve multiple rounds of consultation and coordination among the relevant regulatory agencies before the Council could potentially resort to nonbank SIFI designations. This multi-step process would take so long in practice that by the time FSOC even considered addressing escalating risks through nonbank SIFI designations, it could be too late.[36] The SIFI designation process is already lengthy, with extensive evaluation and ample opportunity for the relevant company to present evidence to the Council. Moreover, it takes additional time for the Federal Reserve to develop appropriately-tailored rules for any company designated as a nonbank SIFI, and even more time for the company to bring itself into compliance with those safeguards. Further delaying the designation process by mandating that the Council first exhaust all activities-based remedies is therefore highly inadvisable.

Proponents of an activities-based approach mistakenly view nonbank SIFI designations as an emergency response to be used if activities-based regulation fails to address systemic risks. Indeed, the Council's proposed amendments to its interpretive guidance commit that FSOC will consider a nonbank SIFI designation "only in rare instances such as an emergency situation."[37] This view gravely misconstrues the purpose of nonbank SIFI designations. A nonbank SIFI designation is not an emergency tool; instead, it is a prophylactic strategy to protect a systemically important nonbank from experiencing distress in the first place.[38] In order for the capital, liquidity, resolution planning, and other safeguards associated with nonbank SIFI designations to have their intended effect, FSOC must proactively use nonbank SIFI designations as an *ex ante* crisis-prevention strategy, not as a belated crisis response.

V. Conclusion

In sum, it is critical that FSOC retain nonbank SIFI designations as a viable regulatory tool. Recent proposals to de-emphasize or eliminate nonbank SIFI designations—either formally or through onerous procedural requirements—ignore the unique ways in which SIFI designations can prevent catastrophic nonbank failures. Moreover, these proposals overlook the serious practical challenges that an activities-based approach would face in the United States' fragmented regulatory framework. Nonbank SIFI designations are therefore essential to mitigate nonbank systemic risk and prevent the next Bear Stearns, Lehman Brothers, or AIG from triggering another financial crisis.

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[36] This is especially true if, as the Council proposes, it only designates nonbanks it determines to be vulnerable to financial distress.

[37] Notice of Proposed Interpretive Guidance Regarding Nonbank Financial Company Determinations, *supra* note 16, at 27.

[38] *See* Gregg Gelzinis, *Don't Put SIFI Designations on the Back Burner*, AM. BANKER (Jan. 29, 2018), https://www.americanbanker.com/opinion/dont-put-sifi-designations-on-the-back-burner.