Insight

Insurance, FSOC, and Systemic Risk: A Parable

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- Section 113 of Dodd-Frank gives the Financial Stability Oversight Council (FSOC) broad latitude to designate firms as systemically important financial institutions (SIFIs), but it hasn't been as activist body as it possibly could.
- There are fundamental differences between banks and insurance companies, and regulations (and designations) should reflect those differences.
- One of the more prominent measures of systemic risk is fatally flawed and should not be used by FSOC (or anyone) to determine an institution's systemic importance.

The Financial Stability Oversight Council (FSOC) is one of many creations of the Dodd-Frank Act (Dodd-Frank). What makes FSOC unique is it's unharnessed and sweeping authority for regulatory oversight. A relatively short (just over 2000 words) Section 113 of Dodd-Frank charges FSOC with designating non-bank financial companies as systemically important financial institutions (SIFIs) when "the Council determines that material financial distress at the U.S. 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."

In other words, FSOC has the ability to arbitrarily designate whenever and however it sees fit. Section 113, by using relative, loosely-defined terms like "material financial distress" and "financial stability" and combining them with a series of factors joined by "or" and ending in a hypothetical "could pose," Dodd-Frank created an entity that can statutorily self-define its own jurisdiction and legal standards.

Luckily FSOC hasn't been as activist as it could be. In fact, with few exceptions, it's just been following in the footsteps of the Financial Stability Board (FSB), the international

regulatory body made up of leaders from G20 countries tasked with "promoting financial stability" in the wake of the financial crisis. While the FSB doesn't have the ability to directly regulate (they trust the national regulators to adopt their recommendations and do the dirty work), they do have broad authority to designate financial companies under no real, uniform set of standards. When the FSB designated American insurance companies as globally systemically important insurers (G-SIIs), FSOC followed suit and designated those same companies as SIFIs.

Although Dodd-Frank gives FSOC pretty free reign, it also has a few requirements for the designation process and post-designation oversight implementation. For example, Section 115 of Dodd-Frank requires that, after a SIFI is designated, "[t]he Council shall…evaluat[e]…the costs to companies, the effects on the structure and operation of credit and other financial markets, and other economic effects of requiring contingent capital." While it doesn't specifically require a cost analysis during the designation process, Section 113 does require FSOC to consider "any other risk-related factors that the Council deems appropriate."

Of course, FSOC will argue that costs to a designee is not an "appropriate risk-related factor," but, as MetLife cited to in their on-going case against FSOC, the Supreme Court recently ruled in Michigan v. Environmental Protection Agency that cost is an appropriate and necessary factor that FSOC should consider because "no regulation is 'appropriate' if it does significantly more harm than good." In MetLife's case, FSOC refused to consider any costs to the company as a result of a designation and argued that the only risk-related factors that should be considered are those that affect the financial stability of the United States. In response, the court ruled that the cost to MetLife or any company under consideration for designation must be considered because it directly affects the risk of distress to that company and, since the company is a SIFI, would indirectly affect the financial system's overall distress. All things considered, FSOC has been overstepping their already immense amount of authority by levying enhanced regulations on companies it arbitrarily deems SIFIs.

Dr. Scott Harrington of the Wharton School recently wrote a paper entitled "Systemic Risk and Regulation: The Misguided Case of Insurance and SIFIs." In it, he raises important questions about whether or not insurance companies (specifically life insurance companies) actually pose a threat to the financial stability of the United States and how exactly, if at all, they should be designated and overseen.

He points out that there are fundamental differences between banks and insurance companies and regulations should reflect those differences. Specifically, "banks rely heavily on short-term, liquid sources of financing (deposits and related instruments) and invest

heavily in illiquid loans with longer maturities than their liabilities." On the flip side "life insurers rely heavily on longer-term, less liquid sources of funds and invest heavily in relatively liquid, longer-term financial assets." As a result, life insurance companies inherently pose significantly less systemic risk than traditional banks.

Dr. Harrington explains that life insurers divide their balance sheets into two categories: general account assets and liabilities and separate account assets and liabilities. General account assets and liabilities are things like traditional life insurance policies, fixed annuities, and certain deposit-type accounts. Separate account assets and liabilities are things like variable life insurance policies, variable annuities, and pension products – all of which have some market-based risk that is borne by those contract or account holders. General account assets are long-term fixed income products, whereas separate account assets are generally common stocks. This divide between lower-risk and higher-risk assets and liabilities gives these companies a greater ability to absorb financial shock.

As Dr. Harrington and so many others have argued, the FSOC's consideration (or lack thereof) of existing state-based insurance regulation ignores the vast differences between banks and insurance companies, their balance sheets, and their activities. It fails to consider recent and not so recent upgrades to states' regulatory regime and their focus on company solvency, and it completely ignores the ability of state insurance regulators, during what they consider to be a financial crisis, to block policyholder withdrawals. Instead of lumping all large financial companies together, FSOC should take time to understand their differences in structure and in oversight and treat them accordingly.

"The alternative and better approach to developing enhanced supervision to mitigate systemic risk is to eschew designation of specific institutions as systemically risky and instead focus on the underlying activities in different sectors that could give rise to systemic risk." Or, instead of picking companies to designate as SIFIs just because their size is over some arbitrary limit, FSOC should target specific activities or behaviors that actually create systemic risk and don't yet have appropriate regulatory or market limits. This sort of activities-based approach allows for a more accurate diagnosis and treatment of systemic risk not just within one institution but across institutions and more efficiently assigns regulatory costs so as to not overburden companies that may not actually be contributing as much to overall systemic risk.

With regard to the "arbitrary limit" that FSOC seems to use in deciding which institutions to designate as SIFIs, one of the more predominant measures of theoretically determining systemic risk is called SRISK. Developed by New York University's (NYU) Volatility Institute, SRISK attempts to quantify individual institutions' systemic risk by estimating an institution's market value of equity relative to what would be a "prudent" value during an

economic downturn. Simply put, SRISK is an attempt to define how much capital a firm would need to hold in order to function normally under stress conditions, and how far below (or above) that level of capital is actually in a firm's coffers indicates that firms level of systemic risk, or SRISK.

Dr. Harrington's paper explains that SRISK depends on four key factors: "(1) the market value of the firm's equity; (2) a leverage measure (the book value of liabilities plus the market value of equity, divided by the market value of equity); (3) the predicted percentage reduction in the firm's market value of equity conditional on a severe market downturn (which is very highly correlated and in some version directly related to an estimated "beta" for the firm's stock); (4) an assumed prudent capital ratio of the market value of equity to assets (typically 8 percent, with assets defined as book liabilities plus the market value of equity)."

On its face, SRISK is a flawed methodology simply because it completely ignores liquidity of a firm's assets. Even FSOC itself concedes that liquidity is an important factor to consider when determining financial stability and systemic risk. Beyond liquidity, SRISK fails to consider other variables important to an institutions health like the nature and diversification of its assets. Specific to insurance companies, Dr. Harrington argues that "[t]he underlying notion that an insurer's need to raise capital during a period of market distress would be closely tied to the market value of its equity is mistaken."

In fact, that SRISK bases its assumptions completely on market data is perhaps its biggest flaw. An institution's financial wellbeing in terms of capital should be measured by statutory, risk-based standards as opposed to market capitalization that can fluctuate based on the stock market's performance. The use of market data, specifically with regard with market capitalization, makes it difficult to distinguish between risks that are simply market implied and those that are fundamental – which would lend themselves to a designation of systemic importance for the carrier institution. Only quantifying market-based risks at individual institutions means that SRISK only measures that institution's financial vulnerability and fails to measure true systemic risk. As such, SRISK cannot and should not be used in determining whether or not a financial institution, particularly an insurance company should be designated as systemically important.

In sum, FSOC has been making arbitrary designations based on flawed methodologies, and, if it wants to start abiding by its Dodd-Frank charge and truly abating systemic risk in an effort to enhance financial stability, it should operate under an activities-based approach and stop simply droning on in the shadows of the FSB. Insurance companies pose much different and much less risk than traditional banks, which should drive the regulation thereof. And SRISK is a terrible, horrible, no good, very bad attempt to quantify systemic

risk.