Research

Considering an Activity-Based Regulatory Approach to FSOC

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SUMMARY

The Financial Stability Oversight Council (FSOC) recently moved to considering a more activity-based approach to oversight and regulation of nonbanks in its dealing with asset managers. By identifying those activities that they believe truly pose a threat to financial stability, they can offer companies an opportunity to remedy any shortcomings in their engagement in those activities, or even divest if that is the least costly solution.

Activity-based regulation really is the story of regulation more broadly. Firms have always been given the latitude to determine if a given activity or product, with its attendant regulation, is a profitable opportunity or not.

Unfortunately, FSOC appears to have quickly abandoned an activity-based approach last week with its decision to designate MetLife as systemically important. This further increases the unpredictability of a SIFI designation process already beset by uncertainty and opacity.

INTRODUCTION

Last week, the FSOC voted to designate MetLife as a “systemically important financial institution,” or SIFI, and subjecting it to additional regulation and enhanced prudential supervisory standards.[1] Although many analysts predicted the designation, the FSOC’s opacity in the designation process makes it difficult to know when such a decision will take place or what factors would underlie it. To add to the uncertainty, Dodd-Frank lays out (to some degree) what designation means for banks, but does not do so for nonbanks – in this case “the nation’s biggest life insurer.”[2]

Dodd-Frank’s regulatory approach to financial stability took a departure from the history and patterns of prior regulation. In many ways it is completely opposite to the approach regulation has taken for decades. Regulation usually seeks to achieve goals related to specific activities or lines of business. However, FSOC’s designation of firms, without explicit explanation of activity-based concerns and aims, is a novel method of achieving goals.

The designation process of MetLife is further complicated based on previous reports that FSOC was embracing an activity-based approach.[3] After extended discussion with and about asset managers, the FSOC wisely reconsidered a firm-level approach. Other nonbanks and entire categories of financial industry firms should now be worried that they will next be targeted for designation, and further that they will have no recourse or response to the process.

THE STRUCTURE OF REGULATION

Regulation (generally) is targeted at specific activities. That activity could be the manufacturing of a type of product, provision of a service, or use of a particular financial instrument. For practical administrative purposes, the company or division which engages in the regulated activity will serve as the nexus through which restrictions, disclosure, and oversight occur. But it is nonetheless the activity itself that is of interest to policymakers and the target of regulation.

In the United States, the regulatory process is a three-branch operation. The ultimate source of the regulation is Congress, which passes statutes outlining the intent and scope of that regulation. Administrative agencies then implement those statutes, filling in detail where necessary and often gathering input from experts and industry to tailor the rules they will promulgate, sometimes doing so to achieve stated or unstated ends. Finally the courts serve as a venue of recourse when parties believe the rules (or the process which led to them) stray too far from or are not in service of the laws passed by Congress. Alternatively, the courts can act as a check on Congressionally-passed laws which may be beyond their Constitutionally-authorized scope, though regulation courts have generally given Congress a fairly wide berth in which to operate.

The regulatory process is, as one would suppose, more circular than linear. Regulation does not have a beginning and an end so much as it has a few spins in the cycle. Congress initially acts often at behest of voters, interest groups, and economic pressures. These factors are not static and in turn are affected by agency rulemakings, spurring stakeholders to seek changes through Congress (or possibly to support maintaining the new status quo). And interest groups can lobby (in various forms) both Congress and the regulatory agencies, so ultimately the cycle is not even a simple circle.

Despite the iterative and distributed nature of the American regulatory process, Congress is vested with a tremendous amount of authority (and thus responsibility). This is in sharp contrast to the primarily European system which combines both rulemaking authority and enforcement power.[4] We can observe one of the widely accepted tenets of Western jurisprudence: laws must apply equally across persons. Put another way, legislatures cannot create one set of rules for the majority and another for the minority, or the extreme case, one set of rules for the vast majority and another for a specific singular entity. Except perhaps in cases where an effective monopoly exists, Congress creates regulations that are applied equally across the market to all firms engaged in particular activities.

RISK WITHIN THE FIRM

One may counter that, for example, the risk to the public of a toaster malfunctioning is different than the risk a financial company poses to the public. The latter's is really an internal risk (insolvency) that is tied to other outside risks: contagion, systemic risk, etc. If that's true, the thinking might go, financial firms must be regulated at the firm-level as opposed to a specific product or activity level (manufacturing of a specific product). But thought of another way, all business activities pose a risk internally to the firm. A toaster as a discrete item may pose an obvious risk of malfunction to a customer, but the activity of manufacturing toasters implies some risk and expected cost of consumer injury (liability) which is borne by the firm. In other words, both financial activity and, say, traditional manufacturing activities entail some insolvency risk, insofar as they are risky at all.

Title I and the creation of the FSOC and its designation process could be summarily called the "AIG rule," as it was intended to solve what was perceived as the inadequacy of the previous system to deal with AIG's insolvency. But in the same way as a manufacturer dealing with a product liability crisis in one of its product lines, AIG was undone by a specific set of financial instruments in one of its divisions (the Financial Products division). Thus a rigorous activities-based standard should theoretically be sufficient for financial regulation.

CONCLUSION

The Financial Stability Oversight Council has recently acknowledged that it is willing to consider a more activity-based approach to oversight and regulation of nonbanks going forward, specifically with respect to asset managers. Though it did not hew to that approach with respect to MetLife, FSOC should continue down this path as it considers the financial stability concerns surrounding other insurers and nonbanks more broadly. By identifying those activities that they believe truly pose a threat to financial stability, they offer companies an opportunity to remedy any shortcomings in their engagement in those activities, or even divest if that is the least costly solution.

Activity-based regulation really is the story of regulation more broadly. Firms have always been given the latitude to determine if a given activity or product, with its attendant regulation, is a profitable opportunity or not. In fact any given firm is a collection of a *sui generis* set of activities – they may be only broadly defined as “insurance company” or “light bulb maker” but these are merely convenient semantic applications. Regulators would do well to remember the unit at which regulations are most appropriately applied.

[1]Victoria McGrane and Leslie Scism, “MetLife Is Closer to Possible 'Systemically Important' Designation,” *The Wall Street Journal*, August 20, 2014, http://online.wsj.com/articles/metlife-is-closer-to-possible-systemically-important-designation-1408559511.