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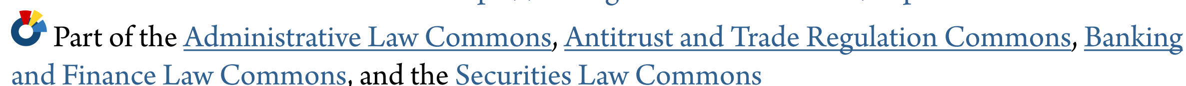
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Harvard Law School Forum on
Corporate Governance and Financial Regulation

Complementary Macroprudential Regulation of Nonbank Entities and Activities

Posted by Jeremy Kress (University of Michigan), Patricia McCoy (Boston College), and Daniel Schwarcz (University of Minnesota), on Thursday, September 13, 2018

Tags: Financial crisis, Financial institutions, Financial regulation, FSOC, Prudence, Risk, SIFIs, Systemic risk
More from: Daniel Schwarcz, Jeremy Kress, Patricia McCoy

Editor's Note: Jeremy Kress is Assistant Professor of Business Law at the Stephen M. Ross School of Business at the University of Michigan; **Patricia McCoy** is the Liberty Mutual Insurance Professor of Law at Boston College Law School; and **Daniel Schwarcz** is Professor of Law at the University of Minnesota Law School. This post is based on their recent **paper**.

The 2008 financial crisis demonstrated unequivocally that nonbank financial firms such as investment banks and insurance companies can threaten the global economy. After the crisis, Congress created the Financial Stability Oversight Council (FSOC) to address emerging forms of nonbank systemic risk. Congress gave FSOC two powers to achieve this objective. The first, dubbed an entity-based approach, empowers FSOC to designate individual nonbank systemically important financial institutions (SIFIs) for macroprudential regulation by the Federal Reserve. The second, known as an activities-based approach, allows FSOC to recommend that federal regulators implement new rules governing specific financial activities to contain systemic risk.

During the first several years after its creation, FSOC deployed both its entity- and activities-based authorities. Using its entity-based power, FSOC designated four firms—American International Group, Prudential Financial, General Electric Capital Corporation, and MetLife, Inc.—as nonbank SIFIs. FSOC used its activities-based authority to recommend that the Securities and Exchange Commission adopt reforms to its regulatory scheme for money market mutual funds.

More recently, however, an emerging view has begun to dominate financial regulatory circles: that FSOC should focus principally on its activities-based authority. This view gained momentum after President Donald Trump's election and became the official policy of the U.S. Treasury Department in a **report** issued last year. FSOC's entity-based approach has now fallen out of favor, with three of the four nonbank SIFIs having been de-designated. In a bid to make this trend lasting, the Treasury report proposes a series of onerous procedural barriers to future nonbank SIFI designations. International policymakers have likewise moved away from an entity-based approach to nonbank systemic risk. Just a week after Treasury released its report, the Financial Stability Board **announced** it would not update its list of international insurance SIFIs and instead focus on developing an activities-based approach.

In our new paper, **Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk**, we challenge this emerging consensus that FSOC and its international counterparts should rely primarily on an activities-based, rather than an entity-based, approach to nonbank systemic risk. Instead, we argue that entity- and activities-based approaches are both essential, and complementary, components of an integrated strategy to effectively regulate nonbanks for systemic risk. Substantially impeding the designation of nonbank SIFIs, as the Treasury report proposes, will ultimately expose the financial system to the same risks the world experienced in 2008 as a result of financial distress at nonbanks like AIG, Bear Stearns, and Lehman Brothers.

We first contend that even a well-implemented activities-based regime cannot, on its own, prevent individual nonbank firms from transmitting systemic risk. This is because an individual firm's systemic riskiness is inherently a product of the interrelations among its various activities and risk-management practices. Individual activities may pose limited systemic

risk in isolation, but much greater systemic risk when combined with one another at a single firm. AIG, for instance, nearly failed because of the toxic interactions between its derivatives and securities lending operations. An activities-based approach is inherently blind to this cumulative nature of a firm's systemic risk profile. Even more importantly, identifying ahead of time which new financial activities may create systemic risk is a nearly impossible assignment for regulators given the varied forms such risk can take and the constant evolution of activities to evade regulatory restrictions.

In contrast to an activities-based approach, an entity-based approach is reasonably well designed to limit the risk that a systemically important nonbank will fail. Perhaps most obviously, the content of entity-based regulation—such as capital, liquidity, and risk-management requirements—is inherently focused on the cumulative impact of a firm's activities. Moreover, an entity-based approach is a more effective deterrent against firms taking on systemic risk than an activities-based approach, as firms can quickly adjust to new activities-based rules through regulatory arbitrage. An entity-based approach is also inherently more reliable than the alternative, as identifying systemically significant firms is substantially easier than identifying systemically significant activities *ex ante*.

We argue that proposals to eliminate an entity-based approach in favor of an activities-based approach are misguided for a second set of reasons: an activities-based approach is much harder to implement effectively, particularly in fragmented regulatory systems like the United States'. This point is underscored by the obvious, but often overlooked, fact that FSOC does not have legal authority to implement activities-based reforms directly. Instead, it can only make nonbinding recommendations that other agencies adopt such rules. As such, proposals to de-emphasize FSOC's designation authority would end up turning it into a glorified think tank.

Not only does FSOC have limited authority to implement activities-based reforms, but so too do other domestic financial regulators. In theory, an effective activities-based financial stability regime would have a single regulator and would apply to all companies that engage in a particular activity, regardless of charter type. In practice, however, it is highly unusual for activities-based rules to apply uniformly to all financial firms, particularly in the United States. This fragmentation often leads to coverage gaps and divergent outcomes, depending on the categorization of firms engaging in specific activities. These gaps and inconsistencies, in turn, promote regulatory arbitrage and undermine regulators' capacity to grasp the full risks created by particular transactions.

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

As currently structured, 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. Effective activities-based systemic risk regulation can only be accomplished by a single financial 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 single stability regulator of this sort would obviate many of the problems with activities-based regulation. With significant structural reforms, therefore, activities-based regulation could meaningfully complement an entity-based approach to nonbank systemic risk. In the absence of such reforms, however, proposals to rely primarily on an activities-based approach are doomed to fail.

In sum, we conclude that an effective approach to nonbank systemic risk would retain entity-based designations while also empowering a unified systemic risk regulator to implement activities-based rules. By using entity-based and properly-configured activities-based approaches as complements, rather than substitutes, policymakers could prevent the next AIG, Lehman Brothers, or Bear Stearns from destabilizing the global financial system.

The complete paper is available for download **here**.

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