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Regulating Systemically Important Financial Institutions That Are Not Banks¹

Background

Certain financial institutions are so central to the American financial system that their failure could cause traumatic damage, both to financial markets and the larger economy. These institutions are often referred to as “systemically important financial institutions” or SIFIs. The Dodd-Frank Act, the comprehensive reform legislation signed into law during the summer of 2010, requires financial regulators belonging to the Financial Stability Oversight Council (FSOC)² to name those financial institutions that it believes are systemically important.³ Such SIFIs are to be supervised more closely and potentially required to operate with greater safety margins, such as higher levels of capital, and to face further limitations on their activities.

Throughout Dodd-Frank the focus is principally on banks, particularly commercial banks, and the act effectively designates all commercial banking groups with \$50 billion or more in assets as SIFIs. However, it requires regulators to consider whether other financial institutions are systemically important, leaving the decision about which non-bank financial institutions should receive that designation up to the FSOC, with advice from the Federal Reserve Board (Fed). The FSOC is in the process of determining what non-bank institutions it will designate as SIFIs, but it seems clear that several large life insurance groups and at least one large finance company (GE Capital) will be named. Eight “financial market utilities” have already been designated. (These

¹ Parts of this paper are adapted from a previous paper that I co-authored with Robert Litan, “Identifying and Regulating Systemically Important Financial Institutions: The Risks of Under and Over Identification and Regulation.” I would like to thank Bob for his permission to use this material.

² Members of the FSOC include the Treasury Secretary (chair), the Chairman of the Federal Reserve System, the Comptroller of the Currency, the Chairman of the Federal Deposit Insurance Corporation, the Chairman of the Securities and Exchange Commission, the Chairman of the Commodities Futures Trading Commission, the Director of the Bureau of Consumer Financial Protection, the Director of the Federal Finance Housing Agency, the Chairman of the National Credit Union Administration Board, a member with insurance expertise designated by the President and confirmed by the Senate, and various non-voting members (such as a representative of state bank regulators).

³ There is some ambiguity in the legislation as to whether all systemically important financial institutions must be designated as such, or only those where the FSOC feels it is necessary to do so. Section 113(a)(1) uses the term “may” whereas Section 112(a)(12)(H) indicates a requirement.

are firms such as clearing houses that do the back office transactions that make many financial markets function.) Other financial institutions may be added as well, such as hedge funds or money market funds.

Dodd-Frank also authorizes the FSOC to designate certain types of activities as systemic regardless of what institution is conducting them, giving the regulators greater powers to control those activities. There is some potential for this to be invoked in regard to money market funds and that possibility has given the FSOC greater leverage in pushing for changes to the rules governing money market funds even if the systemic activities designation is never used. This paper will generally not discuss the activities clause, but will focus instead on the regulation of entire institutions designated as SIFIs.

Once a non-bank financial institution has been designated as a SIFI, very real questions arise as to how best to regulate these institutions. The Fed becomes the regulator for SIFI purposes, alongside the existing primary regulator. However, the Fed has little previous experience of overseeing some of these types of institutions, particularly insurers. Therefore, it needs to figure out how to evaluate their safety and how to coordinate with existing supervisors. Doubtless, the Fed will end up falling somewhere on a spectrum between simple reliance on existing regulatory paradigms and procedures and developing an entirely separate approach that may rely excessively on its prior experience as a banking supervisor.

The Fed should not simply defer to existing regulators and view non-bank SIFIs as safe if they say so. It has a legal obligation to form its own conclusions. Further, viewing the institutions systemically may provide a different perspective, perhaps pointing to systemic risks that would not be given adequate attention by traditional industry regulators who are not responsible for the safety of the financial system across the country or concerned about linkages to the rest of the world. This could be particularly true in insurance, which is regulated at the state level and therefore has not historically had any body whose primary responsibility was to look at national systemic risks. The National Association of Insurance Commissioners (NAIC) acts as a coordinator for the state insurance commissioners and works to ensure high standards across the country. However, these standards are aimed at ensuring the safety of individual institutions with little emphasis on the linkages between these institutions that could lead to systemic problems.

On the other hand, there is a real risk that the Fed will give insufficient deference to the extensive experience and knowledge residing with the existing regulators, particularly in regard to insurance, which has so many differences from banking. Decision-makers at the Fed would be only human if they relied excessively on the tools with which they were already familiar and if they were more comfortable starting from scratch in designing regulation and supervisory tools, instead of relying on the experience of others.

There are multiple dangers in taking an idiosyncratic Fed perspective that pays too little attention to existing regulatory approaches:

The Fed may simply get a decision wrong, out of an insufficient level of understanding of the new industry. It is one thing to study an industry intensively, it is another to have lived with it for many years, as the primary regulators have.

The Fed could be “right” from the point of view of reducing systemic risk, but the economic cost of eliminating or reducing a particular source of risk may far exceed the benefit. Dodd-Frank did not call for the elimination of systemic risk, but rather appropriate control over it. As with so many areas of life, absolute elimination of risk would require forbidding a great deal of beneficial activity. The bureaucratic peril here is that the Fed’s mandate from Dodd-Frank may bias the organization towards elimination or sharp reduction of systemic risk, with insufficient regard to the economic costs that would show up in day-to-day operations.

New Fed regulations could effectively force “relitigation” of a myriad of issues that have already been decided by the primary regulators. Sometimes there are multiple legitimate ways to approach an issue and it may be better to stay with the existing decision than to go through the industry upheaval of adopting to a new approach that simply has a different set of pros and cons, but may not be substantially better.

Lack of sufficient coordination with existing regulators could result in contradictory requirements that hamper operations. The Fed and the primary regulators will presumably manage to avoid outright contradictions, although there is definitely the possibility of temporary stand-offs as the two sides feel their way to a working arrangement. Beyond that, though, there is the risk that the approach of the Fed and of the primary regulators will be incompatible in practice, even if this is not obvious on the surface of the written regulations. One side or the other may believe it is possible to meet their requirements without infringing the rules issued by the other, but it may not in fact be feasible.

Pointing out these dangers of inappropriate regulation is not intended to argue against the designation of non-bank SIFIs, which I do favor and which is clearly the intent of Dodd-Frank. There are legitimately differing views on whether insurers, for example, are ever systemically significant, but I am among those who believe that a few very large life insurance groups likely do merit this designation. The key message of this paper, however, is that non-banks are not just funny looking banks, but operate in truly different industries, providing different services, and facing a different balance of risks and opportunities than do banks. Therefore it is very important that Fed regulation of non-bank SIFIs is tailored to each distinct industry and is managed with appropriate humility about the Fed’s level of understanding and with appropriate deference to primary regulators, while meeting the Fed’s obligations to develop their own independent judgments. This is a difficult balancing act, but not fundamentally different than

the balancing acts that all regulators face between the risks of action and inaction. The bulk of this paper delves deeper into these issues in the context of life insurers.

The Fed is most definitely aware of the dangers and is intent on avoiding them. However, it is virtually certain that mistakes will be made in an area of this complexity where there are at least two sets of perspectives and experiences coming together, especially given the novel nature of the task of regulating systemic risk. One concerning point is that there is not a clear agreement yet on what systemic risk is and how it ought to be measured, adding still more uncertainty about how best to regulate it.

Systemic Risk

There is some disagreement about the best definition of systemic risk. A report by the International Monetary Fund and two global financial regulatory bodies defined systemic risk as:

“a risk of disruption to financial services that is (i) caused by an impairment of all or parts of the financial system and (ii) has the potential to have serious negative consequences for the real economy. Fundamental to the definition is the notion of negative externalities from a disruption or failure of a financial institution, market or instrument. All types of financial intermediaries, markets and infrastructure can potentially be systemically important to some degree.

Three key criteria that are helpful in identifying the systemic importance of markets and institutions are: *size* (the volume of financial services provided by the individual component of the financial system), *substitutability* (the extent to which other components of the system can provide the same services in the event of a failure) and *interconnectedness* (linkages with other components of the system).”⁴

Dodd-Frank defines systemic risk in terms of a situation in which “material financial distress at the [financial institution], or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the [financial institution], could pose a threat to the financial stability of the United States.”⁵

There is substantially more disagreement about how to *measure* the level of systemic risk in the aggregate. Breaking this down to the contribution from individual institutions is yet trickier still. As a further important complication, systemic risk arguably varies over time. An entity could be systemically significant under some circumstances and not others.

⁴ See the report to the G20 Finance Ministers and Governors by the IMF, BIS, and FSB, “Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations”, available at <http://www.bis.org/publ/othp07.pdf>

⁵ See Section 113 of the Dodd-Frank Act.

The FSOC's evaluation process to decide which institutions to designate as SIFIs relies heavily on subjective judgments of the relative importance and inter-relationships of the relevant qualitative and quantitative factors. This is not a criticism. Objective, quantitative criteria will require both a detailed analytical model of how the financial system works that is well beyond the current state of research and considerably more and better quality data than currently exists. Many academics and official researchers are working to create those prerequisites, but it will be years before they can hope to succeed, if they ever fully do.

There are multiple ways in which a financial institution can be systemically important – by its size, the degree to which it is “interconnected” with other parties, or conceivably by its reputation and thus influence on financial markets. The central concern is that a SIFI's failure would cause serious damage to the financial system, and thereby to the rest of the economy. The sources of that damage could be any one or more of the following, and perhaps others as well:

Counterparty and other credit risks. One of the most obvious concerns is that when a SIFI goes under it may impose substantial, if not crippling, losses on other financial institutions and parties who are owed money by the institution. This could cascade throughout the financial system with knock-on damage to the wider economy.

Contagion. Sometimes the principal damage from the collapse of a financial institution comes from serving as a “bad example” that causes the market to reassess which other organizations might wind up in the same difficulties.

Problems with deposit-taking activities. One of the key reasons that banks are regulated so highly in the first place is that consumers and businesses place deposits with them which they count upon to be readily available and riskless. There can be severe economic disruptions if depositors find their funds suddenly unavailable.

Maturity mismatches. Financial institutions often operate by “borrowing short and lending long”, since the interest rates on short-term borrowings are typically below the interest rates earned on longer-term loans and other assets. This strategy usually is exposed to the risk of a sudden liquidity freeze that makes it highly expensive or impossible to “roll over” short-term liabilities. Excessive maturity mismatches become a systemic problem if they are too widespread or concentrated at one or more SIFIs.

Market utility interruptions. Some institutions play a central role in the day-to-day functioning of financial markets, resulting in the potential for widespread damage if they fail.

Types of non-bank SIFIs

There are several major categories of non-banks that could be systemically important; the considerations that could lead to their designation are discussed briefly below. (A fuller review of the issues is available in the paper I wrote with Robert Litan, referenced in footnote 1, which focuses more on the issues surrounding designation of SIFIs.) The discussion excludes banks of all types and their close affiliates, which are effectively already designated as SIFI's under Dodd-Frank.

Finance companies. Until the recent crisis, there were a number of major lenders to consumers and small businesses that financed themselves by issuing short to intermediate term debt in the wholesale financial markets, in contrast to commercial banks that raise their funds primarily with insured deposits. When financial markets froze, this finance company business model proved to be too risky, except in special circumstances, since it exposed the firms to the danger that they would be unable to "roll over" their debts. Borrowing short-term and lending long-term only works if the ability to borrow short-term is not interrupted for any extended period. The recent crisis showed once again that such liquidity freezes occur too frequently to be assumed away.

Smaller finance companies may not pose a systemic risk if they fail, since in a crisis the markets may still be willing to fund their larger competitors. However, when large finance companies are threatened with failure, they may indeed pose systemic risks. Because of the risks of the finance company business model that were revealed in the recent crisis, a number of the solvent finance companies that have survived have converted to bank status in order to have access to insured deposits even in difficult economic conditions.

Securities firms. Investment banks and brokerages can clearly create risks to the financial system, as demonstrated by Bear Stearns, Lehman, Merrill Lynch, and others in the recent financial crisis. However, the most important of these firms are affiliated with commercial banks and are therefore already considered SIFIs for that reason. It appears unlikely that any of the stand-alone securities firms based in the US will be designated as SIFIs, but one or more could expand over time to the point where they might be designated in the future. It is also possible that a large US subsidiary of a foreign securities firm could be designated as a SIFI.

Life insurers. Some life insurance entities are so large that their sheer size makes them obvious candidates for designation since other financial institutions will have major credit exposures to them. On the other hand, the types of activities they undertake tend not to be as risky for the system, especially since they are generally funded by quite long-term liabilities, such as life insurance policies and annuities that have substantial fees for early surrender. In general, the systemic risk created by a life insurer is likely to be considerably less per dollar of asset size than would be true for a bank, taking into account probabilities rather than just worst cases. However, each case must be examined on its own merits and regulators must watch out for the development of activities at one or more life insurance groups that might spawn greater systemic risk in the future. Life reinsurers, which provide wholesale insurance protection to life

insurers, have greater risk per dollar of assets because they are interconnected with many other insurers and reinsurers. However, none of the US-based life reinsurers are of sufficient scale to be likely to be designated as SIFIs.

Property/casualty insurers. Insurers providing protection against accidents and lawsuits are important financial institutions and sometimes very large. However, the nature of traditional property/casualty insurance creates little risk for the financial system as a whole. The investments of these firms tend to be very conservative and liquid, since they could be needed quickly in the event of a natural catastrophe. As a result, the big risks to these insurers are on the claims side, which has little correlation with financial crises. (Financial crises do not spawn natural disasters and even extremely large hurricanes and earthquakes are too small to trigger a financial crisis.) There is no indication that any property/casualty insurers will be designated as a SIFI, with the exception of AIG. That firm will be designated for political and historical reasons more than anything else, although the stated rationale will doubtless refer to its life insurance business and activities outside of traditional insurance.

Hedge funds. These funds cover a very wide range of activities, most of which would not warrant SIFI designation. If any do, it would almost certainly be because they operated with quite significant amounts of financial leverage and were of considerable size (as was LTCM in the late 1990s before the Fed helped arrange a private sector reorganization). The combination of size and leverage could generate sufficiently large credit exposures for other SIFIs to merit inclusion of these funds or they might exacerbate other potential sources of risk, including contagion.

Other fund models. Two other important fund business models are venture capital (VC) and private equity (PE) funds. Neither would appear to create any significant systemic risk when they are run in a traditional manner. However, the legal structure could be used to operate more like a highly leveraged hedge fund, in which case there is at least the theoretical possibility of being a SIFI. In practice, it is unlikely that the FSOC will designate any of these funds as SIFIs for some years, if ever.

Mutual funds. These fund groups are an interesting case, since some of them are of very large size, yet they are essentially pass-through entities and seldom use very much in the way of leverage. The small amount of leverage employed means correspondingly less credit exposure to lenders. There may be significant credit exposures for trading counterparties, but the lack of leverage makes it hard for the funds to go broke and therefore fail to be able to meet their obligations. Given their importance in the financial system as a whole, regulators may wish to know what these funds are up to and thus possibly demand additional information beyond what they are required to submit now, but because of their pass-through nature they are likely to be small contributors to systemic risk. Here, too, it is unlikely that the FSOC will designate any mutual funds or their management companies as SIFIs anytime soon.

Money-market mutual funds. Consumers often use money market funds almost as if they were bank accounts, including writing checks against them in order to make day-to-day transactions or to easily withdraw cash from them. These funds are also large purchasers of commercial paper (CP) issued by both financial and non-financial corporations. In the midst of the recent financial crisis when the main alternative to CP financing -- bank loans -- was often unavailable, the continued viability of these funds was (and remains) especially important.

It was for both these reasons that the federal government felt compelled to guarantee money market funds in the recent crisis. The government feared that a potential major run on many, if not all, money market funds constituted a substantial risk to the financial system.

A number of changes have already been made to the regulation and operation of money market mutual funds in order to reduce their systemic risk, including a shortening of the maximum maturities of their investments and the creation of expanded disclosure. However, it remains an open issue as to whether one or more money market funds will be designated eventually as SIFIs.

Other institutional investors. There are numerous other categories of institutional investors whose members could theoretically be designated as SIFIs, but where this is unlikely to occur in practice. These include pension funds, endowments, and sovereign wealth funds, among others. In general, these share the characteristics of very low leverage, long-term funding, and the absence of a primary role as a financial intermediary. As a result, even the largest of these organizations is unlikely to represent sufficient system risk to be designated as a SIFI.

Financial market utilities. There are many entities that operate behind the scenes to implement financial transactions, such as stock and commodities exchanges, clearing houses for derivatives transactions, etc. Some of these, such as the largest clearing houses, will definitely present enough systemic risk to qualify as SIFIs, in part because of their combination of sheer size and their volume of counterparty credit risk, as well as their overall centrality to important markets. In fact, the FSOC has already designated eight financial market utilities as systemically important and may designate more.

Regulating SIFIs

Once SIFIs have been identified, it is almost certain that they will then be regulated differently from other financial institutions. An important underlying decision is whether the Fed's regulation should focus solely on sources of systemic risk, holistically on the entirety of safety and soundness issues, or somewhere in between. Dodd-Frank does not clearly answer this question. On the one hand, federal regulation is imposed on non-bank SIFI's precisely because of systemic risk issues, suggesting that such issues should be at the core of the Fed's supervision. On the other hand, Dodd-Frank calls for heightened prudential standards for SIFI's of all kinds,

presumably on the theory that the failure of a SIFI, no matter what the cause, would have systemic repercussions.

Blending these two viewpoints, the Fed is almost certain to look at a wide range of prudential concerns, but perhaps with a sharper focus and tougher rules for those aspects that appear to increase systemic risks. For example, the Fed would be particularly inclined to be concerned about maturity mismatch and liquidity issues because they are significant safety and soundness issues in their own right while also bearing the potential to make the system as a whole riskier by triggering the equivalent of a “run on the bank”, with all the potential for contagion that would bring. On the other hand, operational issues that carry idiosyncratic risk may be given a lower priority and left largely to the primary regulators. For example, internal accounting weaknesses could help to sink a single entity, but might not have any larger systemic significance. Similarly, issues that are likely to arise at a time of wider financial crisis may garner more attention than items that are random or more likely to surface during good times, when any potential systemic problems would be easier to handle.

What can the Fed do as a supervisor? There are at least five ways additional regulation of SIFIs could occur:

Regulating at least certain non-bank SIFIs in a manner consistent with banks. One of the hardest questions in financial regulation is where to place the “perimeter of regulation.” In this case, the key question is which entities should face the heavy regulation that banks and their close affiliates do. (Banks also benefit from special privileges, such as access to deposit insurance and the Fed’s discount window, but regulation of other SIFIs may not bring such advantages in the current environment.) One of the concerns expressed in the Dodd-Frank debates was how to prevent some institutions from acting very similarly to banks, but retaining the advantage of lighter regulation. Dodd-Frank provides quite considerable powers that could be used to add many bank-like regulations (such as activity restrictions) for certain non-bank SIFIs.

If such a broad scope of regulation is applied, it is likely only to be for institutions regulators view as acting like banks. Finance companies could be caught in this net and it is theoretically possible that a large hedge fund that went after banking type business could also be brought in. This is unlikely to be an issue for most categories of non-bank SIFIs, such as insurance groups that do not already own deposit-taking institutions. That said, Dodd-Frank does provide that certain restrictions should apply to all SIFIs even though the specifics appear to have been designed primarily with banks in mind.

Information reporting. SIFIs will doubtless be mandated to provide a great deal of information, with particular emphasis on aggregate credit and counterparty exposures to other SIFIs and near-SIFIs. Other information requirements will likely include exposures to particular asset classes, capital levels, and the results of stress tests. It is also likely that many *non-SIFIs* will be

subject to some additional reporting obligations as well, both to determine whether they qualify at some point as SIFIs themselves and also for the FSOC and its new agency in the Treasury, the Office of Financial Research, to better monitor overall system-wide financial risks.

Counterparty exposure limits. Dodd-Frank requires that banking groups limit their total exposure to individual counterparties. Non-bank SIFIs could be faced with similar requirements.

Activity limits. Banking groups are also limited by the “Volcker Rule” included within Dodd-Frank, which requires them to limit or eliminate certain types of proprietary trading and investment activity. Similarly, provisions pushed by Senator Lincoln created restrictions on the ability of banking entities to act as derivatives dealers. Non-bank SIFIs might be placed under similar restrictions on activities that are perceived as being particularly risky and not at the core their business models, or at least the business models policymakers view as being in the public interest.

Capital requirements. One of the most important ways that regulators can encourage safety at financial institutions is to require appropriate levels of capital as a margin for error against losses that might come through bad luck or errors. Banking groups already face substantial capital requirements that are being tightened significantly through the so-called Basel III process, coordinated by the Basel Committee on Banking Supervision. Insurers also have substantial capital requirements imposed by their regulators for similar reasons. Dodd-Frank specifically calls for SIFIs to face higher capital requirements than non-SIFIs, with the details to be determined by the regulators.

Capital requirements are such a universal, and important, element of the regulatory approach to banks that there is a strong likelihood that non-bank SIFIs will be subjected to similar requirements. This is most likely for SIFIs that perform a classic intermediation function and have large balance sheets, such as finance companies, which play a role fairly similar to banks. Some sort of capital regulation might also be extended to hedge funds, although these funds may be able to argue that their differences from banks justify an exemption from any capital regulation. Other asset managers, such as mutual funds or venture capital management companies, are the least likely to have this requirement, because their business models create little need for capital. As discussed below, capital requirements already exist for insurers and may be expanded or altered by the Fed in its role as a regulator of SIFIs.

Capital regulation is an extremely powerful tool to affect the behavior of financial institutions, since it very directly alters their ability to provide an adequate return to their shareholders. This is even more powerful since top managers in financial institutions almost invariably hold a considerable amount of their net worth in company stock. If this powerful tool is applied too widely, such as to funds managers that act as pass-through entities and not true intermediaries, it could substantially change the ability of otherwise valid business models to work. Ironically,

adding an unreasonable burden to, say, mutual funds could push financial assets into the hands of financial intermediaries instead that present greater systemic risks.

Liquidity requirements. The recent financial crisis underlined the importance of liquidity, the ability to come up with cash, potentially on short notice, to cover deposit withdrawals, debt redemptions, and other needs. Banks will have quite extensive liquidity requirements going forward and the Fed will certainly consider appropriate liquidity requirements for other SIFIs.

Principles for regulating non-bank SIFIs

Some key principles should guide the Fed's regulation of non-bank SIFIs.

Carefully balance the costs and benefits when designing regulation and supervision. This is important for all regulators and is so basic that it probably needs little further elaboration. However, it will be critical not to lose sight of this key principle. It will always be tempting for the Fed to add yet further constraints and safety margins on non-bank SIFIs, in its pursuit of systemic stability, particularly as the Fed will take the blame if a serious future crisis develops. However, safety margins come with costs and it would be harmful to the economy if those costs were excessive compared to what may be only a modest increase in stability from a given regulation. For example, equity capital is significantly more expensive, in practice if not always in theory, than other sources of funding. Requiring more capital therefore adds a cost that will have to be absorbed by some combination of customers, employees, stockholders, and others who deal with the firm⁶. Deciding what regulations to impose and choosing which firms they are imposed upon must be a balancing act between the improvements in safety and the economic costs of achieving the improvements.

Defer to primary regulators as appropriate while maintaining the ability to perform the Fed's mission. The Fed will have to balance a second set of considerations, which is how to coordinate with primary regulators, such as the state insurance commissioners and the National Association of Insurance Commissioners, their coordinating body. The Fed should take advantage of the decades of experience and the specific expertise of the primary regulators. It should also avoid conflicts in regulations with those promulgated by the primary regulators, except where the Fed believes that an important principle is at stake. This should leave room for compromise on the many judgment calls that will exist on precisely how best to deal with a particular type of risk. At the same time, the Fed has a different mission from the primary regulators and cannot, and certainly will not, simply assume the primary regulators will take care of the job for them.

⁶ See, for example, the study by the Macroeconomic Assessment Group set up by the Basel Committee on Banking Supervision and the Financial Stability Board, "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements (Final report)", December 2010, <http://bis.org/publ/othp12.pdf>. This report references a large number of other studies on the effect of capital requirements on credit provision and on the real economy.

Do not impose excessively bank-like regulatory approaches. Many of the non-banks, particularly insurers, have quite different business models, and even purposes, from banks. It will be critical to take account of these when designing regulation and supervision. This is discussed in considerably more detail below in regard to the life insurance industry.

Avoid the dangers of a business “monoculture.” SIFIs are likely to be regulated in a common manner on many important dimensions. If this is carried too far, as it easily might be, institutions with quite different business models may be regulated in the same way⁷. For example, if capital regulations are applied to institutions for which capital levels are actually relatively immaterial, it may force them to hold considerably more capital and to make business decisions based on the effects on their actual capital relative to what is required. In essence, this kind of decision-making could force any non-bank SIFIs to act more like banks, even when their business models would not otherwise push them in that direction. This reduction in diversity could expose the system to greater risk from factors common to the regulatory approach. A useful analogy is the danger of a “monoculture” in crops. If the entire Midwest is planted with wheat, for example, then the dangers of contagion from a virus that attacks wheat become more severe than if multiple crops were grown. The same kind of risk may be created when otherwise different kinds of institutions are effectively forced to behave in a similar manner.

Support useful innovation. If SIFIs were to be regulated in an excessively uniform way, then it may become more difficult for organizations to develop innovative new approaches to business. In particular, if SIFI regulation and supervision entails any sort of *ex ante* or *ex post* approval of innovative products or ways of doing business, this prospect could be enough to keep the innovation from being introduced. At the same time, the greater regulatory costs of SIFI designation may also spur some organizations to use “financial engineering” to create new securities or transaction types that appear to pass risk on, without in fact fully doing so. Again, the SIV structures that were created during the boom period and contributed to the recent financial crisis are an example of this type of structure.

Try to minimize the inevitable uncertainty about future regulation and supervision. The cost of regulation does not come just from the actual regulatory choices of policymakers. The sweeping powers of the FSOC and Fed over SIFIs create considerable uncertainty for shareholders, creditors, and counterparties, which is likely to be priced into any transactions. Equity investors would demand higher expected returns to compensate for the greater risk and opacity of the business. Debt holders would similarly increase their demanded interest rates and some would switch to investing in other industries. Lenders and insurers may feel compelled to charge customers more to compensate for the greater uncertainty about the rules under which they

⁷ Regulators are aware that there are significant differences between different types of institutions and will attempt to take this into account appropriately. However, there will also be bureaucratic and political pressures to use common approaches, even when these are not entirely sensible, in addition to a natural human tendency to use tools with which one is already comfortable.

will be operating. There is a limit to how much the Fed can do to alleviate these concerns as it is itself determining how best to operate in this new area, but transparency, clarity, and an appropriate level of deference to existing regulators should help.

Regulating Life Insurers as SIFIs

One of the trickier tasks for the Fed will be to determine how best to regulate groups that are centered around life insurers. Life insurers have a considerably different business model than the banking industry with which the Fed is familiar, yet they also have some important similarities as financial intermediaries. Some of the key points to consider are as follows:

The core task of an insurer is to take risk. The central economic role of an insurer is to pool risk. An isolated family can be devastated financially by the premature death of a breadwinner, but a thousand or a million families pooling their risks together can easily bear that random risk by spreading the cost of premature deaths over the entire group. Paying a thousand dollars a year for life insurance may be feasible for a family who could not have afforded to bear the full cost of a death on their own. For this reason, life insurers have often been founded as mutual aid organizations that eventually converted to a legal status as “mutual” insurers, owned by their policyholders. In many cases, these mutual eventually converted to stock form in order to gain the full benefits of market access. Pooling of risks has costs that raise the average expense level of dealing with the accidents and tragedies that befall us, but virtually all people and firms would rather pay a bit more on average to avoid the chance of financial catastrophe.

Banks also exist to take risks, particularly the risk that a loan will not be repaid, but their central historical economic role has been to channel funds from depositors to borrowers with worthy projects while providing liquidity to depositors and even borrowers. Risk is inherent in those roles, but it does not have the same centrality as risk-taking does for traditional insurance.

However, life insurers are also financial intermediaries, like banks. Much of what life insurers do is to provide attractive investments to their clients, generally with tax advantages. Even traditional whole life policies do this. A life policy that charges the same premium every year of one’s life effectively overcharges in the early years for the mortality risk, allowing a build-up of value that pays for undercharging in the later years. This build-up of value beyond what is needed for the mortality charges and other expenses accumulates as a cash value that can be withdrawn, or borrowed against at a fairly attractive interest rate. Economically, this is equivalent to buying a term life policy and investing the difference between this policy’s

premiums and what a whole life policy would charge in order to build up cash value, which can be used to pay the rising premiums as one ages⁸.

Beyond that, life insurers sell large amounts of annuity products that are generally used as tax-advantaged investment vehicles. The simplest form of an annuity is an immediate annuity, which pays out a fixed amount each year for as long as the annuitant lives. This provides valuable insurance against living too long and running out of money. Most annuities, though, are deferred annuities. For these one pays in advance, with the annuity payments starting some years in the future, such as at one's expected retirement age. The initial investment builds up a cash value that can, and usually is, withdrawn prior to annuitization. Clients often buy these with the expectation of cashing them in, taking advantage of the tax deferral of income in the meantime. On these products, the insurer does take a risk that the contractually promised annuitization terms will prove too generous in the long run, but by far the larger portion of the insurer's risk is from financial intermediation, the danger that it will not invest the funds in a manner that provides a high enough return to cover the increases in cash value plus its expenses.

Life insurers are usually also asset managers. Some life insurers manage client money without taking on investment risk, such as by running a family of mutual funds, just as banks manage trust accounts and often have their own mutual fund offerings. In addition, all of the life insurers that are likely to be SIFIs also do a large volume of business in "variable annuities" and "variable life insurance" products. In purest form, these are identical to traditional annuities and life insurance policies, except that the investment risk resides with the policyholder. (This is accomplished in part by keeping each policy in a "separate account" from a legal point of view.) Instead of building in a fixed rate of increase in cash values, there is a formula based on the performance of an agreed financial instrument or basket of investments. For example, a client who wants to own an insurance product, but desires the potentially higher returns of the stock market, would buy a variable product with a cash value that increases based on a stock market index or on the performance of what is effectively a dedicated mutual fund attached to the variable product.

In many ways, the safety and soundness risks of variable products are low, since investment risk vanishes for the insurer in the purest form of the product. The prudential risk is not zero, since the stream of future fees will generally depend on the underlying cash values and particularly bad performance of a variable fund could lead to lawsuits or certainly to redemption of the insurance products by withdrawing clients. However, the risk in the pure form is quite low.

The risk is somewhat increased by the practice of providing certain guarantees of the investment performance. For example, some deferred annuities carry a guarantee that if the

⁸ It would be necessary to have a guaranteed schedule of premium payments to create a true equivalence and there are other differences, such as in tax treatment.

owner dies before the start of the annuitization, their heirs will receive the original investment amount even if market performance has caused the cash value to be below that level. Other guarantees, potentially more costly, are sometimes provided.

The provision of guarantees complicates some regulatory decisions. In particular, there is the question as to whether to include the assets from variable products in simple ratios, such as the “leverage” ratio. This is a straightforward calculation in which the total capital of a financial firm (the value of its assets beyond those required to pay its obligations) is divided by the total amount of its assets. Although simple, this is a much-used and valuable indicator of the margin of error a financial firm has to cover any mistakes or accidents. Further, this ratio is enshrined in many regulatory requirements, often with mandatory effects. Given the high volumes of assets life insurers have in variable products, their inclusion can have a major impact on the ratios.

The obvious, and probably correct, answer is to count only a portion of separate account assets in these calculations, perhaps only a small fraction. However, adjusting asset values for the amount of risk they entail risks reducing the benefit of using a straight leverage ratio. Banking regulators already use a separate, and much more complex, set of measurements to determine a risk-weighted capital ratio. One of the main arguments for using a straight leverage ratio is to complement the risk-weighted one by providing a test that is much harder to “game” since there is minimal discretion in calculating the figures.

Life insurers take on much longer maturity obligations than banks do. Traditional life insurance is mostly issued with guaranteed terms for long periods, often up to the full lifetime of the insured party. There are some term life insurance policies without guaranteed renewability, but they represent a small fraction of a typical life insurer’s total assets and liabilities. In contrast, a typical bank loan is for a few years at a time. Even mortgages tend to roll over roughly every seven years on average, due to refinancings or home sales.

The long-term nature of the liabilities gives life insurers more time to respond to problems. Banks can fail very quickly if markets lose confidence in them. Life insurers are much more resilient in the short run, since much of their funding is from liabilities that are long term, giving them time to restore confidence or to find alternative funding. This is a critical difference, but not an absolute one. Sometimes banks fail because they have been slowly deteriorating over a long period and eventually a crisis arises which highlights their vulnerability; something similar could conceivably happen with life insurers. For their part, life insurers do have many obligations that can be redeemed over a shorter period, although there is often a significant penalty charged to customers for doing so, which reduces the net damage to the insurer. A bad enough scare could certainly create the equivalent of a bank run, since many customers would be willing to sacrifice 5-10% of their policy’s value in order to be sure of keeping the remainder. That said, there are at least two factors besides the penalties that might discourage a “run”. First, there is a system of statewide guaranty funds for insurance benefits, analogous to federal deposit insurance. This may reduce the propensity of policy owners to flee, although concerns

about the ability of the guaranty funds to cover an insolvency of the size that a SIFI might bring would raise questions about this safety benefit. Second, some policy owners may no longer be able to replace the death benefits provided by their existing policy at a reasonable price, because they have aged, exited a job that provided group benefits, or have suffered from deteriorating health. If those death benefits were a significant factor in the decision to buy and hold that particular policy, then there would be a substantial disincentive to flee.

Long-term liabilities also mean life insurers need long-term assets. Life insurers make commitments that run for many years, meaning that they also need to own assets with long durations, otherwise they run re-pricing risk. That is, if they commit to provide a return of 5% for the next 30 years and invest the funds initially in an investment returning 7% for 5 years, they may find at the end of 5 years they can only earn 3% going forward, turning their 2 point positive spread into a 2 point negative one. Thus, the danger for life insurers is often that their investments are of shorter maturity than their liabilities, because financial markets are substantially shallower in the long end. This is the opposite problem from that of banks, which usually make loans and investments of 3 years or longer, but fund them quite substantially with liabilities that are well shorter than that, including deposits that can be cashed in on any given day without penalty.

The long maturity of insurance liabilities has important policy implications. Bank regulators worry a great deal about banks “borrowing short and lending long,” so they have devised rules to push banks towards shorter-term assets and longer-term liabilities. Using that same approach with life insurers could expose them to dangerously high levels of re-pricing risk. It would also lower their average returns, since longer-term investments tend to pay more, so insurers would have to raise their prices to make up for reduced investment income. The economy as a whole could also suffer in another way, since life insurers are one of the larger providers of long-term investment funds. This would be unfortunate, since many commentators have pointed out the need to increase the supply of such funds, especially with regard to the massive investments in U.S. infrastructure that are needed in the years ahead. (Life insurers are already significant funders of infrastructure projects in the US through their holdings of municipal bonds and sometimes through other investment vehicles.)

There are several factors that could have the insidious effect of pushing the Fed towards encouraging a perverse interest rate mismatch at life insurers. First, using market valuations for longer-term investments can substantially increase their volatility over shorter time horizons. Current GAAP accounting rules often use mark-to-market values and some market participants take the same approach whether or not the figures appear in the accounting statements. This provides incentives for the Fed to take the same approach. (State regulators decided years ago to avoid that level of volatility by not marking bonds to market and they have stayed with that decision.) Volatility in the results reported to markets or regulators, especially if they trigger regulatory pressures, could push managements to optimize their short-term situation at the expense of the long-term. In particular, it could push them to shun investments in long-term

assets even though this provides both a better match with the maturity of their liabilities and higher rates of return.

Second, and related, the Fed may be concerned that such variations in market value may lead insurers to participate in “fire sales” to get out of market segments that are being hit badly in a market panic, exacerbating wider systemic problems. Third, as good bureaucrats, they may simply not want to have to answer questions as to why they allow insurers to hold such long assets, especially questions that would arise in the midst of a market crisis. It may be easier for them to apply an investment model closer to that of banks.

Life insurer failures, which are fairly uncommon, can be triggered by misjudging their obligations, not just their investments. Life insurers can fail because they have mispriced their promises through careless underwriting or faulty assumptions about death rates or health or accident risks. They can also experience a run of bad luck among their clients. These problems are more likely to occur in their related business lines that involve health risk, such as health insurance or long-term care insurance, than in traditional life products. However, it can certainly happen even in traditional long-term life insurance policies. They can also fail because of bad investments, just as banks can do. Many times, it is a combination that does an insurer in, when investment returns fail to keep up over the long term with insurance payouts that rise more steeply than expected.

For their part, virtually all bank failures revolve around asset problems – bad loans or bad investments – since their obligations are generally known with certainty. Some might dispute this characterization, arguing that bank runs result from deposits and other liabilities turning out to be much shorter-term in practice than expected. This is certainly true, but it is fairly rare for a bank run to occur unless it is triggered by losses on assets, especially since the advent of modern deposit guarantee systems.

Thus, there is a significant difference in the sources of failure for life insurers compared to banks.

Maintaining appropriate liability reserves is critical for life insurers. A consequence of the importance of the variations in the cost of future obligations is that regulators need to pay careful attention to the techniques used by insurers to set their reserve levels. These are the amounts set aside on an insurer’s books to reflect payments that must be made in the future for insurance claims of various kinds. If too little is set aside, then an insurer is operating with a much lower margin for error than will be shown on its books, since its true capital will be overstated. If too much is systematically set aside, then insurers will overcharge for their services in order to cover these inflated expectations of future payments. State insurance commissioners in the US pay considerable attention to reserves for future claims and have detailed rules about their calculation, given their importance.

Capital Requirements

For their long-term survival, all businesses need to have a positive net worth, that is, assets worth more than their liabilities. This is critically important for financial institutions and other confidence-sensitive businesses, since they must not only be able to survive, but it must be clear that they can do so. In the financial industry, net worth is referred to as “capital” and the concept can become a lot more complicated. For example, for some purposes the only portion of the financial institution’s balance sheet that may be considered as capital is the accounting value of its common stock, which means that preferred stock and some other non-liability items are treated as if they were liabilities for this measurement. For other purposes, some liability items may be treated as if they were common stock. There are good reasons for these different measurements, depending on the particular purpose of the calculation, but the details are unimportant for this paper. (Please see my primer on bank capital for a fuller description of capital at financial institutions

http://www.brookings.edu/~media/Research/Files/Papers/2010/1/29%20capital%20elliott/0129_capital_primer_elliott.PDF)

Bank capital requirements

Before considering the capital requirements that will be placed on life insurers, it is useful to consider the approach taken to banks. The Fed will be strongly influenced in its thinking about life insurance capital requirements by its experience with these bank capital rules. This is both because it *is* the Fed’s experience with capital requirements, and therefore permeates their thinking on the topic, and because the asset-related risks of life insurers have considerable similarity to the risks for banks. (Realized losses on securities or loans are the same whether held by a bank or by an insurer, although the ability to bear “paper losses” does vary due to differing funding structures.) As discussed in detail below, there are also many differences in how capital requirements should be considered for the two different types of financial institutions.

Formal capital requirements have been imposed on banks for decades, both here in the US and in most of the world, including all of the advanced economies. They are considered important enough that there are global agreements intended to ensure that all major economies meet at least certain standards for the capital of their internationally active banks. Generally the same or very similar rules are used in these countries for their more purely domestic banks as well. The rules are promulgated by the Basel Committee on Banking Supervision (Basel Committee), which reaches them based on a consensus among its members, consisting of the central banks or banking supervisory authorities of all of the most important banking centers and many other nations as well. The original Basel Accord was agreed in 1988 and very substantially revised and altered in 2004 with the resulting version known as Basel II. The global financial crisis has spurred another round of revisions that will sharply increase the total amount and quality of the capital banks are required to hold. The upcoming version is known as Basel III. (There were also

important interim changes that have already taken effect known, perhaps predictably, as Basel 2.5.)

The heart of the Basel approach is a calculation of the ratio of capital to risk-weighted assets. This was incorporated in the first accord and has been considerably expanded with each revision. The idea is that the amount of capital required should be based not just on the size of the bank in terms of assets, but on the total level of risk created by those assets. (Note that liability risk was almost completely absent from Basel I and II. Liquidity issues are being given prominence in Basel III, which goes beyond the capital required to look at maturity mismatches between assets and liabilities. However, there was seen to be no need to reflect the possibility that liabilities might vary in value, since this just is not a serious issue with banks, as opposed to insurers.)

Each asset type is multiplied by a risk weighting, which can range from zero to 1250% depending on its risk compared with a standard loan that receives a risk weighting of 100%. Government bonds of major countries are considered to have no risk and therefore have a zero risk weighting, although there has been serious pushback on this score by outside analysts, spurred in part by the sovereign debt crisis in Europe. Most mortgages have a 50% risk weighting. Very risky tranches of securitized products have risk weightings well north of 100%. There are a large number of other categories with their own explicit risk-weightings.

The total level of risk-weighted assets at a bank is calculated by multiplying the amount of each asset type held by the appropriate weighting and then adding them up. The average risk weighting for banks in the US is about 80%, while it is about half that in Europe and Asia, for a variety of reasons, including varying accounting rules which exaggerate the difference with the US.

The Basel II accord introduced an innovation that has been retained, the use of internal risk modeling by the more sophisticated banks. The core concept is that major banks have a strong economic interest in evaluating the riskiness of their loans and therefore have developed very detailed models, influenced by the latest thinking among financial economists. It was considered desirable to bring this more advanced thinking into the calculation of risk weightings, in part to encourage all banks to move to better risk models and for the major banks to expand and improve their use of such modeling. Therefore, banks can use their own calculations to determine the risk weightings for certain types of assets, subject to supervisory approval of their models.

Some observers expressed concern at the time about the fact that banks would have an economic incentive to bias their estimates of risk to the low side once the results of these internal models took on regulatory implications. These concerns have intensified in light of the under-estimation of risk in the run-up to the financial crisis, but have been handled in the Basel

process by stricter rules about how models should be constructed, rather than by abolishing their use in the capital calculations.

Insurance capital requirements

For their part, US insurers have for many years been subject to their own risk-based capital (RBC) requirements, promulgated by the National Association of Insurance Commissioners and incorporated into law and/or regulation in each state. There are significant similarities to the Basel approach for banks, but the rules are both more and less complex for insurers and reflect the different characteristics of that industry.

The biggest difference with the banking rules is that NAIC RBC requirements take account of risk not just on the asset side, but also in regard to insurance risk (the liability side of the balance sheet), interest rate risk, and other business risks, including litigation. Risk weights are assigned for the different categories of assets, liabilities, and insurance products to reflect their varying risk levels. There are also downward adjustments to account for the interactions between the various sources of risk, recognizing that not all of these areas will necessarily go wrong at the same time and, if they do, they may not all go to their extreme states.

An underlying issue that will have to be resolved is what accounting system the Fed will use in regard to insurers. All insurers that have publicly traded securities report their results using Generally Accepted Accounting Principles (GAAP) as promulgated by the Financial Accounting Standards Board under delegated powers from the Securities and Exchange Commission. However, all US insurers also report to their regulators using a different set of accounting principles known as Statutory Accounting Principles (SAP). The two sets of accounting standards are identical in many aspects, but differ in a few key areas. A crucial difference is that, under SAP, fixed income securities such as bonds are shown at their amortized principal amount (essentially their face value with some appropriate adjustments) and not their market values, as under GAAP. Fixed income securities are a large part of the holdings of insurers and the two valuation methodologies can produce quite different results. In particular, market volatility affects the GAAP valuation of these fixed income assets while it has very little effect on the SAP valuation.

Another crucial difference is that GAAP operates under a “going concern” approach, whereas SAP uses a liquidation approach. Thus, items that would have little value in a liquidation are treated as worth only that much, whereas GAAP rules allow them to be held at the value that will be realized over time. A trivial, but illustrative, example is office furniture. SAP treats it as worth almost nothing since a liquidation would have a fire sale effect. GAAP treats it as worth what was paid for it, minus any depreciation, since it is presumed that its use in the business will justify over time the original purchase price. There are considerably larger items, such as spreading the benefit of up-front sales commissions over the life of the products sold, that make a real difference. SAP is virtually always more conservative in this manner.

There is a good argument for using the SAP approach for regulatory purposes. However, US banking regulators were badly burnt by using Regulatory Accounting Principles (RAP) for banks and savings and loans a couple of decades ago. By allowing non-GAAP rules, they opened themselves up to pressure to soften accounting rules when the savings and loans ran into problems. They switched after the S&L crisis to using GAAP and became allergic to the idea of allowing different accounting for regulatory purposes. It will be interesting to see if the Fed chooses to use different accounting than the insurance regulators do.

Choosing a Fed capital methodology for life insurers

The Fed will clearly focus on capital levels as a major part of its prudential oversight of life insurers. There are multiple methodological choices it could make, broadly including:

Acceptance of the NAIC capital calculations. The Fed could choose to defer to the state insurance commissioners on the capital calculations, in recognition of their role as primary regulators and their far longer experience in analyzing and regulating the industry.

Use of bank capital calculations for insurers. At the other extreme, the Fed could simply try to fit insurers into the bank formulas. This seems unlikely, at least taken to this level, since insurers are so obviously different than banks. It would also expose the Fed to accusations that it was ignoring major areas of risk at the insurers, relating to their liabilities and their pricing of their obligations.

Modification of the NAIC capital calculations. The Fed could accept the basic NAIC approach, but choose to modify parts with which it felt uncomfortable.

Creation of a hybrid NAIC/Basel approach. It is possible that the Fed would choose to use the Basel approach for calculations of risk-weightings for assets and combine that with the NAIC approach for the other categories, perhaps with some modification. This would allow them to argue that they are remaining consistent with the rules for banks, where applicable, while capturing the main elements of difference between life insurers and banks.

Whatever choice the Fed makes, with the exception of simply accepting the NAIC measurements, the devil will be in the details. Insurers are quite different from banks, so even using categories that seem identical between the two industries may be harder than it would first appear. Obviously, this difficulty would be exacerbated the closer the calculations are to those used for banks. A modified version of the NAIC rules would doubtless still require some complex choices, but would be considerably easier to apply to insurers than would be a totally new methodology for them.

What might the Fed do beyond capital standards?

One area of regulation analogous to capital requirements would be liquidity requirements. The Basel III rules, which will be implemented in the US, include quite detailed calculations to ensure that banks have the ability to generate the necessary cash to meet all of their obligations even in a period in which markets freeze up and liquidity vanishes. It is certainly possible that the Fed will apply similar tests to life insurers and other non-bank SIFIs. It is unclear at this point not only what the Fed might do, but how much effect such standards would have. For example, it is possible that life insurers would easily pass the Basel III liquidity tests, since such a high proportion of their liabilities have maturities over one year. However, there is the vexed issue that a large portion of these obligations could be brought forward if the holders were scared enough to pay the full contract penalties. The Fed might choose to make very conservative assumptions about the behavior of these liabilities in a severe crisis that hit the life insurance industry, even though there were relatively few such problems at the life insurers in the recent crisis. They might postulate a future crisis in which life insurers were more central to the problems and therefore suffered higher attrition of their policies. In practice, this would result in a requirement for life insurers to hold large levels of short-term, highly creditworthy liquid assets such as Treasury bills or deposits with solid banks and make it harder for life insurers to hold the long-term assets they need to match their long-term liabilities.

Beyond this, Dodd-Frank gives federal regulators a wide range of powers over SIFIs, including the ability to require the divestiture or cessation of activities that they believe create excessive levels of systemic risk. It would be surprising, however, if the Fed took such an action anytime soon. There is a fairly high hurdle for doing this and the Fed would be under even greater scrutiny in regard to life insurers, since it is not the primary regulator and is known not to have lengthy experience in analyzing them.

That said, the ability to impose tougher capital requirements than those of the primary regulators gives the Fed strong leverage to push for the cessation or modification of activities that it does not like. If, for example, it were to conclude that insurers were taking on too much risk with the guarantees they provide on variable products, it would be easy to discourage this through the risk-weighting procedures. For example, it might decide that any products with the type of guarantees it disliked would be treated for capital purposes as if they were not in separate accounts, with consequent higher capital charges and with inclusion in a straight leverage ratio calculation. There will also be any number of discretionary areas of supervision where the Fed could be more or less sympathetic to management requests depending on how comfortable it was that the company was operating in a sensible manner. It simply does not pay to annoy powerful regulators if one can help it, so there would be a natural tendency to listen to the Fed, even in circumstances where it may seem to be overstepping. Listening may not translate to acting, though, if the economic cost is too high.

One indicator of the Fed's intentions in regard to detailed supervision will be the size of the staff it assigns to the life insurer SIFIs and whether, and to what extent, it places them on-site at the

insurers. Obviously, it will need fewer staff members the more that it relies upon the primary regulators.

Conclusions

In the wake of the recent financial crisis, there is now much more attention paid by policymakers to the question of the overall level of risk in the financial system and the role of systemically important financial institutions in helping to create and spread that risk. This is clearly the case for non-bank financial institutions, especially life insurers. Life insurers are very important financial institutions and have been extensively regulated for centuries for that reason. However, relatively little attention was paid until recently to the ways in which individual insurers might affect the rest of the financial system. Dodd-Frank attempts to ensure that the possible systemic risk created by all the important non-bank financial institutions be considered.

Whatever one believes about the wisdom of designating some life insurers and other types of non-banks as systemically important, it is critical that the ensuing regulation by the Fed of any designated SIFIs be appropriate to their industries. Life insurers in particular are quite different animals from banks and so it is crucial that the Fed not instinctively treat them simply as funny looking banks and try to force them to be more like traditional banks. The most likely place that such a mistake could be made is in the area of capital requirements, where the Fed has extensive intellectual investments in their current approach to bank capital, buttressed by agreements with their peers in other nations. Applying bank capital standards inflexibly to life insurers would run the real risk of forcing them to act more like banks, even when this would actually increase their risk. For example, the long-term nature of life insurance liabilities necessitates the holding of long-term assets in order to reduce the risk that funding costs will shoot up when shorter-term assets are rolled over. Banks, on the other hand, have much shorter liabilities and therefore need to be careful not to lengthen their assets too far.

The Fed has promised to pay careful attention to the differences between banks and other financial institutions that are designated as SIFIs. It is crucial that they be rigorous in doing so.