The Daily Dish

SIFI De-designation Alert

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Eakinomics: SIFI De-designation Alert

The Financial Stability Oversight Council (FSOC) has long been scheduled to meet today. However, Fed Chair Janet Yellen was asked about the designation process for non-bank Systemically Important Financial Institutions (SIFIs) at her most recent press conference. Her reply was interesting:

"Now, it's not meant to be a one way street in the sense that a firm that's designated — the procedures require annual reviews. Firms may change their business models or adjust how they conduct their business and we should welcome dedesignation of firms if their business model is changed in a way that leads us to believe that their failure or distress would no longer be systemically important, and those are decisions that we make every year. So you know, I'm satisfied with that process so far, GE Capital dramatically changed its business model and was dedesignated and I believe that it's a process that works. So I know that the Treasury is looking at this and may make recommendations."

The combination of "it's not meant to be a one way street," "changed its business model," and "may make a recommendation" has led to speculation that the FSOC may de-designation American International Group (AIG) as a SIFI. If so, then I have a couple of thoughts.

1. Great. After all, none of the three large insurers designated by the FSOC — MetLife, Prudential, AIG — should ever have been SIFIs to begin with. MetLife has been freed by a court decision (but if it loses its appeal will be back under the FSOC's thumb) and now AIG would be out of the SIFI regime.

2. It is the right decision, but probably for the wrong reason. After all, the only part of AIG that was involved in the crisis was its financial products division and, specifically, its credit-default swaps activities. Since AIG closed this division, it is now more an insurer than before. So the reason for de-designation cannot have anything to do with AIG being large (it still is) or an insurer (it still is). It has everything to do with a particular activity.

3. This looks like the FSOC is implicitly moving toward an activities-based approach to thinking about insurers. Under an activities-based approach, the FSOC would identify risky activities or products and delegate to the primary regulator the job of addressing those risks. (This is how the FSOC analyzed the asset management industry, which yielded no designations.) Now is the time for the FSOC to move explicitly to an activities-based approach for both Prudential and (if need be) MetLife.

In response to President Trump's Executive Order on February 3, the Treasury will soon issue a report on the future of FSOC. It would be a step in the right direction for the report to recommend that the FSOC adopt an activities-based approach. The undesirable reality of individual designations has simply been to either break up companies (e.g., GE Capital) or subject them to a duplicative layer of prudential regulation.