Insight

The Unravelling of FSOC

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Executive Summary

- The Financial Stability Oversight Council (FSOC), created by the Dodd-Frank Act in the wake of the 2008 financial collapse, seeks to limit systemic risk in the financial system and prevent future financial instability.
- FSOC can designate financial services firms as "systemically important" to the financial system, forcing designated firms to adhere to extensive and costly additional regulations.
- FSOC designated Prudential Financial, an insurance firm, as systemically important in 2013, yet de-designated on October 17, 2018, after FSOC reconsidered its status. FSOC acknowledged that Prudential would not cause a threat to the U.S. economy, but stopped short of saying that Prudential should never have been identified as systemically important.
- Prudential's de-designation means there are no longer any non-banks under the purview of FSOC, signaling the council may be soon revising its criteria as to what constitutes systemically important.

Introduction

Ten years after the financial crisis, Prudential Financial has at long last shed the Financial Stability Oversight Council's (FSOC) designation as a systemically important financial institution (SIFI). As a result, no non-banks remain designated as SIFIs. This raises several important questions, not least concerning the implications for both Prudential and FSOC, but more broadly for the regulation of systemically important institutions across the economy.

Context

Like so much of financial regulation in the last 10 years, the genesis of the SIFI designation was the 2007-2008 financial crisis and more specifically the Dodd-Frank Wall Street Reform and Consumer Protection Act. Among its many provisions was the creation of FSOC, a regulatory board made up of directors from federal financial regulatory agencies tasked with identifying and preventing threats to the U.S. financial services sector. To prevent another instance of a firm being "too big to fail," FSOC would designate financial services firms as "systemic," i.e. one whose failure would jeopardize U.S. financial stability.

These firms, Systemically Important Financial Institutions (SIFIs), are subject to "enhanced prudential standards" with three key elements: first, higher capital requirements; second, the requirement to undergo annual stress testing; and third, enhanced reporting requirements including the creation of recovery and resolution plans or "living wills." The impact of these additional requirements is clear: SIFIs must set aside more capital, significantly increase compliance staff, and increase technology and data capture processing. As a result, the cost of the SIFI designation is enormous.

Under the provisions of Dodd-Frank, all banks holding over $50 billion in assets were automatically designated as SIFIs. In addition to this, Dodd-Frank granted FSOC sweeping discretionary powers to identify non-bank

financial services companies as SIFIs, were FSOC to determine that "material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States." Some thirty U.S. banks were captured under Dodd-Frank; FSOC exercised its authority to additionally designate insurers AIG, Metlife, and Prudential and General Electric's financing arm, GE Capital. In addition, FSOC has the power to designate Financial Market Utilities (FMUs), firms like cleaning houses and trust companies, as systemically important.

Challenges

From inception, FSOC's process for designation faced criticism. The factors used to determine SIFI status are not weighted, and as a result the decision-making process is extremely opaque. The Government Accountability Office has at several junctures reproached FSOC for its lack of transparency. The decision to designate (or de-designate) requires only the support of two-thirds of FSOC, and the decision to designate both MetLife and Prudential was made despite objections from the FSOC members with insurance experience and a lack of consultation with state insurance regulators.

Neither FSOC nor its enabling laws and regulations provided significant information on the exit ramp process by which companies would be de-designated; FSOC seemed more keen simply to slap on sanctions than actually work with companies to reduce their risk profiles. Expressing concerns over this, the White House issued an executive memorandum in 2017 that directed Secretary Mnuchin to conduct a "review of the FSOC determination and designation processes." The Treasury Department later recommended that "FSOC prioritize its efforts to address risks to financial stability through a process that emphasizes an activates-based or industry-wide approach".

Nevertheless, FSOC has never considered the financial costs of designation nor conducted cost-benefit analyses. In determining the appropriate capital surcharge for the global systemically important banks, itself a rather blunt tool, FSOC decided to double the standard applied to U.S. banks. No real rationale was ever provided for this, and this requirement presents a serious threat to the international competitiveness of U.S. financial institutions.

The regulatory burdens placed on SIFIs may outweigh any benefits to the economy. In the case of AIG, *The Financial Times* reported that the insurance firm would save $150 million a year in compliance costs once FSOC de-designated it as a SIFI in 2017. Additionally, AAF's former Director of Financial Services Policy, Meghan Milloy, found that "SIFI designation of asset managers or funds will be costly for investors. In some cases, investors could see their returns reduced by as much as 25 percent (approximately $108,000) over the long term, forgoing several multiples of their initial principal in lost returns over the course of a working life." In news that should surprise no one, a 2013 report by Oliver Wyman further found that the higher capital requirements on insurance companies result in increased costs for consumers.

Besides concerns over the designation process and its cost, the very legality of FSOC has been challenged as well. In 2012, the Competitive Enterprise Institute, the 60 Plus Association, and State National Bank of Big Spring, Texas, filed a lawsuit challenging the constitutionality of FSOC, among other Dodd-Frank provisions. After a drawn out back and forth in the courts, the plaintiffs filed a petition for certiorari with the Supreme Court to hear their case. The Supreme Court has not responded, but considering it has yet to weigh in on decisions delivered by lower courts on disputes pertaining to Dodd-Frank, including FSOC as well as the Consumer Financial Protection Bureau and the Orderly Liquidation Authority, a decision may not come soon.

Other broad philosophical challenges can be made. First, systemic risk has never been (and cannot be) adequately measured. It seems clear that the primary factor for designation is the bluntest, the size of the organization. Size does not necessarily correlate to risk, and larger organizations tend to be better diversified and more capable of absorbing systemic shock.

Fundamental questions remain as to the systemic nature of the business of insurance. Insurers receive systemic risk—they do not drive it. Liquidity is rarely an insurance concern, as assets are matched at long rather than short terms. Insurers do not lend to other insurers and are not as interrelated as banks. We will never see a run on an insurer. AIG failed because it had essentially morphed in to an unregulated hedge fund manager; risk was not in its insurance activities. In his dissent from the FSOC's SIFI designation of Prudential Financial, Roy Woodall, appointed by President Obama as FSOC's independent member with insurance expertise, noted his concerns stating, "The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance."

Perhaps most curiously, despite FSOC's powers to designate as SIFIs all FMUs and other financial institutions, FSOC has declined to designate in certain cases, most notably asset managers. That insurers could be deemed systemic and asset managers not is an odd distinction for which there has never been a justification. In 2014, FSOC indicated that it would focus on the activities of asset managers rather than their size, but it has not justified this treatment. As American Action Forum President Douglas Holtz-Eakin noted,

In this regard, activity-based regulation is more comprehensive as it will identify all of the market participants engaged in an activity that could pose a threat to stability. This is substantially better than singling out one or a few large firms or funds for designation, which creates disparities in regulation across firms and sectors that could have a very real and unintended economic costs. Positively, FSOC has shown it is open to an activity-based approach in assessing the risks posed by asset managers. However, FSOC has acted inconsistently thus far in its approach to insurance companies.

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It is no surprise that SIFIs sought escape from the broad, onerous, and poorly articulated powers of FSOC. Broadly speaking, SIFIs found themselves with three available options: significantly scale back operations to appear less threatening; contest SIFI designation in court; or contest designation from within FSOC's own internal processes.

The four non-bank SIFIs showed a remarkable divergence in approaches. GE Capital vastly decreased its footprint, selling billions of dollars of assets, and was de-designated in 2016. AIG restructured and was de-designated in 2017. MetLife chose to fight its designation in the courts, and in 2016 the designation was rescinded by the DC Court of Appeals, which noted that FSOC failed to consider the costs to MetLife and departed from its own standards. In 2018 FSOC agreed to drop its appeal.

This left Prudential as the only non-bank SIFI. Unlike its former non-bank colleagues, Prudential did not choose either to significantly divest or to contest designation in the courts; instead it has rather patiently argued that it should never have been designated in the first place. In addition to arguments about the non-systemic nature of insurance, Prudential has argued successfully that it is already appropriately supervised by its state regulator, New Jersey, which has the unique power to supervise insurance companies at the group level. Prudential has long been proud of the "vanilla" or non-risky nature of the business it holds, and it seems that FSOC has come around to its way of thinking.

Implications

With the de-designation of Prudential, a unanimous decision by FSOC, there are no remaining non-bank SIFIs. On the banking side, FSOC's portfolio of SIFIs is also shrinking, as the recent congressional partial rollback of Dodd-Frank, the Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155), has raised the threshold for SIFI status from $50 billion to $250 billion. Both facts raise key questions as to the philosophy of FSOC. Has FSOC indicated that insurers are not systemic, or merely that no current insurance companies as structured could possibly cause a financial crisis? Is FSOC increasingly determining that its job is complete? The judgment passed in the MetLife decision indicated that FSOC had not proven that the failure of MetLife would necessarily imperil the U.S. economy. In practice, this decision has raised the administrative hurdle for FSOC such that it is unlikely it would be able in the future to designate any new SIFIs. What then is the future of FSOC?

FSOC's de-designation of Prudential also raises some questions. In the final report FSOC noted that "certain aspects of Prudential's business and activities have not changed materially since the Council's final determination regarding the company in 2013." The report also notes, "Prudential and its subsidiaries continue to exhibit a significant amount of operational and financial interconnectedness and inter-dependencies." If Prudential has not substantially changed, de-designation can only be justified if we understand that they should never have been designated in the first place. FSOC has of course not indicated that de-designation represents a mea culpa, but Prudential in its press release noted that the decision "affirms our longstanding belief that Prudential never met the standard for designation."

FSOC is expected to address these questions later this year with the release of a new mission statement, re-committing FSOC to risky activities in the financial services industry rather than individual firms. Not much is known about the details of this proposed approach, but it is worth noting that, since 2016 when FSOC indicated that it would pursue activities-based regulation for asset managers, we have seen no regulation tailored to either asset managers or their activities.

Conclusions

FSOC performs a valuable role as the only government entity designed to mitigate against systemic collapse of the financial system. FSOC's primary tool, however, SIFI designation, is at best ineffective and at worst counterproductive, and there is little evidence that lumbering firms, particularly non-banks with a SIFI designation, has decreased the likelihood or scale of the next financial crisis. Since the MetLife court decision, the likelihood of new SIFI designations has significantly decreased. An activities-based focus, rather than size, should hopefully bring the more nuanced perspective FSOC needs to fulfil its objectives.