Research

Reform Principles for FSOC Designation Process

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Tomorrow, the Financial Stability Oversight Council (FSOC) is scheduled to hear from stakeholders on ways to improve the nonbank designation process. Treasury Secretary Jack Lew announced the meeting last month stating that: "The council will begin to examine possible changes in the coming months."[1] This long-awaited reconsideration of FSOC processes comes as MetLife, already affirmatively voted as a systemically important financial institution (SIFI), formally challenged the designation at a November 3 hearing.[2]

Admittedly FSOC, established by Title I of the Dodd-Frank Act, has a difficult task in identifying and monitoring financial stability threats in real-time. Without significant changes to how it conducts its designation process, it risks losing the confidence of the public and policymakers in its mission, potentially disrupting markets through secrecy, and imposing unnecessary costs on the economy without attendant benefits.

To restore confidence in the designation process, the following are recommended reforms that FSOC should implement:

- **Transparency, transparency, transparency**

FSOC itself explicitly states its "commitment to conducting its business in an open and transparent manner," and yet also maintains a list of reasons why meetings may be confidential.[3] They point out that concerns about "market-sensitive data" and related privacy concerns require closed meetings. FSOC is right to worry about the effect of leaks and disclosures of proprietary and otherwise private information. But for policy discussion and broader considerations, it's not clear what the harm would be in an open meeting, or at least a detailed release of meeting minutes soon after, similar to the Federal Reserve's Open Market Committee meetings.

When FSOC members are discussing the potential designation of a firm, they ought not be discussing transaction-level data and proprietary technologies, but rather wider concerns of how a given firm's funding structure and exposure to different market risks could affect the financial system in the case of financial distress. None of this information should be sensitive to public exposure. And as the Office of Financial Research made clear in its white paper on asset managers, they are (at least sometimes) thinking of these issues in the broadest, theoretical, macro terms.[4] None of which eliminates the inevitable risk of moving market prices in response to council decisions – a risk that is mitigated by quasi-real-time disclosure of discussion and considerations rather than closed door deliberations followed by sudden major policy announcements.

- **Don't move ahead of the Fed.**

FSOC's SIFI designation means enhanced prudential standards and supervision by the Federal Reserve. But what if the Fed doesn't know exactly what that means? Having designated 12 "financial market utilities" back in 2012, the Federal Reserve only just recently finalized the relevant regulation (Regulation HH).[5] With regard to insurance companies – MetLife being the designation after AIG – it's been widely acknowledged that Dodd-Frank (specifically the so-called "Collins Amendment") requires the Fed "to subject insurance companies to the

same capital and liquidity standards as banks."[6] This was deemed such an inappropriate application of capital rules for insurance companies that two versions of a fix have passed in Congress, though final passage awaits the lame-duck session.

FSOC risks "designating in the dark" when it moves ahead before the council, financial firms, Congress, or even the Fed who is supposed to supervise SIFIs, even know what that new regulatory regime is supposed to (or even can, given statutory restrictions) look like.

- **Determine the costs as well as the benefits.**

FSOC must make an attempt to move in the direction of fully assessing the economic effect of designating certain nonbanks (both the costs and the benefits). In fact this was an omission in part pointed out by a recent GAO study.[7] This begins with having a convincing model of how a given firm's (or firm type, e.g., asset managers) failure or distress could destabilize the financial system. This will help clarify what exactly is at stake, how designation will indeed help, and further justify any potential costs.

Preventing the next financial crisis will no doubt have enormous benefits, but the approach taken by FSOC thus far implies benefits are infinite and costs are negligible. And without clearly outlining how each firm or industry segment poses an actual, credible threat to stability, the *net* benefits may actually be negative.[8]

- **Remember the ultimate aim**.

The Council should remember the goal of Dodd-Frank's Title I, which is ultimately financial stability. If, for example, the council determines in its considerations that a particular firm's exposure to certain markets, or extensive use of particular types of financial instruments, poses significant counterparty risk, the firm itself should theoretically be able to remediate that problem if possible.

A basic principle of regulation is that a rule's burden should be avoidable if a lower cost alternative achieves the same desired end. Consider a manufacturer subject to pollution regulations. If the firm is found to be beyond the allowable acceptable limit of smokestack emissions, it can do one of the following: (1) pay the required penalty for violation of the regulation; (2) invest in a cleaner production technology which does not emit as much pollution; (3) divest or otherwise lower production volume such that pollution emissions are below the allowable level. The single regulation with a single desired aim results in multiple paths to achieving it. The firm will choose the least-cost option, which is both economically efficient and consistent with the rule's goal. The current FSOC approach, instead, is akin to telling the firm: "The problem is you. Report to detention."

Of course not all systemic threats will be easily defined (the way point source pollution might be). But this should not deter the council from nonetheless doing so when they can. This will mean, among other things, tasking the Office of Financial Research with the mission of clearly defining the potential systemic threat through data and modeling. It will then behoove the council to fully consider this information and work with the firm to address it or move forward with designation.

In its broadest application, this ends-focused approach would establish a tentative model of how particular nonbank firm-types (as opposed to specific firms) are systemically important; insurance companies no doubt are structurally very different from asset managers, etc. Remember that the FSOC's mission consists of "identifying and responding to emerging threats to financial stability"[9] – designation of financial firms is but one tool among many to achieve that goal.

It's likely that the Financial Stability Oversight Council will continue down this path of designating nonbanks. With additional time passing since the passage of Dodd-Frank, the number of questions will grow rather than diminish. For its part, some folks in Congress are already skeptical of the FSOC and its authority: House Financial Services Committee Chairman Jeb Hensarling earlier this year said "FSOC may very well be the nation's least transparent federal entity" next to security agencies, referring to the Council as "front and center" of "the shadow regulatory system."[10]

By committing itself to a more open, rigorous designation process, FSOC can preserve its ability to effectively address systemic risks without being unnecessarily restricted. Systemic risk is a real concern, made more so by its elusive and difficult to define nature. To that end, FSOC is better served by a process which instills confidence rather than one that engenders doubts.

[1] Douwe Miedema, "FSOC may tweak process for spotting super-risky firms," *Reuters*, October 6, 2014, http://www.reuters.com/article/2014/10/06/us-regulations-usa-fsoc-idUSKCN0HV24I20141006.