Insight

Congress: FSOC is “Arbitrary and Inconsistent”

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In May of 2015, the House Financial Services Committee (the Committee) began its investigation into the Financial Stability Oversight Council’s (FSOC) process for designating nonbank financial companies as systemically important financial institutions (SIFIs). In February of this year, the Committee released its report detailing its findings, and explaining how it arrived at the conclusion that “FSOC’s nonbank designation process is arbitrary and inconsistent.”

Specifically, based on internal documents obtained by the Committee, the investigation found that:

“The FSOC does not follow its own rules and guidance in multiple ways.

- The FSOC considers non-systemic risks in its determination of whether to designate a company as systemically important.
- The FSOC does not determine whether material financial distress at a company will cause “impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy,” as required by the FSOC’s rules, and instead simply assumes both impairment and significant damage on the economy.
- The FSOC does not follow its own requirement that evaluations of the systemic risk posed by individual firms be done in the “context of a period of overall stress in the financial services industry and in a weak macroeconomic environment,” and instead the FSOC has analyzed some companies only in a normal macroeconomic environment and then declined to designate those companies.”

and that:

"The FSOC's analysis of companies has been inconsistent and arbitrary.

- The FSOC performed, for some companies, an analysis of that company's vulnerability to financial distress, and declined to designate those companies.
- The FSOC did not perform an analysis of vulnerability to financial distress for all of the companies that it designated as SIFIs.
- For some companies that it declined to designate, the FSOC considered the use of collateral in certain financial transactions as a mitigating factor against designation.
- For companies that it designated as SIFIs, the FSOC did not consider the use of collateral in certain financial transactions to be a mitigating factor."

The American Action Forum (AAF) has previously written at length about FSOC's "arbitrary and capricious" decision making, especially as it applies to nonbank financial companies and FSOC's lawsuit involving MetLife, one of the companies it designated as a SIFI. The Committee's report now solidifies those concerns, and shows that the FSOC's inconsistencies and self-contradictions are even worse than once believed. Now that there is no question of FSOC's fault, the questioning should turn to the consequences of FSOC's designations, inconsistent or not.

AAF has noted that FSOC's regulatory designation "imposes direct costs and risk on the designated institutions. The magnitude of the costs is uncertain, especially given that the specific rules and capital requirements have largely yet to be determined, but it cannot be presumed negligible." More worrisome is the fact that FSOC's "two-tiered system will alter competitive dynamics in the insurance sector…Other things being equal, the increased costs of enhanced supervision will reduce their ability to compete effectively, plausibly shifting some amount of business and risk to entities not subject to the additional level of regulation, and destabilizing rather than stabilizing the market. Large banks who compete with each other are all under the same regulatory umbrellas." Such is not the case with FSOC-designated SIFIs.

The arbitrary and inconsistent designations should also raise questions of regulatory scale, scope, and overreach. At a very basic level, it should be obvious that FSOC's decisions to regulate insurers, capricious or not, disregard the role that state regulators already play in overseeing insurance companies. As Scott Harrington wrote in a paper for AAF, "[FSOC] largely ignores the historical solvency record, pays little attention to the history of improvements in solvency regulation, and dismisses states' ability to issue stays on policyholder withdrawals because doing so 'could' undermine financial stability during an unspecified crisis. The treatment reflects the notion that the lack of a true consolidated regulator at the state level trumps any argument for the effectiveness of state regulation, including changes in response to the crisis."

Similarly, given FSOC's failure to perform a basic cost benefit analysis, it failed to consider even the costs of its macroprudential regulating to consumers of those companies' products. In a 2013 report, Oliver Wyman explains how FSOC's heightened capital requirements on insurance companies result in increased costs to consumers. Specifically, the report finds that designated insurers will reduce their capacity or exit the market entirely, leaving the remaining insurers to increase their prices. And in markets with higher barriers to entry with a high market share by the designated insurers, the ability for the undesignated insurers is even greater, leaving consumers with significantly increased costs for the same or fewer benefits.

The Committee's report is a step in the right direction toward ending FSOC's designation authority, and, based on previously-introduced legislation, the majority party in Congress supports, at the very least, ending non-bank designations. For the sake of American competitiveness in the international marketplace and for the sake of consumers facing increased prices and reduced benefits, it should be a priority of this Congress to see that FSOC is no longer allowed to arbitrarily designate financial companies.