The Daily Dish

And Then There Were None

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Eakinomics: And Then There Were None

Yesterday the Financial Stability Oversight Council (FSOC) announced that it had revoked its designation of Prudential as a non-bank Systemically Important Financial Institution (SIFI). Recall that the Dodd-Frank financial reform act created the FSOC to regulate systemic risk in the U.S. financial system. Despite this mandate, there is no generally accepted measure of systemic risk, and, if there were, there would not be an agreement on the safe level of systemic risk. If you can't measure the risk and don't have a target, you don't have a mission. The Obama Administration created a regulator that cannot fulfill its mission. The FSOC should be repealed.

The FSOC instead set out to create a mission, using its power to designate as SIFIs those institutions that might threaten the U.S. financial system. In practice, there are really two ways to identify SIFIs. The first is size alone. This is the approach used to designate banks; Congress has just raised the threshold from $50 billion in assets to $250 billion. Basing risk-designations on size is way of doing business, but it is not right because risk is not really about size, per se. The second approach builds off the section of Dodd-Frank that provides the non-bank designation authority. It tells the FSOC to consider "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States." The key phase is the "mix of activities." In the "activities-based approach," it is the activities of a firm that may make it a systemic risk regardless of its size.

The FSOC started out by designating GE Capital, AIG, MetLife, and Prudential as non-bank SIFIs. As part of the larger disintegration of GE, GE Capital downsized and discarded some lines of business. It was relatively quickly de-designated. AIG rid itself of its problematic financial products division that was the sole source of problems in the crisis. Having changed its activities, it was de-designated. MetLife sued the FSOC over the process used to designate it as a SIFI. The FSOC lost this legal skirmish and MetLife was de-designated shortly thereafter. In each case, there was a clear material or process change that could explain the de-designations.

This brings us to Prudential, the last non-bank SIFI. Prudential was and is an insurer whose activities pose no identifiable systemic risk. It has a safe and soundness regulator (New Jersey) that has the authority to look comprehensively at all of the affiliates. Even though it is "big," it should never have been designated. Yesterday's de-designation is a tacit admission of this error.