The Daily Dish

Treasury and the Non-bank SIFI Designation Process

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Eakinomics: Treasury and the Non-bank SIFI Designation Process

As part of his executive order on review of financial regulation, President Trump asked the Secretary of the Treasury to "conduct a thorough review of the FSOC [Financial Stability Oversight Council] determination and designation processes under section 113 (12 U.S.C. 5323) and section 804 (12 U.S.C. 5463) of the Dodd-Frank Act and provide a written report to the President." The Treasury report is anticipated in the next several weeks (AAF provided comments to the Treasury for its consideration).

In anticipation of its release, *The New York Times* editorial page published a screed decrying the "rollback" that it is forecasting. The editorial intermixes the very different economics of banks and non-banks (e.g., insurance companies) and ignores the substantive shortcomings that caused the courts to overturn the designation of MetLife as a non-bank Systemically Important Financial Institution (SIFI).

But most important, *The New York Times* continues the incorrect focus on firms and firm size. The phrase "too big to fail" (TBTF) gets the discussion off on the wrong foot entirely. First, TBTF is not the fault of the private sector. It is the fault of policymakers who self-interestedly intervened. Had they resisted, there would be no incentive for private entities to structure themselves with some anticipation of public sector assistance.

Second, it is not really about size, per se. The section of Dodd-Frank that provides the non-bank designation authority 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"; it is the activities of a firm that may make it a systemic risk regardless of its size.

This points the way to a better approach for the FSOC to use when considering enhanced supervision: focus on the underlying activities that could give rise to systemic risk. If the evidence exists that a particular activity (no-downpayment mortgages for unqualified borrowers) or product (negative amortization mortgages) gives rise to systemic risk, the activities-based approach would lead the FSOC to develop new rules for those activities across all sectors and firms of all sizes. It would consider systemic issues in a way that is fundamentally different than simply having more prudential regulation. The FSOC used the activities-based approach when thinking about the asset management sector and chose not to enhance regulation. If an activities-based approach had been in effect during the housing boom, it's possible that the financial crisis would have been much less catastrophic.

The Treasury report is an important moment in the evolution of the FSOC and systemic risk management. One hopes that it contains a full-throated endorsement of an activities-based approach and a move away from mindless size-based designations.