Insight

FSOC Knows It Was Wrong – Now What?

MEGHAN MILLOY | MAY 10, 2016

On March 30th of this year, Judge Rosemary Collyer of the United States District Court for the District of Columbia signed an opinion deciding, among other things, that the Financial Stability Oversight Council's (FSOC's) designation of MetLife as a Systemically Important Financial Institution (SIFI) was "fatally flawed" as its decision, along with its decision-making process, was "arbitrary and capricious." Last week, Hal Scott wrote an op-ed to the Washington Times explaining what the decision said and what that means for FSOC and for potential SIFI designees going forward.

The court's opinion left us with no question that FSOC did a bad job in the process of designating MetLife, and the court called them out on it in no uncertain terms. Specifically, Judge Collyer said, "FSOC made critical departures from two of the standards adopted in its Guidance, never explaining such departures or even recognizing them as such. That alone renders FSOC's determination process fatally flawed."

Further, as AAF pointed out last year, FSOC failed to take into account the Second Determination Standard as required by Section 113 of Dodd-Frank which includes a study of whether 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" regardless of whether the company were experiencing material financial distress. Not only should FSOC perform a basic cost-benefit analysis, it should be looking at the activities of a company, not just an arbitrary measure of the company's size.

With no question that what FSOC did and has been doing was bad, the issue now turns to the future. It's safe to assume that FSOC will be forced to learn its lesson and get the process right, but now we must focus our attention on the substance of FSOC's designations. For example: are insurance companies like MetLife really systemically important? That is, would their failure cause such a ripple in the overall financial wellbeing of the United States that their downturn would trigger nationwide financial downturn? On the other hand, how exactly does one define "systemic importance?" Dodd-Frank set some ambiguous standards, but it's mostly up to interpretation by FSOC and any other agency charged with deciding whose importance is in fact systemic.

Those are all questions for a much longer discussion, but at a very minimum, FSOC must address the concerns raised by the court and must increase its transparency in its designation process. Doing so is essential for FSOC and its processes to function effectively and as it was intended.