Insight

The 5-5-5s of Dodd-Frank at 5: Episode 4

MEGHAN MILLOY | JULY 16, 2015

The Problem: FSOC and Its SIFI Designation Process

One of two new regulatory bodies created by Dodd-Frank, the Financial Stability Oversight Council (FSOC), is tasked with identifying and addressing threats to the U.S. financial system. Perhaps most significantly, FSOC holds the power of designating as "systemically important" certain financial institutions that it believes would threaten the financial stability of the United States if they were to fail. If an institution is designated as a Systemically Important Financial Institution (SIFI), it is then subject to heightened supervision by the Federal Reserve Board (FRB) and a litany of "enhanced prudential standards" including increased capital requirements, requirement to produce a "credible living will" outlining its wind down procedures in the event of failure, stress testing, credit exposure limits, and more.

The concept of designating certain institutions as SIFIs in and of itself is not all that troublesome since many of the "enhanced prudential standards" were the logical next steps after 2008. The real concern is the process by which FSOC choose and designates the institutions. Earlier this year, MetLife sued FSOC following its SIFI designation arguing that FSOC's process was "arbitrary and capricious" – words that are commonly associated with FSOC designations. In fact, two of FSOC's very own members dissented from the MetLife designation since FSOC failed to inform the company of the particular aspects of its business that led to its designation and FSOC seemingly did not consider the preexisting regulatory systems already overseeing the company. And there aren't only substantive problems with the process. One of the biggest concerns is that FSOC isn't required to notify an institution that it's being considered for SIFI designation until the third and final stage of the process, at which point an institution has little time to take steps to avoid designation – especially when FSOC isn't forthright with exactly what it considers as SIFI qualifications.

The Repercussion: Limits Options, Raises Costs for Consumers

As with most financial regulations, SIFI designations bring with them burdensome compliance costs as the financial institutions are forced to hire new staff to ensure the firms remain compliant. In turn, those SIFIs end up having to pass along many of those costs to consumers either in the form of increased fees or limited investment options as firms cut their offerings because they no longer can afford to manage smaller accounts.

Paul Schott Stevens, president of the Investment Company Institute explained that "[t]he consequences of SIFI designation could significantly impair fund investing" because "*it would not take much in added fees, assessments and capital costs to increase significantly what these funds would have to charge their shareholders, making them less competitive and less attractive to investors.*" Recent research by AAF suggests that SIFI designation of asset managers or funds would cost investors around $108,000 over the long term, forgoing several multiples of their initial principal in lost returns over the course of a working life. Obviously that number will vary based on the investor and what type of company is designated. For non-bank financial companies, like MetLife, those costs to consumers will come in the form of lowered industry competition and higher prices. For other institutions, the designation reduces access to credit and market liquidity. A February 2015 Bloomberg report shows that 2014 regulations similar to those that come along with SIFI designation (specifically, being restricted to buying only U.S. government-backed securities) have already had the effect of creating a $100 billion funding hold for lenders who rely on the Fidelity Cash Reserves Fund to buy their commercial paper. As banks face higher borrowing costs, lenders do as well.

The Fix: Increase FSOC Transparency; Activity-Based Approach

Legitimate arguments can be made on the merits (or lack thereof) of having such a macroprudential regulator at all. But since FSOC is unlikely to go anywhere anytime soon, in the meantime two minor fixes could greatly improve FSOC and its designation process: 1) increased transparency throughout the process and 2) using an activity-based approach.

One of MetLife's biggest concerns throughout its designation process and into its lawsuit is that FSOC violated its due process by not being completely transparent and responsive while making its decision. Those sentiments have echoed throughout the industry as firms have called for FSOC to, at the very least, inform involved parties on the criteria they review when determining whether or not an entity is systemically important. Until FSOC comes forward with those sorts of details, firms will be unable to prepare for or overcome the designation and the process will continue to be unfair to those companies that FSOC seems to cherry pic for designation.

Secondly, FSOC should take a more activity-based approach to its oversight and regulation of nonbanks. By identifying those activities that pose a threat to financial stability, FSOC can offer companies an opportunity to remedy any shortcomings in their engagement in those activities, or even divest if that is the least costly solution. Activity-based regulation really is the story of regulation more broadly. Firms have always been given the latitude to determine if a given activity or product, with its attendant regulation, is a profitable opportunity or not. Regulators would do well to remember the unit at which regulations are most appropriately applied.

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