



## Testimony

# FSOC Accountability: Nonbank Designations

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Chairman Shelby, Ranking Member Brown, and members of the Committee, thank you for the opportunity to appear today and share my views on the Financial Stability Oversight Council (“FSOC” or “the Council”) nonbank designation process. FSOC’s mission is to identify, monitor, and address threats to America’s financial stability. Yet without significant changes to the process by which nonbank financial companies (“NBFCs”) are designated as systemically important and regulated, FSOC risks losing the confidence of the public and policymakers and burdening the economy without resultant benefits. In my testimony, I wish to make three main points:

- FSOC’s process thus far has prioritized designation and regulation of institutions over the identification of activities that pose systemic threats, and done so in a fundamentally flawed manner. I applaud the Committee for taking a critical look at this process and all its implications;
- Further clarity is needed on the metrics leading to designation. And equally important, companies must be able to address the activities identified as posing systemic risk, avoid a designation, and, if unable to do the aforementioned, have a path exiting designation;
- Finally, recently adopted procedures to open up FSOC and improve communication with firms under review should be commended as a good first step.

Let me provide additional detail on each in turn.

## Current Nonbank Designation Process

Title I, Subtitle A, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) established FSOC, outlined the Council’s powers, and introduced factors that must be considered when designating NBFCs as systemically important financial institutions (“SIFIs”). Because banking companies with over \$50 billion in assets are automatically considered SIFIs in the Dodd-Frank Act, key issues involving designation revolve around nonbanks.

Specifically, Section 113 of the Dodd-Frank Act gives FSOC the authority by two-thirds vote (including the chairperson) to bring a NBFC under increased supervision and regulation by the Federal Reserve Board (“FRB”) if the Council determines that “material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States.”<sup>[1]</sup> In making that determination, the Dodd-Frank Act lists ten criteria for FSOC to consider along with “any other risk-related

factors that the Council deems appropriate.”<sup>[2]</sup> As such, FSOC has broad authority statutorily when evaluating companies for SIFI designation. In April 2012, FSOC released a final rule and interpretive guidance on the process it uses to designate SIFIs.<sup>[3]</sup> The Council recently voted to supplement that process during its February 2015 meeting following an internal review and input from the public and stakeholders.<sup>[4]</sup>

The three-stage evaluation process FSOC developed is intended to narrow the pool of companies potentially subject to designation by applying specific thresholds based on 11 criteria included in Section 113 of the Dodd-Frank Act. The 11 criteria have been incorporated into six overarching framework categories that FSOC considers: (1) size, (2) interconnectedness, (3) leverage, (4) substitutability, (5) liquidity risk and maturity mismatch and (6) existing regulatory scrutiny. Table 1 highlights how thresholds in these categories are applied and how scrutiny increases as a company advances through each stage. However, in practice, it is not clear the weight given to certain factors over others or what makes a designation more likely.

<b>TABLE 1. FSOC DESIGNATION PROCESS</b>
<b><i>STAGE 1: APPLY QUANTITATIVE THRESHOLDS</i></b>
<p>A NBFC moves on to Stage 2 if it has:</p> <p>(1) \$50 billion in total consolidated assets, and</p> <p>(2) One of the following:</p> <ul style="list-style-type: none"> <li>· \$30 billion in gross notational credit default swaps outstanding for which a NBFC is the reference entity;</li> <li>· \$3.5 billion of derivative liabilities;</li> <li>· \$20 billion in total debt outstanding;</li> <li>· 15 to 1 leverage ratio of total consolidated assets (excluding separate accounts) to total equity; or</li> <li>· 10 percent short-term debt ratio of total debt outstanding with a maturity of less than 12 months of total consolidated assets (excluding separate accounts).</li> </ul> <p>Note: FSOC reserves the right to “evaluate any NBFC based on other firm-specific qualitative or quantitative factors, irrespective of whether such company meets the thresholds.”<sup>[5]</sup></p>
<b><i>STAGE 2: QUANTITATIVE &amp; QUALITATIVE ANALYSIS</i></b>
<p>In further detail, FSOC applies its six-category framework:</p> <ul style="list-style-type: none"> <li>· Size</li> <li>· Leverage</li> <li>· Interconnectedness</li> <li>· Liquidity Risk &amp; Maturity Mismatch</li> <li>· Substitutability</li> <li>· Existing Regulatory Scrutiny</li> </ul> <p>The Council evaluates the risk profile and characteristics of each NBFC using industry- and company-specific factors, with company information being gathered from existing regulators and public sources as well as information submitted voluntarily by companies under consideration.</p>
<b><i>STAGE 3: IN-DEPTH ANALYSIS OF COMPANY</i></b>

With previously amassed information, FSOC performs an in-depth analysis of the company based on the six-category framework. Through OFR, FSOC further collects confidential data obtained from the firm to incorporate in its analysis.

Table 2 includes a summary of all changes adopted in February, many of which attempt to address the need for increased transparency and communication. Items shaded in gray are substantially similar to reforms previously highlighted in past work by the American Action Forum.<sup>[6]</sup><sup>[7]</sup><sup>[8]</sup>

**TABLE 2. SUMMARY OF FSOC'S SUPPLEMENTAL PROCEDURES ADOPTED IN FEBRUARY 2015**

***CATEGORY 1: ENGAGEMENT WITH COMPANIES UNDER CONSIDERATION BY FSOC (IN STAGES 2 & 3)***

- Company to be notified in Stage 2 when it comes under active review
- Company in Stage 2 has the opportunity to submit relevant information to the Council and meet with FSOC staff
- When requested, FSOC staff should provide a company under consideration with a list of the public sources of information from which FSOC derives its decision
- Company notified in writing if it is not advanced to Stage 3 (though FSOC reserves the reconsider the company again in the future)
- Staff would meet with a companies' representatives at the start of Stage 3 to explain the evaluation process, framework for analysis, and specific activities and operations viewed by FSOC staff as the primary focus of their Stage 2 evaluation
- FSOC will explain the purpose of requested information in Stage 3 in relation to the risks being analyzed
- Companies can continue to submit material they deem relevant and request meetings with FSOC staff during Stage 3
- FSOC intends to grant hearing requests from companies subject to a proposed designation
- FSOC will engage with a company's primary financial regulatory, including notifying the regulator when a company comes under active review in Stage 2 and beginning the consultation process before any vote to advance a company to Stage 3

***CATEGORY 2: THE ANNUAL REEVALUATION OF DESIGNATED COMPANIES***

- Designated company is given the opportunity to meet with FSOC staff prior to annual reevaluation of its designation, discuss scope and process of review, and present them with any relevant information that could change the need for a systemically important determination
- FSOC will issue an explanation of its decision (addressing the company's objections) to maintain a systemically important designation if a company contests following its annual reevaluation, and inform the company, its primary regulator, and the primary regulator of its significant subsidiaries
- FSOC will provide a company subject to determination the opportunity for an oral hearing once every five years to contest its designation

***CATEGORY 3: TRANSPARENCY TO THE BROADER PUBLIC REGARDING THE DESIGNATION PROCESS***

- If a company publicly announces it is in active review in Stage 2 or 3, FSOC will confirm it upon request

<ul style="list-style-type: none"> <li>· FSOC will include more public information on the bases of its designations</li> </ul>
<ul style="list-style-type: none"> <li>· FSOC will publish more information during its annual report including the number of nonbanks FSOC voted to move or not move on to Stage 3, became subject to a proposed or final determination, and the aggregate number of companies subject to a final determination</li> </ul>
<ul style="list-style-type: none"> <li>· FSOC will publish further detail on how the Stage 1 thresholds are calculated</li> </ul>

Because Dodd-Frank gives FSOC such expansive authority to set the specific determinants of a SIFI designation, FSOC’s operational procedures have largely been set internally and through the regulatory rulemaking process. Table 3 outlines the actions FSOC and the Federal Reserve Board have taken to date to define their procedures, receive feedback from the public, and exercise their authority to designate NBFCs and regulate them. Since its creation, four NBFCs (AIG, GE Capital, Prudential Financial, and MetLife) have already been affirmatively voted as SIFIs. FSOC voted unanimously to designate AIG and GE Capital in June 2013 and reaffirmed their status last year. The votes to designate Prudential Financial and MetLife, in September 2013 and December 2014, respectively, were not unanimous—both included objections from the voting and non-voting members of FSOC with insurance experience.

July 2010	Dodd-Frank Act Effective
October 2010	1 <sup>ST</sup> FSOC Meeting APNR: FSOC’s Authority to Require NBFC Regulation/Supervision
January 2011	1 <sup>ST</sup> NPR: FSOC’s Authority to Require NBFC Regulation/Supervision
February 2011	RFC: Modifications to the Concentration Limit on Large Financial Companies
April 2011	NPR & RFC: Resolution Plans & Credit Exposure Reports Required by FRB & FDIC
September 2011	FR: Resolution Plans Required by FRB & FDIC IFR: Resolution Plans Required for IDIs with > \$50 Billion in Total Assets by FDIC
October 2011	2 <sup>nd</sup> NPR: FSOC’s Authority to Require NBFC Regulation/Supervision
January 2012	NPR: Enhanced Prudential Standards & Stress Testing For SIFIs By FRB FR: Resolution Plans Required for IDIs with > \$50 Billion in Total Assets by FDIC
April 2012	FR & IG: FSOC’s Authority to Require NBFC Regulation/Supervision
May 2012	RFC: FSOC Hearing Procedures
September 2012	GAO Releases Recommendations to Improve FSOC Process
October 2012	FR: Stress Testing of SIFIs by FRB
November 2012	RFC: FSOC Recommendations to SEC on Money Market Mutual Fund Reform
January 2013	Vote: AIG, GE Capital & Prudential Advanced from Stage 2 to 3
April 2013	Notice: FSOC Amends Hearing Procedures NPR: Supervision & Regulation Assessments by FRB

May 2013	<a href="#">Vote</a> : AIG, GE Capital & Prudential Evidentiary Records Completed
June 2013	<a href="#">Vote</a> : AIG, GE Capital & Prudential Designations Approved (10-0; 9-0, 7-2 with Non-Voting State Insurance Rep Also Dissenting)
July 2013	<a href="#">Vote</a> : AIG & GE Capital Designated SIFIs (10-0; 9-0); Hearing Granted To Prudential (9-0) <a href="#">Vote</a> : MetLife Advanced from Stage 2 to 3
August 2013	<a href="#">FR</a> : Supervision & Regulation Assessments by FRB
September 2013	<a href="#">Vote</a> : Prudential Designated a SIFI (7-2 with Non-Voting State Insurance Rep Also Dissenting)
March 2014	<a href="#">FR</a> : Enhanced Prudential Standards from FRB
May 2014	<a href="#">Vote</a> : FSOC Adopts Amendments to Transparency Policy & Updated Bylaws for Council's Deputies Committee FSOC Holds <a href="#">Public Conference</a> on Asset Managers  <a href="#">NPR</a> : Concentration Limits on Large Financial Companies from FRB
July 2014	<a href="#">Annual Reevaluation</a> : AIG & GE Capital Maintain SIFI Designation <a href="#">NPR &amp; RFC</a> : Amendments to the Capital Plan & Stress Test Rules by FRB
August 2014	<a href="#">Vote</a> : MetLife Evidentiary Record Completed
September 2014	<a href="#">Vote</a> : MetLife Designation Approved (9-0 with Non-Voting State Insurance Rep Expressing Concern)
October 2014	<a href="#">Vote</a> : Hearing Granted to MetLife (10-0) <a href="#">FR</a> : Capital Plan & Stress Test Rules from FRB
November 2014	<a href="#">Annual Reevaluation</a> : Prudential Maintains SIFI Designation (8-1) GAO Releases Further Recommendations to Improve FSOC Process  <a href="#">FR</a> : Concentration Limits on Large Financial Companies From FRB
December 2014	<a href="#">Vote</a> : MetLife Designated a SIFI (9-1 with Non-Voting State Insurance Rep Opposing) <a href="#">RFC</a> : Asset Management Products & Activities  <a href="#">Insurance Capital Standards Clarification Act of 2014</a> Becomes Law  <a href="#">RFC</a> : Applying Enhanced Prudential Standards to GE Capital
January 2015	MetLife Files <a href="#">Lawsuit</a> Challenging FSOC Designation FSOC Reviews <a href="#">Staff Recommendations</a> for Process Changes
February 2015	<a href="#">Notice</a> : FSOC Adopts Supplemental Procedures For NBFC SIFI Determinations <a href="#">Extension of Comment Period</a> for Asset Management Products & Activities

## Primary Criticisms & Recommended Changes

Established in Section 113 of the Dodd-Frank Act, FSOC has been given the difficult task of identifying and monitoring threats to U.S. financial stability in real-time. However, there is no single or simple way to measure and mitigate systemic risk. In fact, the process FSOC has developed to designate NBFCs as SIFIs can also disrupt markets and impose unnecessary regulatory burdens and costs that outweigh its benefits to the economy. So despite recent improvements, FSOC's process needs more rigorous quantitative analysis, respect for other regulators and their expertise, greater concern for market impacts, and a clear path for the removal of a designation. Here is further detail on the issues FSOC reforms should address:

**1. FSOC's lack of transparency and failure to provide meaningful information on the determinants leading to designation result in unclear guidance on systemic threats.** While FSOC is right to worry about the effect of leaks and disclosures of proprietary information, room still exists for the release of more information detailing issues in the broadest, macro terms. According to a report issued by the Government Accountability Office ("GAO"), "FSOC's transparency policy states its commitment to operating transparently, but its documentation has not always included certain details."<sup>[9]</sup> GAO recommended, "To enhance disclosure and strengthen transparency, the Secretary of the Treasury, in consultation with FSOC members, ... should include additional details in its public basis documentation about why FSOC determined that the company met one or both of the statutory determination standards."<sup>[10]</sup> Designation decisions available to the public should reflect the shared goal of minimizing systemic threats; if there is a specific activity or subsidiary of a designated firm that poses an acute threat, the final decision should disclose it. Furthermore, GAO is not alone in suggesting more open communication with the public and companies under consideration, the Bipartisan Policy Center and many others have echoed such concerns.<sup>[11]</sup>

**2. If there is a particular activity or activities that threaten the financial system, a company should be able to work with FSOC to remediate the problem.** As a company moves through FSOC's 3-stage evaluation process, FSOC does not inform companies of what changes could be made to either their structure or operations to avoid designation. While FSOC has outlined the characteristics it considers in its evaluation process, it is still not clear the weight they give to certain factors over others or what makes a designation more likely. In the supplemental procedures adopted in February, FSOC made some effort toward increasing the amount of communication between firms under consideration and FSOC staff. Yet ultimately, the Council does not encourage companies to work with the Office of Financial Research and FSOC staff to clearly define a potential systemic threat through data and modeling, explore lower cost alternatives to designation, and then move forward if a company cannot remediate the problem. In meeting its aim of financial stability, FSOC should consider all the tools available instead of quickly moving to designation.

**3. FSOC should consider the effectiveness of existing primary regulators and defer to their expertise when designating nonbanks.** While FSOC is comprised of relevant financial regulators, each one has different expertise and experience. A firm's primary regulator should be given an enhanced role in designation proceedings. Thus far this has not been the case; insurance company designations proceeded with little respect for state regulators and over the objections of FSOC's voting and non-voting members with insurance expertise.<sup>[12]</sup>

**4. FSOC's institution-by-institution approach engenders disparate treatment and misses the key issue, identifying activities and practices that generate systemic risks.** After designating AIG, Prudential Financial and MetLife, FSOC appeared it would move next to asset managers. Yet that institution-by-

institution approach misses the key issue: what specific activities or practices generate systemic risks? In this regard, activity-based regulation is more comprehensive as it will identify all of the market participants engaged in an activity that could pose a threat to stability. This is substantially better than singling out one or a few large firms or funds for designation, which creates disparities in regulation across firms and sectors that could have a very real and unintended economic costs. Positively, FSOC has shown it is open to an activity-based approach in assessing the risks posed by asset managers. However, FSOC has acted inconsistently thus far in its approach to insurance companies.[13]

**5. Designation decisions must be supported by evidence, rooted in rigorous economic analysis, and backed by statutory authority.** In his dissent from the FSOC’s SIFI designation of Prudential Financial, Roy Woodall, appointed by President Obama as FSOC’s independent member with insurance expertise, noted his concerns about the analytical rigor of the designation process stating, “The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance.”[14] John Huff, the non-voting member of the Council representing state insurance regulators, echoed Woodall’s concerns, writing in his dissent, “The analysis contained in the basis for the final determination in large part relies on nothing more than speculation.”[15] Experts have further argued that the analytical processes behind designations are generally far too opaque and likely insufficient.[16] Additionally, FSOC has stated it does not intend to “conduct cost-benefit analyses in making determinations with respect to individual nonbank financial companies,” reflecting how recent designations have failed to accurately assess the implications of SIFI designations on the insurance industry.[17]

FSOC should attempt to fully assess the economic effect, both costs and benefits, of designating only certain nonbanks as SIFIs. This means producing a convincing model that a firm’s failure, its financial distress, or its activities could destabilize the financial system. In such a way, FSOC can demonstrate what is at stake and how a designation will help, and then justify the costs. Preventing the next financial crisis may undoubtedly have enormous benefit, but FSOC has not clearly outlined how each firm or industry segment it has scrutinized poses an actual threat to stability. Since the economic cost of eliminating systemic risk entirely is prohibitive, FSOC’s goal must be to find the “right” amount of risk, a difficult feat since FSOC can neither measure its progress nor know its target. Because of the difficulty of regulating entities posing only a potential systemic threat, designations should be firmly rooted in sound economic analyses that explore all costs and benefits (as well as alternatives to designation) and be substantially justified by applicable Dodd-Frank Act statutes.

**6. Annual reevaluation should not be a check-the-box exercise, but a genuine opportunity for a nonbank SIFI to address Council concerns and exit designation.** SIFI designation should not be indefinite. FSOC must create a process that permits firms to address risks and avoid designation. Once designated, FSOC revisits the designation annually and must vote only to rescind, creating little more than a check-the-box exercise. SIFIs should have a way to “de-risk,” address the concerns or activities raised by FSOC that merited a designation, and follow an exit ramp from SIFI status. Whether through sunset provisions or other policy options, the changes announced in February do not go far enough to tackle this issue.

**7. FSOC and its staff must continue to actively engage the public, experts, and stakeholders to comprehensively examine potential systemic threats, firm types, and changes in the financial economy environment as well as areas for FSOC procedural improvement.** Last fall FSOC began the process of reviewing and evaluating its SIFI designation process for nonbanks, seeking input from stakeholders and assessing potential changes. Ultimately, this process led to the adoption of a number of positive steps toward increasing communication between FSOC staff and firms under review and adding transparency to the process. If anything, this should encourage FSOC to continue to collaborate with stakeholders, seek input

from the public, and continue to advance efforts that open up its opaque process. As FSOC considers increasingly different potential threats, firms, and industry changes, engagement with outside experts will be integral and may substantially improve public confidence in its efforts.

***8. The Federal Reserve's role as chief regulator of designated firms will likely endanger and diminish its independence, which should concern lawmakers.*** The Federal Reserve Board is the chief regulator of all firms designated as SIFIs, whether insurance companies, asset managers, or something else. While the Federal Reserve is a world-class monetary authority and quality bank regulator, it may struggle to tailor regulations for other financial companies outside of its expertise. This will also likely lead to greater scrutiny by the Congress and endanger central bank independence. In addition to the designation process, it may behoove policymakers to consider primary regulators in an enhanced supervisory role instead of the Federal Reserve Board.

At a minimum, FSOC must conduct its business in a way that is analytically sounder and better grounded in the data and regulatory history, with a clear path away from SIFI designation for nonbanks. Thank you and I look forward to answering your questions.

[1] 12 U.S.C. § 5323 (a)(1)