



Testimony

FSOC Nonbank Designations

DOUGLAS HOLTZ-EAKIN | MARCH 14, 2019

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** The views expressed here are my own and not those of the American Action Forum. I thank my colleague Thomas Wade for his insights and assistance.*

Chairman Crapo, Ranking Member Brown, and members of the Committee, thank you for convening this hearing and providing me with the opportunity to appear today and share my views on the Financial Stability Oversight Council (FSOC) nonbank designation process. I had the honor and privilege of addressing the Committee on this exact topic in 2015. Although so much in the world has changed since then, FSOC's designation process has not. As a result, my comments will have a tenor similar to my previous testimony.^[1]

Ten years after the financial crisis, Prudential Financial has shed its designation as a systemically important financial institution (SIFI).^[2] As a result, no nonbank financial companies (NBFCs) remain designated as SIFIs. This raises questions as to the future role of FSOC in the regulation of systemically important institutions across the economy.

In my testimony I wish to make two main points:

- FSOC was given a challenging, if not impossible, mandate and responded by significantly hampering U.S. NBFCs and increasing costs for consumers without demonstrably improving the safety or soundness of the U.S. financial system; and
- The exit of the last NBFC from SIFI designation, while welcome, has demonstrated that FSOC lacks relevance in NBFC regulation. For FSOC to remain relevant, it must significantly overhaul its operating procedures, beginning with a philosophy of activities-based rather than entity-specific regulation.

Safety and Soundness

Title I, Subtitle A, of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") established FSOC, outlined FSOC's powers, and introduced factors that must be considered when designating NBFCs as SIFIs. Because banking companies with over \$50 billion in assets are automatically considered SIFIs in the Dodd-Frank Act, the 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 FSOC 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.”^[3] In making that determination, the Dodd-Frank Act lists 10 criteria for FSOC to consider along with “any other risk-related factors that FSOC deems appropriate.”^[4] As such, FSOC has broad authority statutorily when evaluating companies for SIFI designation.

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.^[5]

Some 30 U.S. banks were captured under the Dodd-Frank Act; FSOC exercised its authority to additionally designate insurers AIG, Metlife, and Prudential, and General Electric’s financing arm, GE Capital.

Implications

SIFIs are subject to “enhanced prudential standards” with three key elements: first, higher capital requirements; second, the requirement to undergo annual stress testing; and third, enhanced reporting requirements including the creation of recovery and resolution plans or “living wills.” The impact of these additional requirements is clear: SIFIs must set aside more capital, significantly increase compliance staff, and increase technology and data capture processing. As a result, SIFI designation is a significant cost.

AIG estimated that de-designation would save the company \$150 million a year in compliance costs once FSOC de-designated it as a SIFI in 2017.^[6] Additionally, previous research by the American Action Forum (AAF) found that “SIFI designation of asset managers or funds will be costly for investors. In some cases, investors could see their returns reduced by as much as 25 percent (approximately \$108,000) over the long term, forgoing several multiples of their initial principal in lost returns over the course of a working life.”^[7] These additional costs are, of course, passed on to consumers.^[8]

Criticisms and Policy Recommendations

The safety and soundness of the financial system is clearly a fundamental goal. FSOC was however tasked with a difficult mandate in that the concept of “systemic risk” has never been adequately defined and cannot be measured (let alone a “safe” level of systemic risk). FSOC’s response to this challenge has been to create an environment where NBFCs were laden with excessive regulation, and increased compliance costs, that were necessarily passed on to consumers. All this, and there was no evidence that either the NBFCs designated were a risk to the stability of the financial sector or that enhanced prudential measures demonstrably decreased such a risk.

The following analysis underpins the need for wholesale reform:

1. **FSOC’s focus on entities that might contribute to systemic risk does not pursue the goal of systemic risk itself.** Having identified banks and insurers as potential contributors to systemic risk, FSOC indicated

it would then focus on asset managers. To date FSOC has declined to give the asset management industry in a clear case of picking regulatory winners and losers. Even if FSCO had given asset managers appropriate scrutiny this would still miss the key issue of what drives systemic risk itself.

In 2017, the White House directed Treasury to review FSOC's designation procedures. The key recommendation of the resulting report (the 2017 Treasury Report)[9] was that FSOC prioritize industry-wide approaches to systemic risk, and moving from entity-specific designation to monitoring the specific activities that increase systemic risk across the financial system.

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 approach 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.

2. **Size is not a useful indicator of risk.** It seems clear that the primary factor for designation is the bluntest: the size of the organization. Size does not necessarily correlate to risk, and larger organizations tend to be better diversified and more capable of absorbing systemic shock.

FSOC has not indicated that it has appropriately considered the riskiness of the insurance industry at all. Insurers receive systemic risk—they do not drive it. Liquidity is rarely an insurance concern, as assets are matched at long rather than short terms. Insurers do not lend to other insurers and are not as interrelated as banks. We will never see a run on an insurer. AIG failed because it had come to contain an unregulated hedge fund; risk did not stem from its insurance activities. 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 stating, "[The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance.](#)"[10]

The 2017 Treasury Report noted the lack of academic backing for FSOC's determinations and recommended that FSOC "increase the analytical rigor of designation analyses."

3. **Lack of transparency.** The factors used to determine SIFI status are not weighted, and the decision-making process is extremely opaque. The Government Accountability Office (GAO) has at several junctures [reproached FSOC for its lack of transparency.](#)[11] The decision to designate (or de-designate) requires only the support of two-thirds of FSOC, and the decision to designate both MetLife and Prudential was made despite objections from the FSOC members with insurance experience and after a lack of consultation with state insurance regulators.[12] 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.[13] 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.
4. **FSOC's focus has been to punish, not to remediate.** As a company moves through FSOC's three-stage evaluation process, FSOC does not inform companies of what changes could be made to either their structure or operations to avoid designation. In the supplemental procedures adopted in 2015, FSOC made some effort toward increasing the amount of communication between firms under consideration and FSOC staff. Yet ultimately, FSOC 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 and then explore lower cost alternatives to designation. In meeting its aim of financial stability, FSOC should consider all the tools available instead of quickly moving to designation.

5. **The designation process has never involved a cost-benefit analysis.** 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.

The 2017 Treasury Report recommended that FSOC revise its guidance to specifically require a cost-benefit analysis.

6. **FSOC and its staff must continue actively to engage the public, experts, and stakeholders to examine comprehensively potential systemic threats, firm types, and changes in the financial economy environment as well as areas for FSOC procedural improvement.** In 2015, 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 change 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.

FSOC Proposes Amending Interpretive Guidance

It is in this context that last week FSOC voted unanimously to amend its interpretative guidance relating to the designation of NBFCs. FSOC has stated its intent to dedicate itself to a new approach that would replace entity-based designation with activities-based supervision. FSOC will also "enhance the analytical rigor and transparency of the Council's process for designating nonbank financial companies" and commit to the performance of cost-benefit analyses.^[14] This revision to the interpretative guidance, and all future revisions to internal procedures, will be made available for public comment—a welcome demonstration of willingness to continue engaging with all stakeholders.

Conclusions

The nonbank designation process is arbitrary, inconsistent, and opaque. Four years later the only thing that has changed is the exit of the last unwilling participant from this system. Now FSOC must consider its role as a regulator. The passing of the Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155)^[15] demonstrated the need and an appetite to redress the overreach of the Dodd-Frank Act. FSOC must redefine its mission, which must involve a shift from entity-specific regulation to activities-based regulation, or be disbanded as a regulator. FSOC's decision to amend its interpretative guidance is to be welcomed and we look forward to seeing how policy will evolve in this area.

- [1] <https://www.americanactionforum.org/testimony/fsoc-accountability-nonbank-designations/>
- [2] <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf>
- [3] 12 U.S.C. § 5323 (a)(1)
- [4] 12 U.S.C. § 5323 (a)(2)(K)
- [5] 12 U.S.C. § 5323 (a)(2), (b)(2)
- [6] <https://www.ft.com/content/31b36b9a-a662-11e7-93c5-648314d2c72c>
- [7] <https://www.americanactionforum.org/research/the-investor-cost-of-designating-investment-funds-as-systemically-important/>
- [8] <http://responsibleregulation.com/wpcontent/uploads/2013/05/Pricing-impact-study-Oliver-Wyman-April-10-2013.pdf>
- [9] <https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf>
- [10] <https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf>
- [11] <https://www.gao.gov/products/GAO-15-51>
- [12] [http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September 19 2013 Notational Vote.pdf](http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf) & [http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/December 18, 2014 Meeting Minutes.pdf](http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/December%2018%202014%20Meeting%20Minutes.pdf)
- [13] <http://bipartisanpolicy.org/library/report/dodd-frank's-missed-opportunity-road-map-more-effective-regulatory-architecture>
- [14] <https://home.treasury.gov/news/press-releases/sm621>
- [15] <https://www.congress.gov/bill/115th-congress/senate-bill/2155/text>