The FSOC’s Off-Ramp for the Systemically Important Financial Firm

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SUMMARY

The recent House-passed CHOICE Act includes the repeal of the authority of the Financial Stability Oversight Council to designate non-bank financial firms as systemically important and thus subject to the Fed’s oversight. This change to the post-financial crisis regulatory architecture is deeply unwise. Such authority is essential to the long-term maintenance of financial stability, because financial intermediation will increasingly move outside the current regulatory perimeter. This was demonstrated during the crisis itself, the acute phase of which was triggered by the failure of a non-bank financial firm, Lehman Brothers.

Moreover, repeal of the Orderly Liquidation Authority and its replacement with a bankruptcy alternative negatively interacts with this elimination of FSOC authority. This is because the proposed new bankruptcy provision, the Financial Institutions Bankruptcy Act, will fail without a specialized capital structure that would recapitalize a failing financial firm through a straightforward over-the-weekend conversion of debt into equity. Such a capital structure has been a consequence of the “living wills” requirement for large bank holding companies and non-bank financial firms designated by the FSOC. Elimination of FSOC designation authority will eliminate this resolution pre-planning for systemically important non-bank financial firms. The consequence of the elimination of FSOC authority alongside the substitution of bankruptcy for OLA is to leave the US exposed, once again, to the severe financial sector disruption of a Lehman Brothers-type failure.

Thus FSOC authority is essential for the maintenance of long-run stability in the US. The most effective way for FSOC to use its designation authority, however, is prospectively: to negotiate size, regulatory constraints, and resolution pre-planning with firms to avoid designation, because the optimal number of additional systemic firms is zero.

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Historically, national and international financial crises have been of two general types: foreign exchange and domestic banking. A foreign exchange crisis is rooted in the issuance of foreign-currency denominated debt by either a sovereign or a country’s private sector (or both). A contraction in the local economy or an adverse change in the exchange rate means that the sovereign or the private sector is unable to obtain foreign currency sufficient to pay off the debt. In consequence the public sector or the private sector (or both) will need to shrink rapidly. Think Argentina the country or various Argentinian private companies issuing dollar-denominated debt. The likely outcome is a sharp contraction in public sector spending (austerity) and asset sales, restructuring, or insolvency by private sector firms, producing a recession. When the dollar was convertible into gold at a fixed rate, the U.S. was also susceptible to foreign exchange crises.

A banking crisis generally arises from a credit-fueled asset bubble in which much of the banking sector faces insolvency when the bubble collapses and loans go unpaid. Insolvent banks will default on obligations to depositors and other creditors and of course can no longer funnel credit to businesses or consumers. Bank insolvencies can also disrupt the payments system, meaning that consumers and businesses lose the channels for making or receiving payments for goods and services. Before deposit insurance, the risk of bank insolvency could readily become self-fulfilling, because a run by self-protecting depositors could force the rapid sale of a bank’s assets at “fire sale” prices, producing insolvency even for relatively well-capitalized banks. Banking crises are commonly associated with real estate, in the belief that the supply inelasticity of real estate assets means that prices will invariably increase, but, as exemplified by the stock market crash of 1929, can be associated with any asset that investors mistakenly believe will always appreciate.

A critical fact about the global financial crisis of 2007-09 is that a banking crisis emerged outside of the traditional commercial banking sector. The investment bank Bear Stearns failed when short-term credit suppliers grew suspicious of the value of the mortgage-backed securities on its balance sheet. Lehman Brothers, another investment bank, failed because of similar suspicions about its commercial real estate assets. AIG, an insurance company, failed because it was unable to make good on its guarantees of mortgage-related derivatives. Reserve Primary Fund “failed” because the write-down of its credit extension to Lehman meant that it was unable to cover redemption requests by its own short-term claimants. Bear and AIG were, of course, rescued; Lehman was not. The crisis demonstrated that a significant portion of the U.S. “banking” system had migrated outside of the official commercial banking sector to institutions that operated through securities markets. Investment banks and money market funds performed all three “transformations” that characterize banking: credit, maturity, and liquidity; that is, the conversion of risk-laden, illiquid, long-term assets into short-term risk-free liabilities. The counterparty relationships that were sundered by the Lehman failure also revealed the existence of a private payments system that tied together financial firms.

Thus one of the most important lessons of the financial crisis was that systemic risk could arise outside of the official banking system. A further lesson was that reforms designed to protect the banking sector may prompt the migration of such systemic risk. For example, the Glass-Steagall Act was designed to protect the banking sector by separating commercial banks from securities market activities. In achieving this separation, Glass-Steagall also energized free-
standing investment banks to use securities markets to create functional substitutes for credit provided by commercial banks. A substitute banking system (the “shadow banking” system) emerged but without the oversight, deposit insurance, and public lender-of-last-resort backstop that we have come to think necessary to assure the stability of the banking sector. More generally, measures that strengthen the official commercial banking sector almost invariably produce financial innovation outside the official sector, with the goal of providing equivalent credit-intermediation while not bearing the financial stability costs.

The core regulatory problem is this: The maintenance of financial stability requires the adjustment of the regulatory perimeter to cover new financial intermediaries as they become systemically important. This is true for three reasons. First, the failure of such a large intermediary could eliminate an important credit channel for a significant group of borrowers. Second, its failure may well have knock-on effects for the official banking sector through balance sheet linkages or correlated asset holdings that will damage banks’ financial position. Banks may have extended credit to the new financial intermediary, either through a direct loan, purchase of a debt security, or purchase of an asset backed by the intermediary’s guarantee. Banks may have entered into contingent credit (or guarantee) arrangements with the intermediary. Banks may hold similar assets as the new intermediary, which are subject to abrupt devaluation as the troubled intermediary disposes of assets to meet claims of counterparties and the official sector hoards liquidity. Thus, directly and indirectly, the failure of such an institution will damage the real economy through an abrupt contraction in credit availability.

And third, the success of new intermediaries will presumably come at the expense of institutions in the official banking sector and will be attributable at least in part to a lighter, less costly regulatory burden. This competitive success will put pressure on the overseers of the official sector to relax regulatory constraints so that official banking institutions can compete, even though these costs were necessary to maintain financial stability. Thus financial stability free-riding by extra-perimeter systemically important financial intermediaries undercuts the capacity of regulators to maintain financial stability over the long term.

One of the most valuable, if imperfectly realized, achievements of the Dodd-Frank Act is the recognition of evolving systemic risks and the design of a regulatory apparatus to address this. The Act created a council of U.S. regulators, the Financial Stability Oversight Council (“FSOC”), which is charged with identifying “potential emerging threats to the financial stability of the United States.” FSOC was given a research arm, the Office of Financial Research, and also various tools to engage with these threats. One of the most important tools is the power to designate a non-bank financial institution as systemically important and subject it to “prudential standards” devised by the Board of Governors (of the Fed) and otherwise to the Fed’s supervision. To designate the non-bank firm for such treatment, the Council must “determine that material financial distress [at this firm], or the nature, scope, scale, concentration, interconnectedness, or mix of activities of [this firm] could pose a threat to the financial stability of the United States.” Let’s call this the designation of the firm as a systemically important financial institution, or “SIFI.” To guide FSOC in this determination, the Act specifies that FSOC “shall consider” ten wide-ranging “considerations” “and any other risk-related factors that the Council deems appropriate.” The Council’s designation decision is
reviewable, but the applicable standard of review is the deferential test of “arbitrary and capricious.”

This SIFI-designation authority has been controversial. Its opponents bring out the heavy artillery: The broad grant of discretion is said to be inconsistent with the rule of law, because by regulatory determination, a large financial firm can be made subject to a potentially stringent prudential regime of a regulator, the Fed, with whom it may have had no prior engagement. The proposed CHOICE legislation just moved forward by the House of Representatives would eliminate SIFI-designation, because it purportedly exemplifies “regulatory overreach,” “injects unprecedented levels of political risk into the financial system,” and under the guise of additional regulatory oversight, will instead create a new set of institutions that are “too big to fail.” One of the few designated firms, MetLife, challenged FSOC in court and achieved initial success (though an appeal is pending).

A major reason for the controversy over SIFI designation is that no one knows exactly what it entails. The Fed becomes a regulator of the designated firm, responsible for setting prudential standards and engaging in supervision, but it has significant flexibility in fulfilling these tasks. The Council has a mandate to offer “recommendations” to the Fed, including recommendations tailored to the designated firm’s business. The Fed is invited to “consult” with the Council about alternatives to risk-based capital and leverage that achieve “similarly stringent” risk control. The Fed is required to “consult” with the primary “functional” regulator of the subject firm (if any). Nevertheless, the Fed has the last word on the substance of the standards and the nature of the supervision. The only statutory structural requirement is that the designated firm must prepare a “living will” for its resolution in bankruptcy, just like the large bank holding companies that were designated as systemically important under the Dodd-Frank Act.

The concern that the Fed will apply bank-like capital and liquidity standards to every designated SIFI, no matter its business model, has created much of the resistance to the FSOC’s designation power, whether or not such fears are justified. The discretion granted to the Fed for “tailored application,” necessary in the circumstances, is an incomplete solution.

This analysis of FSOC designation authority misunderstands how the FSOC scheme should function. The key point is this: The optimal number of new SIFIs is zero. The FSOC designation process and the subsequent annual review for each designated SIFI is designed to

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2 “CHOICE” is an acronym for “Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs.”
5 See generally DFA § 165
6 DFA §§ 115, 165 (a)(1)
7 DFA §§ 115(a)(3), 165 (a)(2)(A)
8 DFA § 165(b)(1)(A)
9 DFA § 165(b)(4).
10 DFA § 165(b)(1)
11 DFA § 165(a)(2) (caption of section)
provide an off-ramp for firms whose size, business strategy, interconnectedness, and other characteristics would raise questions about their systemic import. In other words, the FSOC’s designation authority becomes the mechanism for avoiding the creation (or continuation) of firms that are “too big to fail.” The designation process is a way to identify systemic concerns and to give firms the opportunity to mitigate them. It is not a mechanism by which new classes of financial firms are ported over to the Fed for regulation and supervision.

Moreover, FSOC’s designation authority often spurs other regulators to expand their perimeters and set stability-promoting standards. One example is the recent program of the Comptroller of the Currency to offer special national banking charters to fintech firms, which could bring some prudential oversight to this rapidly expanding sector.12 The recent initiative of the SEC to require mutual funds to plan for adequate liquidity buffers came in response to FSOC’s investigation of systemic concerns in asset management.13 Liquidity buffers reduce the risk of runs and fire sale dispositions that could have knock-on effects to other financial institutions holding similar assets. FSOC’s possible designation of particular asset managers prompted the SEC’s action, which aims to reduce systemic risk by other means.

Understanding how FSOC’s designation authority can best discourage the creation or maintenance of a SIFI requires looking at both at the statutory mandate and a “Three Stage Process” described in FSOC’s interpretive guidance.14 In Stage 1, FSOC will use quantitative thresholds to identify a set of nonbank financial firms “that merit further evaluation,” in particular a consolidated asset threshold ($50 billion) plus one other quantitative measure in specific categories pertaining to the firm’s size or risk appetite (such as leverage or short term funding). In Stage 2, each firm identified in Stage 1 will be subject to analysis of its potential threat to US financial stability, using existing public and regulatory resources. For firms that present a prima facie case for designation after Stage 2, FSOC will collect information directly from the particular firm, including, presumably, proprietary information; this is Stage 3. Based on its assessment, FSOC may move to a “Proposed Determination” that the firm presents a risk to financial stability that requires oversight by the Fed. Before the determination becomes final, FSOC must provide notice to the candidate firm, “including an explanation of the basis of the proposed determination.” The firm is entitled to respond with written submissions and, at the Council’s invitation, oral testimony and argument.

Consider the factors that FSOC says it will consider in Stage 3, in addition to the quantifiable ones, that “could mitigate or aggravate” the firm’s potential threat to financial stability: “the opacity of the [firm’s] operations, its complexity, and the extent to which it is subject to existing regulatory scrutiny and the nature of such scrutiny.” The analysis will include “an evaluation of the [firm’s] resolvability … [which] entails an assessment of the complexity of

14 See 12 CFR § 1310 and Appendix thereto, and discussion at 77 Fed. Reg. 21637-21662
the [firm’s] legal, funding, and operational structure, and any obstacles to the rapid and orderly resolution of the [firm].” Resolvability factors include “legal entity and cross-border operations issues;” “the ability to separate functions and spin off services or business lines; the likelihood of preserving franchise value in a recovery or resolution scenario, and of maintaining critical services within the existing or in a new legal entity or structure; the degree of the [firm’s] intra-group dependency for liquidity and funding, payment operation, and risk management needs; and the size and nature of the [firm’s] intra-group transactions.”

Each of these elements is an invitation to the targeted firm to try to eliminate its threat to financial stability and avoid a designation. The firm can restructure to reduce its systemic profile; subject itself to regulatory oversight as a substitute for the Fed (e.g., OCC for fintech firms); and, in particular, subject itself to a “living wills” process designed to facilitate the resolution of a significant financial firm. In other words, the FSOC review process is designed to avoid designation by giving a firm the opportunity to address the issues that trouble FSOC. The targeted firm and FSOC can negotiate a solution that mitigates the systemic risk that would otherwise call for the Fed’s oversight. One analogy is Justice Department review of a significant merger: The parties and the Department negotiate to look for acceptable accommodation to antitrust concerns before the Department brings an enforcement action. There is no serious criticism that this practice, which is common to competition regimes world-wide, is inconsistent with the rule of law. The interaction between FSOC, the targeted firm, and the Fed is quite similar.

Even after designation, the non-bank financial firm is entitled to annual review of its designation. This too is an invitation for the designated firm to address FSOC’s financial stability concern. The goal of the FSOC designation process is to avoid the creation or maintenance of systemically important firms. Subjecting non-bank financial firms to the Fed’s oversight is a backup where accommodation cannot be found. In short, the FSOC process is set up to provide off-ramps from designation.

Evidence for this dynamic is in FSOC’s designation of GE Capital in July 2013 and its rescission of that determination in June 2016. The basis for the initial determination was straightforward: GE Capital, a wholly owned subsidiary of General Electric Corp., was “one of the largest financial services companies in the United States, ranked by assets,” $539 billion as of yearend 2012, and was “a significant source of credit to the US economy,” extending credit to 243,000 commercial customers, 201,000 small businesses, and 57 million consumers. Through many different channels, “material financial distress at the company, if it were to occur, could pose a threat to U.S. financial stability.”

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16 DFA § 113(d).
Yet over the subsequent three years, “GE Capital has fundamentally changed its business model. Through a series of divestitures, a transformation of its funding model, and a corporate reorganization, the company has become a much less significant participant in financial markets and the economy. GE Capital has decreased its total assets by over 50 percent, shifted away from short-term funding, and reduced its interconnectedness with large financial institutions. Further, the company no longer owns any U.S. depository institutions and does not provide financing to consumers or small business customers in the United States.”19 The 2016 rescission decision described how company officials met with Council staff regarding how it might undertake strategic actions that would reduce its systemic risk. In short, in response to guidance by FSOC, the company steered away from those activities and mechanisms that would render its failure a systemic threat. The head of GE Capital said the decision reflected the transformation of GE Capital into a “smaller, safer financial services company.”20 It was once a SIFI but no longer.21 And the American economy is now more stable because of the change.

Moreover, the Fed played a role in this process of negotiated un-designation. It both issued enhanced prudential standards for GE Capital and substantially suspended them while the company was in the process of restructuring.22

In sum, GE Capital’s travels through the FSOC designation process underscore that the ultimate goal is to reduce the number of systemically important financial institutions, not to increase the Fed’s regulatory reach and regulatory burden. Presumably all sides of the debate can embrace this objective. Those who think that SIFI designation means the firm will be regarded as “too big to fail” and thus a bailout candidate should welcome a process aimed at reducing the number of firms that are “systemic.” Those who think that FSOC needs to expand the regulatory perimeter to protect financial stability should appreciate that ex ante reduction of systemic risk is better than greater ex post regulation. The key legislative fact is this: FSOC’s designation authority is essential to this dynamic. The credible possibility of designation is what disciplines managerial decisions about the size, scope, leverage, and interconnectedness of a financial firm’s activities.

Thus FSOC’s designation authority can play a major role in maintaining financial stability over the long term. FSOC intervention (or its threat) can help keep some firms below the systemic threshold, induce some firms to back-off if they have crossed it, and lead other regulators to constrain some of the systemically-risky behavior of firms that they oversee. In short, there will be fewer SIFIs with FSOC-designation authority than without. And for firms that are unavoidably systemic, FSOC designation (and Fed oversight) will be very important.

19 Id., p. 2.
21 A similar process of down-sizing and restructuring is underway in the case of MetLife, which is separating its U.S. individual life insurance business from its remaining insurance and financial-services businesses. This is described in Form 10-K, Brighthouse Life Insurance Co, FY 2016 (March 28, 2017), available through the SEC’s EDGAR site. For current developments, see Leslie Scism, “MetLife Closer to Spinning Off U.S. Life Insurance Business,” Wall St. Journal, June 28, 2017.
Interaction with OLA Repeal

In light of the proposed repeal of “Orderly Liquidation Authority,” Title II of the Dodd-Frank Act, it is important to emphasize the critical role of the FSOC’s designation authority in maintaining financial stability in a post-OLA regime. The CHOICE act would repeal OLA and replace it with a new chapter of the Bankruptcy Code designed specifically for the orderly resolution of financial firms, the Financial Institutions Bankruptcy Act (“FIBA”). Whether this charged-up bankruptcy regime could, in present form, successfully address the failure of a large financial firm, especially one with global reach, is a matter of some doubt. There is no doubt, however, that the success of a post-OLA bankruptcy regime depends upon a capital and organizational structure in which specific forms of debt can be readily converted into equity so as to recapitalize the failed financial firm and avoid a disorderly unraveling that will spread to other financial firms and then the real economy. Such a capital and organizational structure is generated as part of the “living wills” requirement imposed on systemically important firms by Dodd-Frank, § 165(d). Large bank holding companies are made subject to the living wills process automatically under Title I of Dodd-Frank. But it is FSOC’s designation authority that brings systemically important non-bank financial firms to the living wills process. As the FSOC/Stage 3 language quoted above indicates, the firm’s “resolvability” is one of the critical elements of an FSOC determination.

Without resolution pre-planning, a bankruptcy proceeding for a large financial firm is doomed to failure even using the FIBA provisions, and the consequences will be severe. The fall-out will be exacerbated in the case of a failed global non-bank financial firm. Foreign regulators will need assurance from their US counterparts that the FIBA-mechanism can function properly, but US authorities cannot provide that assurance if they have not been involved in checking for the specialized capital structure that bankruptcy needs to succeed. If OLA is repealed, FSOC’s designation authority, particularly if used in the “off-ramp” strategy that this paper suggests, is a critical element in avoiding a future financial crisis. The combination of OLA repeal and elimination of FSOC’s designation authority would leave the United States exposed, once again, to the financial disruption of a Lehman Brothers-type failure.

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