Financial Stability Oversight Council Reform Agenda

CENTER FOR CAPITAL MARKETS COMPETITIVENESS

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) created the Financial Stability Oversight Council (FSOC), composed of 10 voting members with diverse areas of expertise, to comprehensively monitor and mitigate threats to the U.S. financial system as well as ensure greater coordination among the array of financial regulators. While there was agreement that absent consolidation among the nearly two dozen financial regulators a body like FSOC tasked with assessing risks to the system would be needed, there was little agreement at the time about the best way to ensure systemic risks are identified and mitigated. In the over three years since FSOC's creation, we believe several fundamental shortcomings in the FSOC's structure and operations have been exposed.

For example, although FSOC was tasked with over a dozen assignments, including enhancing regulatory coordination, the systemic risk designation function appears to have dominated the FSOC's agenda. The FSOC has operated without the minimally necessary due process for effective regulation often relying on brief media "readouts" after meetings. Companies facing potential designation have little clarity about the lines between reasonable and unreasonable risk taking, what steps they can take to avoid crossing the line to designation, what designation would mean if they are designated, or what steps they could take in the future to become undesignated. And, although Congress anticipated the need for the FSOC to have access to independent, rigorous data and analytical insights to inform its decision making, the Office of Financial Research (OFR) has fallen far short of functioning in this role.

Structural shortcomings have been exposed as well. Although nine agencies are represented on FSOC, only the Chair of independent agencies participates in official council actions. The FSOC is thereby deprived of the balance and input from the diverse sets of expertise and experience that make up financial regulatory agencies.

In order to make the FSOC a more effective and transparent organization, we believe important changes must be made. We continue to believe that a well-functioning council of financial regulators can help ensure better regulatory outcomes that will both enhance financial stability and ensure our nation's economy and job creators benefit from efficient, robust, transparent, and well-regulated capital markets.

The FSOC Reform Agenda is organized into the following recommendations:

- Strengthen Evidence-Based Analysis
- Modify FSOC's Structure to Improve Effectiveness
- Address Unfilled Responsibilities: Regulatory Efficiency
- Reform the Systemic Risk Designation Process By Establishing Clear Rules of Due Process

Strengthen Evidence-Based Analysis

- **Improve OFR's Empirical and Analytical Reports:** OFR was designed to be an independent body that supports FSOC and the member agencies by accessing and analyzing the vast financial data and information collected by primary regulators as well as filling data gaps OFR identifies. The OFR Director serves a six-year term and has full discretion over how best to perform the congressionally mandated responsibilities. Much like the GAO provides empirical research and analysis for the government broadly, OFR was designed to serve as an independent analytical agency to better inform the FSOC. Unfortunately, OFR has not yet lived up to this objective. For example, its recent report on asset management is woefully incomplete and appears to have been developed without the benefit of the best available or sufficient data. While it is probably true that OFR's full capabilities are still being developed, this work must be accelerated.

- **OFR Should Coordinate Data Collection Amongst Multiple Agencies:** OFR is supposed to standardize the data collected by the council to produce better-informed analysis for the council and to eliminate duplicative burdens on companies. OFR has failed to leverage the existing expertise and data of the primary regulators and industry.

- **Increase OFR Oversight:** OFR's budget should be subject to Congressional oversight through the formal appropriations process. We believe appropriate checks and balances lead to stronger and more effective agencies that spend taxpayer money wisely.

Modify FSOC's Structure to Improve Effectiveness

- **Enhance FSOC Representation:** The diverse expertise and views of multi-member independent agencies, commissions, and boards should be fully represented on the FSOC rather than the just those of the heads of each agency. The voting members of FSOC representing multi-member commissions or boards should be encouraged rather than prevented from obtaining input from the full commission or board. Staff of other commissioners and board members should be included in staff-level FSOC working groups. The agencies represented on FSOC were often deliberately structured to include diverse expertise and political backgrounds, and FSOC would benefit from this broader input.

- **Change Voting Threshold:** FSOC's actions, including the designation of a nonbank financial company as a systemically important financial institution (SIFI), will have significant implications. Therefore, any action taken by FSOC should require the affirmative vote of at least three quarters of the council to ensure that a diverse set of views is represented. In the case of a designation vote, if the primary regulator or independent council member does not vote in favor of designating a non-bank financial company for which the council member has industry expertise or the council member's agency already overseas, then a second vote shall be scheduled within 45 days. The primary regulator shall issue a report to the FSOC within 30 days of the initial vote explaining its rationale as to why a firm should not be designated. When a second vote is required, an entity can be designated, even if the primary regulator or the council member with industry expertise once again votes against designation.

- **Empower Primary Regulators:** The prudential regulator of nonbank SIFIs should be the companies' primary regulator, which has expertise in the relevant industry.

Address Unfilled Responsibilities: Regulatory Efficiency

- **Coordinate and Streamline Regulatory Agencies:** In addition to its designation responsibilities, Congress anticipated FSOC would take on a broader coordination role among regulators to identify gaps in regulation, as well as minimize regulatory conflicts and duplication. To ensure effective and efficient regulation FSOC should:
  - **Create a regulatory conflicts "window"** with the goal of harmonizing conflicting regulations among agencies. FSOC should prioritize addressing and soliciting input to help it minimize regulatory conflicts. For example, regulations designed to encourage small business lending can be undermined by other regulations seeking to limit bank risk-taking.
  - **Streamline duplicative regulations**, **reporting, and oversight** of entities so companies are not required to submit similar information to multiple agencies.
  - **Modernize outdated regulations** by determining which are no longer effective and working with regulators, in accordance to Executive Orders 13563 and 13579, to sunset obsolete regulations.
  - **Identify and fill regulatory gaps** to ensure the financial system is regulated holistically.
  - **Monitor and mitigate cumulative impacts** of regulations across the entire system to ensure that regulation at large fosters capital formation and market efficiency.

Reform the Systemic Risk Designation Process By Establishing Clear Rules of Due Process

- **Refine the Systemic Risk Designation Process:** FSOC should refrain from any final SIFI designations for nonbank financial companies until all systemic risk rules adhere to the limits Congress enunciated on FSOC's designation authority. Specifically, the Federal Reserve should adhere strictly to boundaries set by Congress in Dodd-Frank with regard to defining the universe of nonbank financial companies eligible for SIFI designation in the predominantly engaged in financial activities rule.

- **Clarify and Implement Due Process Before Designations:** FSOC should provide clarity on its processes and criteria for designation and other decisions. For example, prior to the council considering specific nonbank financial companies, the companies should be informed what behaviors and activities the council considers systemically risky and what the consequences and obligations of designation would be. Companies should then be able to decide whether to curtail or modify those activities to avoid designation.

- **Improve Accountability:** FSOC should bear the burden of proof that a company poses a threat to the financial stability of the United States and that designation, as a last resort, is the only effective tool available to address the perceived threats. Moreover, the FSOC should evaluate the consequences of designation for each company prior to designation—and annually thereafter to ensure that designation and enhanced prudential standards continue to be appropriate and necessary.

- **Increase Transparency on Metrics:** Consideration for designation includes meeting a $50 billion asset threshold and triggering of one of five metrics set by Congress. However, it is unclear how the council calculates, measures, or otherwise determines whether a potential designee has triggered any of the five metrics. FSOC should provide on its Web site, or through other means, guidance clarifying the method it uses to determine whether any of the five metrics have been met therefore advancing a company to stage two of the designation process.

- **Amend Systemic Risk Regulations to Fit Specific Industries:** Systemic risk regulation and orderly liquidation authority for nonbank financial companies should not be bank-centric. Instead, they should be tailored to the business model and industry realities of the designated company to prevent policies that may cause unnecessary market disruptions. While regulators have indicated the intent to pursue this approach, designations have proceeded without any clarity on how this will work.

- **Create a Path for Un-Designation:** FSOC should determine the appropriate criteria and processes for nonbank SIFIs to reverse their designation and no longer be subject to enhanced prudential standards and heightened supervision by the Federal Reserve.

- **Ensure Confidentiality:** The names of companies discussed during closed FSOC meetings should remain confidential to mitigate any potential market reaction or reputational damage to the company; as such discussions may be based on initial conversations and incomplete analysis. In addition, FSOC and OFR should continue to safeguard the confidentiality of proprietary and consumer information gathered from data requests and examinations of regulatory agencies and individual companies.