BIPARTISAN POLICY CENTER

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"FSOC Accountability: Nonbank Designations"

Committee on Banking, Housing, and Urban Affairs

U.S. Senate

March 25, 2015

The Bipartisan Policy Center's (BPC) Financial Regulatory Reform Initiative (FRRI) was launched in 2012 to assess the Dodd-Frank Act: what is working, what is not working, and how financial regulation and supervision can be improved. Over the last three years, the performance of the Financial Stability Oversight Council (FSOC) has been a key area of our research and focus.

As part of this effort, BPC recently analyzed and summarized 56 recommendations by stakeholders with a range of perspectives on ways to improve the FSOC. The proposals included ideas to enhance transparency and communications with the public, improve the "systemically important financial institution", or SIFI, designation process, strengthen communications with market participants and further develop the "de-designation process" for nonbank firms already designated by FSOC as SIFIs. (A copy of this FSOC Reform Overview is attached as an addendum to this testimony.)

In an effort to improve its processes, FSOC recently solicited reform ideas from outside stakeholders, including BPC. In January, the Council adopted a series of measures designed to improve transparency, strengthen communications, and enhance its designation and de-designation processes. These reforms are important steps in the right direction and FSOC should be applauded for taking them. Despite these initial, incremental steps, FSOC still has a long way to go in order to address legitimate concerns regarding its opaque processes, to improve its communication with companies under consideration for SIFI designation and those already designated, and to create a robust and implementable de-

designation process. If it is to fulfill its core missions of improving regulatory coordination and mitigating risks to the financial system, FSOC must continue to evolve.

Let me turn to two specific areas where there is room for improvement — public transparency and SIFI de-designation —while noting that BPC research has recommended several other reform measures that FSOC should adopt to improve its operations.[1]

Enhancing Public Transparency

FSOC has struggled to find the proper level of transparency with both the public and the nonbank companies under consideration for designation as SIFIs. In particular, FSOC has been wary of communicating with the public in real time. At first, minutes from FSOC meetings were essentially lists of attendees and broad topics of conversation with no real insight into what was discussed. Topics the Council would have likely discussed due to their potential impact on financial stability, such as the potential systemic consequences from a possible default on Puerto Rican debt, were simply not mentioned in the minutes. This stands in sharp contrast to the minutes published by the Federal Reserve's Federal Open Markets Committee (FOMC), which releases detailed insights into its conversations on issues that can have similar market-moving implications. The BPC recommended in April 2014 that FSOC improve the quality of its minutes, using the FOMC as a model.[2]

In May 2014, FSOC, to its credit, committed to release more detailed minutes. While the minutes have improved in quality since then, they remain inadequate and insufficient. For example, at January's FSOC meeting, the only mention of the financial stability impact of the sharp decline in the price of oil which had just occurred is at the end of a sentence summarizing concerns relating to leveraged lending and speculative-grade debt. It stated:

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[1] John Dugan, Peter Fisher and Cantwell Muckenfuss III. *Responding to Systemic Risk: Restoring the Balance.* Bipartisan Policy Center. September 2014. 38-53. http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/BPC%20Responding%20to%20Systemic%20Risk.pdf.

[2] Richard Neiman and Mark Olson. *Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture.* Bipartisan Policy Center. April 2014. 42. http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/BPC%20Dodd-Frank%20Missed%20Opportunity.pdf.

"Members of the Council then asked questions on topics including implications of the decline in oil prices, and had a discussion."[3]

It is not clear what views, if any, were expressed by any of the members of the Council on the subject at hand. All we know is that there was a discussion, with no insight into what actually was discussed.

In stark contrast, the FOMC's January minutes devote an entire paragraph to specific staff reports on potential risks to financial stability with a detailed discussion that included a cogent analysis on the effect of the decline in oil prices on financial stability: "The effects on the largest banking firms of the sharp decline in oil prices and developments in foreign exchange markets appeared limited, although other institutions with more concentrated exposures could face strains if oil prices remain at current levels for a prolonged period."[4]

FSOC should take two further simple steps to improve the quality of its minutes:

First, instead of identifying a regulator but not the substance of his or her comments in its minutes, the Council should do the reverse, instead adopt the FOMC's "Chatham House Rules" approach to recording the minutes of its meetings. The minutes should convey substance of conversation but not identify the individual speakers who made specific remarks.

Second, FSOC should prepare detailed, substantive minutes, and then only allow member agencies to edit portions that are substantively inaccurate or would reveal sensitive or proprietary information. In other words, the Council needs to produce detailed minutes and set a higher bar to redact information in order to avoid the minutes devolving into the "lowest common denominator" of agreement among the ten voting members.

More broadly, FSOC should also improve its communication with outside stakeholders. Late last year, the Council engaged with stakeholders, including BPC, on ways to improve the SIFI designation and de-designation processes – an

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[3] "Minutes of the Financial Stability Oversight Council." Financial Stability Oversight Council. January 21, 2015. http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/January%2021,%202015-Minutes.pdf.

[4] Thomas Laubach. "Minutes of the Federal Open Market Committee." Board of Governors of the Federal Reserve System. January 27-28, 2015. http://www.federalreserve.gov/monetarypolicy/fomcminutes20150128.htm.

outreach effort that resulted in many of the positive steps described above. However, it remains to be seen whether this outreach was a one-time endeavor, or whether FSOC will engage in semi-regular outreach or even establish a formal and regular pattern of engagement with a wide variety of outside stakeholders. We urge FSOC to build on its recent progress and formalize its stakeholder outreach efforts.

Developing a More Formal De-Designation Process

Once a nonbank firm has been designated as a SIFI, Dodd-Frank envisions a process by which a firm may be de-designated if it no longer poses a significant threat to financial stability. Because the SIFI framework is new and the designation process has generally been lengthy, we have yet to see a firm be de-designated. This is not troubling. What would be troubling is if no real process emerges that would ever realistically allow for a de-designation to occur. It is also not clear whether there is full commitment by FSOC and all of its members to the intent of Congress that de-designation be an important and necessary component to the new systemically focused regulatory framework.

BPC was pleased that FSOC highlighted the question of how to look at de-designation during its recent engagement with stakeholders. FSOC said that the changes it adopted earlier this year would "create a clearer and more robust process for the Council's annual reviews of its designations."[5] This is another step in the right direction. However, many details as to how exactly this will occur remain unanswered:

- What are the metrics by which FSOC will review a SIFI's designation?
- How much detail and clarity will be given to companies as to why they were designated?
- Will the same FSOC staff that recommended designation be responsible for annual reviews?
- What will be the role of the Federal Reserve, which through designation became each SIFI's primary regulator where it was not prior to designation?
- Is conducting annual reviews the most appropriate time frame, and should each review be conducted the same way?

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[5] "Financial Stability Oversight Council Announces Changes to Nonbank Designations Process," Financial Stability Oversight Council, press release, February 4, 2015, on the U.S. Department of the Treasury website, http://www.treasury.gov/press-center/press-releases/Pages/jl9766.aspx, accessed March 23, 2015.

- Is the current system, that a firm is designated as a SIFI in perpetuity and can only lose that status via de-designation, the right framework or should SIFI designations be sunset to force a more thorough review?
- Is de-designation something a SIFI can reasonably expect to achieve if it sufficiently reduces its systemic risk, or is it a "Hotel California," pro forma process with no viable exit?

BPC is actively engaged in research attempting to answer these and related questions. We hope to publish our recommendations later this year. We believe that this is an important issue and hope that FSOC remains committed to producing additional work, including making clear to the public what metrics are involved in the de-designation process. It also may yield additional benefits. One way FSOC could clarify how the *designation* process works is by clarifying how the *de-designation* process works.

CONCLUSION:

When BPC began its work three years ago, we wrote that the creation of FSOC "has the potential to be the crown jewel of Dodd-Frank."[6] We still think it can be. Yet, FSOC is still very much a work in progress with significant room to improve its processes, communication, transparency, and operations. We urge the Council and Congress to carefully consider these recommendations as well as many of the other thoughtful reform measures proposed by other stakeholders. If we can improve transparency, accountability, and efficacy of this important institution, we can help FSOC live up to its potential – and enable this "crown jewel" of Dodd-Frank to shine.

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[6] Dr. Martin Neil Baily, Dr. Phillip Swagel and Aaron Klein. *Promoting Financial Stability and Economic Growth: An Introduction to the Bipartisan Policy Center's Financial Regulatory Reform Initiative*. Bipartisan Policy Center, October 2012. Available at: http://bipartisanpolicy.org/wp-content/uploads/sites/default/files/FRRI%20White%20Paper.pdf.