

V. *The Financial Stability Oversight Council*

A. Introduction

In July 2010, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), Congress created a new agency attached to the U.S. Treasury Department: the Financial Stability Oversight Council (“FSOC”).¹ As the first-ever systemic regulator, the FSOC is charged with identifying potential risks that could harm the financial stability of the United States and finding gaps in current regulation that could allow systemic risks to arise.² The FSOC is the largest agency comprised of ex officio members ever to be created by Congress.³ Chaired by the Secretary of the Treasury, the FSOC is comprised of ten voting members and five non-voting members, most of whom represent the heads of the federal financial regulators.⁴ Under the Dodd-Frank Act, the primary responsibility of the FSOC is to identify non-bank financial firms that pose a risk to the stability of the United States and designate these firms as systemically risky financial institutions (“SIFIs”).⁵ If designated as a SIFI, the Board of Governors of the Federal Reserve System (“FRB”) will subject the SIFI to heightened prudential oversight.⁶

In this development article, I explore whether the FSOC will be effective at promoting stability or whether it is simply more bureaucracy. Part B provides an overview of the mission of the

¹ SUSAN BERSON & DAVE BERSON, *THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT—FROM LEGISLATION TO IMPLEMENTATION TO LITIGATION*, 159 (American Bar Association 2012).

² Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), Pub. L. No. 111-203, §112(a), 124 Stat. 1376, 1394-96 (2010) (to be codified at 15 U.S.C. § 5322).

³ John Hawke, Jr., *Will the FSOC Be a Bully or a Band of Equals*, AMERICAN BANKER (Dec. 7, 2011, 1:54 PM), available at <http://www.americanbanker.com/bankthink/will-the-financial-stability-oversight-council-bully-or-band-of-equals-1044674-1.html>.

⁴ Dodd-Frank Act §111.

⁵ See Jill Fisch & Eric Roiter, *A Floating NAV for Money Market Funds: Fix or Fantasy?* 21 (Univ. of Penn. Law Sch. Inst. For Law & Econ., Working Paper No. 11-30, 2011), available at <http://ssrn.com/abstract=1923828> (discussing how FSOC rules may affect money market fund regulation).

⁶ Dodd-Frank Act §113.

FSOC and the Council's responsibilities. In Part C, I discuss the entities subject to FSOC regulation and the Council's proposed rule to regulate these institutions. Part D addresses whether it is possible to effectively regulate systemic risk. Part E explores the benefits and drawbacks of the chosen Council structure. Finally, Part F concludes by discussing the future of the FSOC.

B. The Early-Warning System: FSOC Mission and Responsibilities

By the time the Dodd-Frank Act got its start in March 2009, American taxpayers were demanding a solution to the “too big to fail problem,” one that prevented the government from using taxpayer dollars to bail out an ailing financial institution.⁷ The creation of the FSOC was part of the solution to prevent future government bailouts.⁸ The three goals of the FSOC are to: “(1) identify risks to the financial system that may arise from large, complex financial institutions; (2) promote market discipline by reducing expectations of federal support for failing institutions; and (3) respond to emerging threats to the stability of the U.S. financial system.”⁹ Additionally, the FSOC must identify and designate financial market utilities (“FMUs”), payment clearing, and settlement activities that are, or are likely to become, systemically important.¹⁰ The FSOC is also responsible for directing the Office of Financial Research (“OFR”) to collect information and analyze the Council's perceived systemic threats.¹¹

⁷ DAVID SKEEL, *THE NEW FINANCIAL DEAL: UNDERSTANDING DODD-FRANK AND ITS (UNINTENDED) CONSEQUENCES* 3 (2011).

⁸ *See id.*

⁹ *See* EDWARD V. MURPHY & MICHAEL B. Bernier, CONG. RESEARCH SERV., CRS-R42083-1, *FINANCIAL STABILITY OVERSIGHT COUNCIL: A FRAMEWORK TO MITIGATE SYSTEMIC RISK* 4 (2011) [hereinafter *CRS Financial Stability*] (citing Dodd-Frank Act §112(a)(1)).

¹⁰ Steven Quinlivan, *FSOC Adopts Final Rule on Designation of Systemically Important Financial Market Utilities*, DODD-FRANK.COM (July 18, 2011), available at <http://dodd-frank.com/fsoc-adopts-final-rule-on-designation-of-systematically-important-financial-market-utilities/>.

¹¹ Dodd-Frank Act §153(a); *see* *CRS Financial Stability*, *supra* note 9, at 11.

The creation of a systemic risk regulator first arose in a report by the Group of Thirty in January 2009.¹² Led by Paul Volcker, one recommendation stated, “[a] legal regime should be established to provide regulators with authority to require early warning, prompt corrective actions, and orderly closings of regulated banking organizations, and other systemically significant regulated financial institutions.”¹³ The concept of an early warning system that allowed regulators to identify market risks in advance and take the necessary action to head them off was attractive to members of Congress.¹⁴ Overall, the FSOC was seen as a way to give regulators more control over the financial system as a whole.¹⁵ Indeed, in a speech on the Senate Floor in 2010, Senator Dodd said, “[w]e have established what we call a systemic risk council that will allow us to observe what is occurring on a regular basis so we can spot these problems before they metastasize and grow into, as we have seen, problems that created as much harm for our economy as the present recession has.”¹⁶

The broad mandate of the FSOC allows the Council to take a variety of actions to head off systemic risk.¹⁷ To take any action, though, the FSOC must have an affirmative vote of the majority members.¹⁸ However, designating an institution as a SIFI requires an

¹² The Group of Thirty, *Financial Reform a Framework for Financial Stability* (Jan. 15, 2009), available at fic.wharton.upenn.edu/fic/policy%20page/G30Report.pdf.

¹³ *Id.* at 67.

¹⁴ See Donald N. Lamson & Hilary Allen, *Financial Stability Oversight Council: All New or Deja Vu?*, BNA BANKING REPORT (May 24, 2011).

¹⁵ Peter J. Wallison, *Magical Thinking: The Latest Regulation from the Financial Stability Oversight Council*, AM. ENTER. INST. (Oct.-Nov. 2011), available at <http://www.aei.org/article/magical-thinking-the-latest-regulation-from-the-financial-stability-oversight-council/>.

¹⁶ *Id.* (quoting S. REP. NO. 2773 (2010) (statement of Chris Dodd)).

¹⁷ The FSOC is responsible for recommending heightened prudential standards for SIFIs to the Fed. in the areas of: (i) capital requirements, (ii) liquidity requirements, (iii) resolution plans, (iv) credit exposure requirements, (v) concentration limits, (vi) contingent capital requirements, (vii) enhanced public disclosures, (viii) short-term debt limits, and (x) risk management requirements. See Dodd-Frank Act, Pub. L. No. 111-203, §115(b)(1), 124 Stat. 1376, 1403 (2010) (to be codified at 15 U.S.C. § 5325).

¹⁸ *Id.* §113.

even greater majority; a two-thirds vote is required, and the Secretary must join in that vote.¹⁹

C. Entities Subject to FSOC Regulation

1. Large Bank Holding Companies

Large bank holding companies (“BHCs”) are automatically subject to FSOC regulations.²⁰ Under the Dodd-Frank Act, large BHCs that have total consolidated assets of \$50 billion or more and are presumed to be systemically risky.²¹

2. Systemically Important Financial Institutions

In addition to large BHCs, the FSOC may also designate SIFIs for increased regulation.²² Section 113 of the Dodd-Frank Act requires that a SIFI must be a “U.S. nonbank financial company” or a “foreign nonbank financial company” that is “predominantly engaged in financial activities” and whose “material financial distress . . . could pose a threat to the financial stability of the United States.”²³ The Dodd-Frank Act lists several vague considerations for the Council to consider in designating a firm as a SIFI.²⁴ Factors include: “the nature, scope, size, scale, concentration, interconnectedness, and mix of [the firm’s] activities”²⁵ Additionally, the Act advises the Council to consider firms with excessive leverage, off-balance-sheet exposures, dependence on short-term funding, and assets that are managed rather than owned.²⁶

¹⁹ *Id.*

²⁰ *Id.* §165.

²¹ *Id.*

²² *Id.* §113.

²³ *Id.*; *see also* §102(a)(4)(B)(i)-(ii). Dodd-Frank defines a company “predominantly engaged in financial activities” as any company who derives at least 85% of annual consolidated gross revenue from financial activities or at least 85% of consolidated assets consist of financial assets. *Id.* §102(a)(D)(6)(A)-(B).

²⁴ *Id.* §113(a)(2).

²⁵ *Id.* §113(a)(2)(G).

²⁶ *Id.* §113(a)(2)(A), (B), (F), (J).

On October 18, 2011, the FSOC published its second notice of proposed rulemaking regarding the criteria that should inform the designation of a SIFI.²⁷ The Council's first proposed rule received criticism for essentially repeating the statutory language of Dodd-Frank verbatim and for not including any specific metrics for designating SIFIs.²⁸ The second proposed rule attempts to clarify the SIFI designation process by using a three-stage evaluation process to identify companies that pose the greatest threat to U.S. financial stability.²⁹ The first-stage of the evaluation process uses uniform quantitative metrics to narrow down nonbank financial companies for further evaluation.³⁰ In the second-stage, the FSOC conducts a "robust analysis of the potential threat" using quantitative and qualitative information available to the Council.³¹ Finally, in the third-stage, the FSOC will formally notify the nonbank financial institution that it has been selected for additional review and will be subject to an in-depth evaluation.³²

Although the second proposed rule is considerably more detailed than the first, commentators have expressed confusion with the three-stage process.³³ Some expressed a desire for more transparency in the designation process.³⁴ Others requested clarification of several key definitions.³⁵ Given that designation of SIFIs is arguably the biggest responsibility of the Council, how the

²⁷ See Notice of Proposed Rulemaking Regarding the Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64,264, 64,264 (proposed Oct. 18, 2011) (to be codified at 12 C.F.R. pt. 1310).

²⁸ See Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 4555, 4560-61 (proposed Jan. 26, 2011).

²⁹ Notice of Proposed Rulemaking Regarding the Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. at 64,269.

³⁰ *Id.*

³¹ *Id.* at 64,270.

³² *Id.* at 64,269.

³³ Wallison, *supra* note 15.

³⁴ See, e.g., Comment Letter from Douglas Lowenstein, President, Private Equity Growth Capital Council, to Timothy F. Geithner, Secretary, Dep't of Treasury (Feb. 25, 2011).

³⁵ See, e.g., Comment Letter from J. Stephen Zielezienski, Senior Vice President & General Counsel, American Insurance Association (Dec. 16, 2011).

Council proceeds with SIFI designation will influence whether the Council is an effective systemic risk regulator.

D. Is it Possible to Regulate Systemic Risk?

The 2008 financial crisis highlighted the flaws in the previous approach to systemic risk regulation.³⁶ It was no longer enough to protect individual banks from failure; the crisis demonstrated that other financial institutions (i.e. investment banks, hedge funds, mutual funds, and insurance) also contribute to systemic risk.³⁷ The creation of the FSOC reflected the focus on macroprudential regulation.³⁸ However, it is by no means clear whether it is possible to successfully identify or evaluate the causes of systemic risk.³⁹

One of the biggest challenges facing the FSOC is developing a precise definition of systemic risk.⁴⁰ Systemic risk is often viewed with a “you know it when you see it” approach.⁴¹ Recently, in a report to the G20 by the International Monetary Fund, systemic risk was defined as “the disruption to the flow of financial services that is: (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy.”⁴² The vagueness in this definition exemplifies the inherent difficulty in the FSOC’s broad mandate to identify

³⁶ MARC LABTONE, CONG. RESEARCH SERV., CRS-R40877, SYSTEMIC RISK AND THE FEDERAL RESERVE 2 (2009) [hereinafter CRS Systemic Risk] (discussing the need for a “macroprudential” regulator).

³⁷ Heidi Mandanis Schooner, *Private Enforcement of Systemic Risk Regulation*, 74 CREIGHTON L. REV. 993, 996 (2010).

³⁸ CRS Systemic Risk, *supra* note 36.

³⁹ Alex Pollack, *Is a ‘Systemic Risk Regulator’ Possible?*, THE AMERICAN (May 12, 2009), available at <http://american.com/archive/2009/may-2009/is-a-2018systemic-risk-regulator2019-possible/>; Dean Baker, *Making Financial Regulation Work: A Systemic Risk Regulator*, WASHINGTON POST (Jun. 22, 2009), available at http://voices.washingtonpost.com/hearing/2009/06/one_of_the_major_debates.html.

⁴⁰ International Monetary Fund, *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risk* 113 (Apr. 2009).

⁴¹ *Id.*

⁴² International Monetary Fund, *Guidance to Assess the Systemic Importance of Financial Institutions, Markets and Instruments: Initial Considerations* 5-6 (Oct. 2009).

“emerging threats to the stability of the United States financial system.”⁴³ The problem stems from the unpredictability of knowing when or under what circumstances the failure of a particular firm will cause a systemic breakdown.⁴⁴ It is impossible to identify ex ante all the potential sources of panic.

Many policymakers recognize that predicting systemic risk is an imperfect science but still believe the FSOC is a valuable reform initiative. It is certainly unrealistic to expect the FSOC to foresee all emerging threats or to prevent future bubbles. History has shown that business and credit cycles will continue.⁴⁵ Nevertheless, policymakers believe a goal of the FSOC should be to communicate candidly about the causes of systemic risk.⁴⁶ These discussions may allow the government to contain and limit the impact of emerging systemic threats.⁴⁷ An inherent problem with the responsibility designated to the Council is that it will be impossible to evaluate a systemic risk regulator.⁴⁸ In good years, it will be difficult to discern whether the outcome is due to the vigilance of the Council or rather a peak in our economic cycle.⁴⁹ While there is reason to be skeptical of the Council’s likelihood of success in predicting systemic risk, the 2008 financial crisis has shown that there is merit in trying to obtain a better understanding of emerging risks in the financial system.

⁴³ Dodd-Frank Act, Pub. L. No. 111-203, §112, 124 Stat. 1376, 1394-95 (2010) (to be codified at 15 U.S.C. § 5322).

⁴⁴ Peter J. Wallison, *TARP Baby: The Administration’s Resolution Authority for Nonbank Financial Firms*, AMERICAN ENTERPRISE INSTITUTE (Sept. 2009), available at <http://www.aei.org/article/economics/financial-services/tarp-baby-the-administrations-resolution-authority-for-nonbank-financial-firms/>. Tim Geithner, Chairman of the FSOC stated, “[C]reating effective, purely objective criteria for evaluating systemic risk is not possible . . . it depends too much on the state of the world at the time.” Chris V. Nicholson, *Citi’s Bailout: Ad Hoc Rescue for an Unwilling Bank*, N.Y. TIMES (Jan. 14, 2011), available at <http://dealbook.nytimes.com/2011/01/14/citis-bailout-ad-hoc-rescue-for-an-unwilling-bank/>.

⁴⁵ See generally CARMEN REINHART & KENNETH ROGOFF, *THIS TIME IS DIFFERENT—EIGHT CENTURIES OF FINANCIAL FOLLY* (2009) (describing the cycles of banking crisis).

⁴⁶ See Testimony of John Walsh, Chairman, Acting Comptroller of the Currency, Senate Committee of Banking, Housing, and Urban Affairs (May 12, 2011).

⁴⁷ *Id.*

⁴⁸ CRS Systemic Risk, *supra* note 36, at 23.

⁴⁹ *Id.*

E. FSOC Organizational Structure—Beneficial or Flawed?

In addition to the notoriety the FSOC received because of its broad mandate to designate SIFIs, the FSOC is also known for its unique organizational structure. To date, the FSOC is the largest multi-member agency made up entirely of ex officio members.⁵⁰ Voting members include: (i) Secretary of the Treasury; (ii) Chairman of the FRB; (iii) the Comptroller of the Currency; (iv) Chairman of the FDIC; (v) Director of the Bureau of Consumer Financial Protection; (vi) Chairman of the Securities and Exchange Commission (“SEC”); (vii) Chairman of the Commodity Futures Trading Commission (“CFTC”); (viii) the Director of the Federal Housing Finance Agency; (ix) Chairman of the National Credit Union Administration; (x) and an independent insurance expert appointed by the President.⁵¹ While there are many other multi-member agencies (i.e. the SEC, the FDIC, the CFTC, and the FRB), these agencies have members who only represent that agency.⁵² Here, the FSOC members are only part of the Council because of their positions with other federal agencies.⁵³ Proponents of the FSOC structure argue the design is aimed at leveraging the existing expertise of the member agencies and to promote the sharing of information.⁵⁴ Mary Schapiro, the Chairman of the SEC, noted that a multi-disciplinary group of financial regulators is critical in effectively assessing emerging systemic risks.⁵⁵

⁵⁰ Hawke, *supra* note 3.

⁵¹ Dodd-Frank Act, Pub. L. No. 111-203, §111, 124 Stat. 1376, 1392-94 (2010) (to be codified at 15 U.S.C. § 5321). Nonvoting members include: (i) Director of the Office of Financial Research; (ii) Director of the Federal Insurance Office; (iii) a State insurance commissioner; (iv) a State banking supervisor; (v) and a State securities commissioner. §111.

⁵² Hawke, *supra* note 3.

⁵³ *Id.*

⁵⁴ Statement of J. Nellie Liang, Director, Office of Financial Stability Policy & Research, Board of Governors of the Federal Reserve, Oversight of the Financial Stability Oversight Council, House Committee on Financial Services 15 (Apr. 14, 2011), *available at* financialservices.house.gov/UploadedFiles/112-26.pdf.

⁵⁵ Testimony of Mary Schapiro, Chairman, Sec. & Exch. Comm’n., Regulatory Perspectives on the Obama Administration’s Financial Regulatory Reform Proposals, House of Representatives Committee on

Aside from the Council's multi-disciplinary structure, many have questioned why Congress would stitch together a group of people with seemingly separate agendas rather than create a new agency or assign the task to an existing agency.⁵⁶ A chief criticism of the current makeup of the FSOC is that it closely resembles the failed President's Working Group on Financial Markets ("PWG").⁵⁷ Ronald Reagan created the PWG in 1988 in response to "Black Monday."⁵⁸ The role of the PWG was to give recommendations for solutions that would enhance the integrity and competitiveness of the U.S. financial markets.⁵⁹ The PWG is largely known for supporting the deregulation of financial institutions in the 1990's, a policy many have claimed helped cause the 2008 financial crisis.⁶⁰

Because the FSOC is a grouping of financial regulators, like the PWG, commentators are uncertain about the Council's organizational structure.⁶¹ While the FSOC's focus is on macroprudential issues, members may still vote in a way that protects the interests of their largest regulated constituents.⁶² The tendency of financial regulators to wage so-called "turf wars" demonstrates that the same incentives that exist in the private sector, exist in the public sector as well. Additionally, the FSOC's mission of cooperation and candid discussion could be undercut by disputes among members.⁶³ Similarly, the current structure of the FSOC may deter accountability amongst its members. The agency spreads power out among the nine

Financial Services (July 22, 2009), available at <http://www.sec.gov/news/testimony/2009/ts072209mls.htm>.

⁵⁶ CRS Systemic Risk, *supra* note 36, at 18.

⁵⁷ See generally Lamson & Allen, *supra* note 14 (discussing the roles of the FSOC and the PWG).

⁵⁸ See *id.*; see also Exec. Order No. 12,631, 3 C.F.R. 559 (1988). The PWG is comprised of the Treasury Secretary, the Chairman of the FRB, and the Chairman of the SEC. Exec. Order No. 12,631, 3 C.F.R. 559 (1988).

⁵⁹ See Exec. Order No. 12,631, 3 C.F.R. 559 (1988).

⁶⁰ FINANCIAL CRISIS INQUIRY REPORT, FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES 58 (2011).

⁶¹ See, e.g., Lamson & Allen, *supra* note 14, at 4.

⁶² See generally, Arthur E. Wilmarth Jr., *The Financial Services Industry's Misguided Quest to Undermine the Consumer Financial Protection Bureau*, 41 (George Washington Univ. Law Sch., Working Paper No. 2012-4), available at <http://ssrn.com/abstract=1982149> (describing the tension between the FSOC and the Consumer Financial Protection Bureau).

⁶³ Lamson & Allen, *supra* note 14, at 4.

different financial regulators in an effort to promote diverse opinions.⁶⁴ However, this approach creates the risk that members will shift blame to each other if something goes wrong. Ultimately, only time will tell whether the structure of multi-member Council is a beneficial way to address systemic risk.

F. The Future of the FSOC

The FSOC has an uncertain future. Congress granted the FSOC broad authority to regulate systemic risk in the United States, but the Council is still in the early stage of the rulemaking process. The Council faces the lofty goal of regulating systemic risk in the United States, but it is unclear whether systemic risk can be effectively regulated. Additionally, the Council has the added pressure of being the successor of the failed President's Working Group.

The FSOC's success will depend on a multitude of factors. Key is the Council's ability to communicate candidly about emerging risks and struggling institutions. The Council must be willing to make difficult calls when required, such as restricting a failing firm's activities. The Council members must be willing to accept accountability and not shift blame to one another. While the nature of the Council organization may allow Council members to pursue their own agendas at the expense of the FSOC mission, that tendency must be fought. Finally, the Council must devote a sufficient amount of time and the energy to carry out its mandate.

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⁶⁴ Schapiro, *supra* note 55.

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