AMERICANS FOR FINANCIAL REFORM
ACCOUNTABILITY ★ FAIRNESS ★ SECURITY

Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

BACKGROUND ON THE FINANCIAL STABILITY OVERSIGHT COUNCIL

The Significance of FSOC

The Financial Stability Oversight Council (FSOC) was created as a response to the 2008 financial crisis, which revealed grave weaknesses in the U.S. system of financial regulation and oversight. Many of these weaknesses were related to the fragmented and divided nature of our regulatory apparatus, which no longer reflected the reality of the modern financial system.

After the Gramm Leach Bliley Act repealed the last vestiges of the Glass-Steagall divisions between banking, insurance, and trading markets, the financial system became more highly interconnected, allowing for the rapid transfer of risk between insurance companies, commercial banks, broker-dealers, and large hedge funds.[1] Problems emerging in any one of these sectors can easily impact the others, and if the risks involved are large enough they can threaten the stability of the entire financial system. But even as the financial system grew more deeply interrelated, our regulatory system continued to rely on over a half a dozen separate and siloed financial regulators that often did not share information and failed to spot critical emerging risks.

This problem made a direct contribution to the financial crisis of 2008 and its disastrous impact on the U.S. and world economy. Commercial and investment banks transferred hundreds of billions of dollars in mortgage risk to an insurance company, AIG, escaping the supervision of banking and securities regulators. AIG eventually received the largest government bailout in U.S. history. Broker-dealers which were not commercial banks, such as Bear Stearns, Lehman Brothers, Morgan Stanley, and Goldman Sachs, were at the center of the Wall Street network that created and distributed the 'toxic assets' central to the crisis. Hedge funds were also key intermediaries in the distribution and structuring of these toxic assets.[2] The failure of a single money market mutual fund, the Reserve Primary Fund, triggered a massive run on prime money funds followed by a government bailout of the entire sector, which is a crucial part of the asset management industry. Of course, the nation's largest commercial banks were also central to the crisis, ranging from the failed Washington Mutual to 'too big to fail' entities such as Bank of America and Citibank, which were rescued by the Federal government.

---

[1] See Billio, Monica & Getmansky, Mila & Lo, Andrew W. & Pelizzon, Loriana, 2012. "Econometric Measures of Connectedness and Systemic Risk in the Finance and Insurance Sectors," Journal of Financial Economics, Elsevier, vol. 104(3), pages 535-559.

[2] For one example, see Eisinger, Jesse and Jake Bernstein, "The Magnetar Trade: How One Hedge Fund Helped Keep the Housing Bubble Going", ProPublica, April 9, 2010.

In the Dodd-Frank Act, Congress took a measured approach to addressing the problem of the fragmentation of the regulatory system. The Dodd-Frank Act eliminated only one financial regulator (the Office of Thrift Supervision). The other nine financial regulators were directed to coordinate their efforts to address threats to the financial system through a new joint council, the Financial Stability Oversight Council (FSOC). The FSOC also has a research arm (the Office of Financial Research, or OFR), which is a non-policy making body dedicated to gathering information on financial system risks.

The FSOC is chaired by the Secretary of the Treasury. The heads of the eight independent financial regulators are also voting members, as is an independent expert on the insurance industry appointed by the President.[3] There are thus ten voting members of the Council.

Based on the input of all participating financial regulators, as well as data gathered by the OFR, the FSOC has the power to designate large non-banks that play a crucial role in the financial system for heightened prudential oversight by the Federal Reserve. Such oversight applies only to specified financial activities of companies so designated, and may or may not be 'bank like' in nature, depending on what type of supervision is appropriate for a specific company.

The question of exactly which non-banks should be designated as systemically significant and how such institutions should be regulated is a complex and institution-specific question. However, given the central role of non-banks in both the financial crisis and in the modern financial system, the general need for a designation power is clear. Furthermore, the role of the FSOC and OFR in scrutinizing the financial sector for emerging risks, including gathering the necessary information to do so, should not be controversial. Without such a central point for the gathering and analysis of data, the fragmentation of our regulatory system could lead to a repetition of past failures to 'connect the dots' of financial risk.

The FSOC Designation Process

As detailed in the attached Table 1, the FSOC has laid out an extensive multi-step process for the designation of systemically significant non-bank financial companies. This process involves extensive communication between the FSOC and the company under consideration and permits the company multiple opportunities to challenge a potential designation. For example, if the FSOC issues a Proposed Designation of a company – a decision that requires a two-thirds approval by the Council, including a positive vote by the Treasury Secretary – the company may challenge the proposal in a private hearing with the FSOC. If the FSOC then votes (again by a two-thirds majority) to designate the company for increased prudential supervision, the company may then appeal this decision to U.S. District Court. The District Court may then review the

---

[3] The eight independent financial regulators whose chairs are voting members of the FSOC are the Commodity Futures Trading Commission (CFTC), Consumer Financial Protection Bureau (CFPB), the Federal Deposit Insurance Commission (FDIC), the Federal Housing Finance Agency (FHFA), the Federal Reserve, the National Credit Union Administration (NCUA), the Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC).

designation record and overturn the designation if it finds that the FSOC acted in an arbitrary and capricious manner.

This process requires detailed examination of each company and has in practice extended for multi-year periods. For example, the FSOC did not designate the recipient of the largest single-company cash bailout in U.S. history, the American International Group (AIG), for increased prudential supervision until July 2013. This was three years after the FSOC's creation.

<u>FSOC Transparency</u>

As should be clear from the preceding discussion and the attached table, the FSOC designation process includes a large amount of transparency and interaction with the specific companies under consideration for designation. But there have been legitimate concerns raised about the transparency of FSOC proceedings to the broader public. The FSOC has committed to making its meetings open to the press and public "wherever possible," and often does conduct open and accessible meetings through live web stream.[4]

However, the Commission also conducts many closed meetings in cases where they judge an open meeting would reveal any of a wide range of types of information the FSOC believes should remain confidential. Types of information that trigger a closed meeting include information generated by regulatory or supervisory operations, information that may lead to financial speculation, information that includes trade secrets or commercial and financial information considered confidential, or the discussion of agency memoranda not otherwise available publicly.[5]

A 2012 General Accounting Office examination of the FSOC includes a number of sensible suggestions concerning transparency, including the release of closed meeting transcripts after a suitable time period has passed and/or suitable redactions have been made.[6] This recommendation deserves serious consideration. Another possibility for improving transparency would be reconsidering the list of information types that trigger closure of an FSOC meeting. While some reasons for closing a meeting are appropriate, others appear overly broad.

---

[4] See United States Treasury, "Transparency Policy For the Financial Stability Oversight Council", available at http://www.treasury.gov/initiatives/Documents/FSOCtransparencypolicy.pdf. See also the minutes to FSOC's May 7th , 2014 meeting where this policy is discussed, available at http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/May%207,%202014.pdf .

[5] Ibid.

[6] General Accounting Office, "Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions", GAO-12-866, September 11, 2012.

TABLE 1: STEPS IN FSOC DESIGNATION PROCESS FOR NON-BANK FINANCIAL COMPANIES	
Step 1: Public data screen of companies.	Compare publically available information on financial companies to pre-specified thresholds.
Step 2: Further review of companies.	More detailed examination of public and regulatory data for selected companies.
Step 3: Inform selected company of consideration.	Inform company that passes step two screen that it is under consideration for designation.
Step 4: In-depth analysis of company.	In-depth information exchange with individual company under consideration. Likely to involve private and confidential data.
Step 5: Proposed Determination.	FSOC votes on Proposed Determination of selected company. Proposed Determination requires two-thirds approval by the Council, including approval by the Treasury Secretary.
Step 6: Send notice to company.	If a Proposed Determination is issued, FSOC sends a private notice and explanation to the selected company.
Step 7: Opportunity for company challenge.	If the company wishes to challenge a Proposed Designation, it receives a confidential hearing with the FSOC to argue the challenge.
Step 8: Final Determination of company.	FSOC votes on whether to issue a final designation of the company. Designation requires two-thirds approval of the Council and approval of the Treasury Secretary.
Step 9: Opportunity for company appeal.	A designated company may appeal a final designation to U.S. District Court, which has the power to overturn the designation.
Step 10: Continuing review of designation.	Each final designation must be reviewed on an annual basis by the FSOC and may be overturned by a two-thirds vote of the Council.