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BACKGROUNDER

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The Financial Stability Oversight Council: Helping to Enshrine "Too Big to Fail"

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Abstract

History shows that more regulation does not inherently prevent financial panics and crises. Yet the 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act essentially provides more of the same old financial regulation. Much of this regulation is propagated through a multi-regulator Financial Stability Oversight Council. Many associate this council with identifying systemically important financial institutions (SIFIs), but its responsibilities are much broader than that. For instance, the council has the authority to require new regulations for any financial company it determines poses a threat to U.S. financial stability, an ill-defined concept. Exercising this authority will invariably cross more than one regulatory agency's domain, yet the council has no binding authority to resolve any jurisdictional disputes. Future government bailouts are now more likely because the council identifies firms whose failure would—by its determination—be catastrophic to the U.S. economy.

The 2010 Dodd–Frank Wall Street Reform and Consumer Protection Act was Congress's response to the 2008 financial crisis. Yet many of the act's components do virtually nothing to fix the root causes of the financial crisis and simply expand the government's reach into financial markets. Some of the biggest changes are in the nonbank financial sector, where Dodd–Frank greatly expanded the federal regulatory net. In particular, Dodd–Frank created a multi-regulator council called the Financial Stability Oversight Council. Many associate this council with identifying systemically impor-

Key Points

- The Financial Stability Oversight Council selects nonbank financial firms for heightened regulatory supervision by the Federal Reserve.
- The council adds layers of complexity to an already tangled mess of financial regulations and seemingly absolves regulators of any responsibility for previous financial crises. Nearly all large financial firms—including AIG—were federally regulated before the 2008 crisis.
- The council purports to lower expectations of government bailouts, but bailouts are now more likely because the council identifies firms considered too big to fail.
- This process minimizes the role of potential losses in managerial decision making, thus providing incentives to take on even more risk.
- Focusing on the term "systemically important financial institution" obscures two facts: (1) There is no such legal distinction in the U.S., and (2) the council can require new regulations for virtually any financial company, for nearly any stability-related reason.

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tant financial institutions (SIFIs), but its responsibilities are much broader than simply singling out these firms.

The council's broad responsibilities make the achievement of one of Dodd–Frank's stated objectives—lowering expectations of government bailouts—highly unlikely. In fact, future government bailouts are now more likely because the council identifies firms whose failure financial regulators would consider catastrophic. In other words, the council identifies firms considered too big to fail. The council also adds layers of complexity to an already tangled mess of financial regulations and seemingly absolves regulators of any responsibility for previous financial crises.

This *Backgrounder* argues that the Financial Stability Oversight Council was created based on the faulty notion that deregulation caused the 2008 financial crisis. The council designates certain companies for heightened regulatory supervision, but nearly all of these firms were regulated by at least one federal agency prior to 2008. In a very real sense, the council is simply more of the same, particularly with respect to bank regulation.

Council Unlikely to Maintain Stability with "New" Regulations

The Financial Stability Oversight Council was created based on the faulty premise that financial market deregulation caused the 2008 financial crisis. If eliminating rules and regulations really had caused the crisis, Congress would have simply needed to restore those rules. Dodd–Frank did not mandate restoration of rules because there was nothing to restore. Even the 1999 Gramm–Leach–Bliley Act (GLBA), one of the few pieces of financial market legislation from the past 50 years that can be viewed as deregulatory, only allowed banks to affiliate with firms in the (regulated) securities and insurance industries.[1] Given that Dodd–Frank expands financial market regulation with newer versions of the same rules and regulations that have been in place for years, there is little reason to expect less economic turmoil in the future.

The Federal Reserve has been the primary regulator of bank holding companies since the Bank Holding Company Act of 1956, yet the U.S. experienced a major banking crisis in the 1980s and a severe financial crisis in 2008.[2] The GLBA did amend the 1956 act so that bank holding companies could engage in activities such as securities and insurance underwriting, but it left the Fed in place as the primary regulator of these (newly named) financial holding companies (FHCs). In fact, under the GLBA, the Fed could approve applications to become a FHC only after certifying that both the holding company and all of its subsidiary depository institutions were "well-managed and well-capitalized, and … in compliance with the Community Reinvestment Act, among other requirements."[3]

The term "well capitalized" has not always meant the same thing, but the Fed and the Federal Deposit Insurance Corporation (FDIC) adopted risk-based capital requirements for U.S. commercial banks (based on the Basel I accords) in 1988.[4] Since then, U.S. commercial banks have been required to maintain several different capital ratios above specified minimums in order to

1. Even by alternative measures, such as regulatory agencies' budgets and employees, it is clear that regulatory agencies had not decreased their presence leading up to the 2008 crisis. See James Gattuso, "Meltdowns and Myths: Did Deregulation Cause the Financial Crisis?" Heritage Foundation *WebMemo* No. 2109, October 22, 2008, http://s3.amazonaws.com/thf_media/2008/pdf/wm2109.pdf.
2. Technically, the Fed was involved in bank holding company regulation since 1914 and became the regulator for all holding companies owning a member bank with the Banking Act of 1933. However, bank holding companies, as well as their permissible activities, became more clearly defined under the Bank Holding Company Act of 1956. See Thomas G. Watkins and Robert Craig West, "Bank Holding Companies: Development and Regulation," Federal Reserve Bank of Kansas City *Economic Review*, June 1982, http://kansascityfed.org/PUBLICAT/ECONREV/EconRevArchive/1982/2q82watk.pdf (accessed March 18, 2014).
3. Dafna Avraham, Patricia Selvaggi, and James Vickery, "A Structural View of U.S. Bank Holding Companies," Federal Reserve Bank of New York *Economic Policy Review* July 2012, p. 67, http://www.newyorkfed.org/research/epr/12v18n2/1207avra.pdf (accessed January 22, 2014).
4. The rules were phased in through 1990. Codified to 12 C.F.R. Part 225, Appendix B (formerly appendix A), amended at 50 Fed. Reg. 16066, April 24, 1985, effective May 15, 1985; 51 Fed. Reg. 40969, November 12, 1986, effective November 4, 1986; redesignated as appendix B at 54 Fed. Reg. 4209, January 27, 1989, effective March 15, 1989; 55 Fed. Reg. 32832, August 10, 1990, effective September 10, 1990; 58 Fed. Reg. 474, January 6, 1993. The Basel I agreements were from the Basel Committee on Banking and Supervision, an international body established in 1974 to consider capital adequacy rules and to mitigate bank risk. However, the Basel I rules borrowed heavily from the "risk-bucket" approach developed by the Federal Reserve in the 1950s. See Howard D. Crosse, *Management Policies for Commercial Banks* (Englewood Cliffs, NJ: Prentice-Hall, 1962), pp. 169–172.

be considered "well capitalized." According to the FDIC, U.S. commercial banks (on average) exceeded these requirements by 2 to 3 percentage points for the six years leading up to the crisis.[5] The fact that new versions of risk-based capital requirements are a centerpiece of the Financial Stability Oversight Council's new "heightened regulations" suggests that these regulations will do little to prevent future financial crises.

Perpetuating bailout expectations minimizes the role that potential financial loss plays in managerial decision making, thus providing incentives to take on even more financial risk—making future crises more likely.

Further, even the nonbank financial companies that did not previously fall under these risk-based capital requirements were, in most cases, regulated in some way before the crisis. For instance, life, property/casualty, and health insurance companies have been required to insure for losses (reinsurance) and hold reserves against estimated future losses since at least the 1940s, even though there was no federal mandate. In addition to reserve and reinsurance requirements, many states have even adopted risk-based capital standards for insurance companies operating under their jurisdiction.[6]

In fact, the only large insurance company at the center of the 2008 crisis was a federally regulated company. The American International Group (AIG) was regulated by the Office of Thrift Supervision (OTS) because it was a holding company that owned savings and loan institutions.[7] If history is any guide, the fact that the council expands regulations over financial markets should not inspire confidence that future crises will be mitigated. Less regulation, not more, gives firms the flexibility to learn and adapt in order to avoid repeating past mistakes. Taxpayers should not, therefore, feel protected from future bailouts even though the council is intended to eliminate such fears.

Council Does Not Lower Bailout Expectations

Although Dodd–Frank states that the Financial Stability Oversight Council is designed to eliminate the expectation of government bailouts, the statement amounts to an empty promise. The reality is that financial firms undertake risky activities, and Dodd–Frank requires the council to identify firms whose activities (or failure) might threaten U.S. financial stability. Once designated, these firms are subjected to heightened regulation under the Federal Reserve, the U.S. central bank that financed the bailouts during the 2008 crisis. Allowing any of these companies to fail after being designated for special supervision under the Fed would be an admission that the new regulations—and the Fed itself— did not protect financial markets.

Still, proponents of Dodd–Frank claim that the law lowers bailout expectations because it limits the Federal Reserve's emergency lending authority. In particular, Section 1101 amends the Federal Reserve Act so that the Fed can provide emergency funds *only* as part of a program with "broad-based eligibility." In other words, now the Fed can provide emergency funds to a company only if it offers the same access to a group of firms.[8] A large portion

5. Juliusz Jablecki and Mateusz Machaj, "The Regulated Meltdown of 2008," *Critical Review*, Vol. 21, Nos. 2–3 (2009), pp. 306–307.
6. National Association of Insurance Commissioners, "Risk-Based Capital: General Overview," July 15, 2009, http://www.naic.org/documents/committees_e_capad_RBCoverview.pdf (accessed March 18, 2014), and National Association of Insurance Commissioners, "The United States Insurance Financial Solvency Framework," 2010, http://www.naic.org/documents/committees_e_us_solvency_framework.pdf (accessed March 18, 2014). For historical mortality tables used to estimate future life insurance claims, see Society of Actuaries, "Mortality and Other Rate Tables," http://mort.soa.org/ (accessed January 27, 2014).
7. Chana Joffe-Walt, "Regulating AIG: Who Fell Asleep on the Job?" National Public Radio, *Planet Money*, June 5, 2009, http://www.npr.org/templates/story/story.php?storyId=104979546 (accessed March 18, 2014).
8. The Fed's final rules have not been issued, but the proposed rules state that the emergency lending program will be considered to have broad-based eligibility only if it "is designed to provide liquidity to an identifiable market or sector of the financial system." See "Extensions of Credit by Federal Reserve Banks," *Federal Register*, Vol. 79, No. 3, (January 6, 2014), Proposed Rules, p. 619.

of the government bailouts during the 2008 financial crisis, though, was conducted through broad-based programs.[9]

The council provides a ready-made group for the Fed to offer emergency funds to during the next crisis because it identifies companies whose failure may threaten U.S. financial stability. Touting this provision as lowering bailout expectations is particularly strange because financial crises manifest themselves when multiple firms are in danger of failure.[10] Perpetuating bailout expectations in this manner minimizes the role that potential financial loss plays in managerial decision making, thus providing incentives to take on even more financial risk—making future crises more likely. Worse, the council has a much broader role than identifying so-called SIFIs, and its overall purpose is ill-defined.

The Main Roles of the Financial Stability Oversight Council

Title I of Dodd–Frank established the Financial Stability Oversight Council, a multi-regulator council tasked with identifying risks to the financial stability of the United States. The council has the authority to bring certain nonbank financial companies under a new regulatory regime if it decides that the companies pose a risk to U.S. financial stability, a concept that Dodd–Frank does not define.

The 15-member council includes 10 voting seats and five nonvoting positions. The 10 voting seats are filled by the heads of nine federal agencies, including the Treasury Secretary and the chairman of the Federal Reserve, plus one presidential appointee. The council's five nonvoting slots are occupied by two federal agency heads and three state regulatory officials. Section 112 of Dodd–Frank broadly—and vaguely—defines the council's purpose as follows:

- To identify risks to the financial stability of the United States that could result from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies;

- To identify risks to the financial stability of the United States that could come from "outside" the financial marketplace;

- To eliminate the expectation of government bailouts on behalf of "shareholders, creditors, and counterparties"; and

- To respond to emerging threats to the stability of the U.S. financial system.

Dodd–Frank does not spell out exactly how the council is supposed to eliminate expectations of bailouts, and it leaves open how the council may respond to emerging threats to financial stability. In contrast to this ambiguity, Section 112 of Dodd–Frank lists 14 specific duties, four of which express the council's core functions:

1. **Make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices.** As of this writing, individual practices have not yet been singled out.

2. **Identify systemically important financial market utilities and payment, clearing, and settlement activities.** This duty requires the council to bring an entirely separate sector of the financial industry under a new regulatory regime.[11]

9. Much of the Fed lending was done jointly by the U.S. Treasury and the Fed under TARP-based programs, such as the Term Asset-Backed Securities Loan Facility (TALF). See U.S. Government Accountability Office, *Financial Audit: Office of Financial Stability (Troubled Asset Relief Program) Fiscal Years 2012 and 2011 Financial Statements*, November 9, 2012, http://www.gao.gov/assets/650/649913.pdf (accessed January 27, 2014).

10. The case can also be made that the Fed should not lend to nonbanks at all. Anna Schwartz, for instance, stated that "Congressional authorization and Federal Reserve implementation of loans to nonbanks for use as capital was, in my judgment, a sorry reflection on both Congress's and the Fed's understanding of the System's essential monetary control function." Anna J. Schwartz, "The Misuse of the Fed's Discount Window," Federal Reserve Bank of St. Louis, September/October 1992, http://research.stlouisfed.org/publications/review/92/09/Misuse_Sep_Oct1992.pdf (accessed February 25, 2014.)

11. Companies such as exchanges and check-clearing institutions are now referred to as financial-market utilities. These regulations are dealt with in Title VIII of Dodd–Frank; they are distinct from the regulations for large bank holding companies and nonbank financial companies discussed in this *Backgrounder*.

3. **Require supervision by the Board of Governors for nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure or because of their activities.** This obligation represents one of Dodd–Frank's largest—and often misquoted—regulatory changes. The provision allows the council to require more stringent regulations (under Fed supervision) for financial firms if it believes the companies threaten the financial stability of the U.S.

4. **Make recommendations to the Board of Governors for heightened regulatory standards for nonbank financial companies and large, interconnected bank holding companies supervised by the Board of Governors.** Dodd–Frank requires that these new regulations are more stringent than those applied to banks and nonbank financial firms that do not pose a threat to the financial stability of the U.S.

Dodd–Frank defines a nonbank financial company as one that is not a bank but is predominantly engaged in financial activities.[12] It considers a company to be predominantly engaged in financial activities if 85 percent of its revenues (or assets) is derived from any of the items on a list of more than 40 financial activities in the Bank Holding Company Act of 1956.[13] Dodd–Frank does not, however, define financial stability.

In fact, the term "financial stability" lacks a clear, objective definition. For instance, the Deputy Director of the Financial Markets Group at the London School of Economics, Charles Goodhart, once admitted, "Indeed there is currently no good way to define, nor certainly to give a quantitative measurement of, financial stability."[14] Goodhart went on to note that one of the most persuasive definitions of financial stability was simply the absence of financial instability. Obviously, this definition does little to provide specific rules or guidelines to regulators trying to implement Dodd–Frank.

Not surprisingly, neither the Federal Reserve's nor the council's final rules for implementing Title I of Dodd–Frank define financial stability. The council's final rules say only that it will consider a threat to U.S. financial stability to exist if "there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy."[15] But the rules do not attempt to define terms such as "impairment" and "significant damage" objectively.

The fact that these terms are so subjective puts the council in a powerful position because it can justify its decisions based on a concept that has no clear standard. Of course, this subjectivity does nothing to relieve the uncertainty faced by the newly regulated companies. In apparent recognition of these difficulties, the council's final rules identify the following "channels" through which a failing firm could spread economic damage to the broader economy:[16]

- **Exposure.** When a nonbank financial company's creditors, counterparties, investors, or other market participants have exposure to the nonbank financial company that is significant enough to materially impair those creditors, counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability.

- **Asset liquidation.** When a nonbank financial company holds assets that, if liquidated quickly, would cause a fall in asset prices and thereby significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings.

12. Technically, the firm also cannot be an exchange, a clearing facility, or any of several other specialized entities; see Section 102 (a)(4)(B).
13. Even if 85 percent of the revenues or assets are derived from ownership or control of an insured depository institution, the firm is also considered predominantly engaged in financial activities. See Dodd–Frank Section 102(a)(6). The list of specific activities ranges from asset management to leasing, but this section of the 1956 Bank Holding Company Act also gives the Fed the authority to designate *any* activity it deems closely related to banking or managing a bank as a financial activity.
14. Charles Goodhart, "Some New Directions for Financial Stability?" Bank for International Settlements, June 27, 2004, http://www.bis.org/events/agm2004/sp040627.pdf (accessed January 10, 2014).
15. "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," *Federal Register*, Vol. 77, No. 70 (April 11, 2012), Rules and Regulations, p. 21657.
16. Ibid.

- **Critical function or service.** When a nonbank financial company is no longer able or willing to provide a critical function or service that is relied on by market participants and for which there are no ready substitutes.

Even regarding these channels, though, there is no objective way to measure the risk at any one firm, much less how that risk relates to the broader economy. There is no unbiased threshold, for example, that determines when a firm's exposure to creditors is "significant enough to materially impair those creditors." Even worse, virtually all financial firms hold assets that, "if liquidated quickly, would cause a fall in asset prices," especially once a downturn or crisis begins.

The council even admits that

> [D]ue to the unique ways in which a nonbank financial company may provide a critical function or service to the market, the Council expects to apply company-specific analyses with respect to this channel, rather than applying a broadly applicable quantitative metric.[17]

Firms will exist under the constant threat of targeted regulations imposed on their operations because Dodd–Frank gives regulators so much flexibility to achieve a nebulous goal.

The Council and Other Financial Regulators

U.S. financial market regulation has long consisted of multiple agencies with overlapping responsibilities, particularly with respect to banks. The Financial Stability Oversight Council is not in charge of any of these agencies, and its responsibilities only complicate what is already a tangled mess of federal and state regulatory agencies. For example, the primary regulator of federally chartered banks is the Office of the Comptroller of the Currency, while the Federal Reserve is the main regulator of state-chartered banks that are members of the Federal Reserve System.[18]

Because virtually all banks participate in the federal deposit insurance system, the FDIC is the primary federal regulator for state-chartered banks that are not members of the Federal Reserve System. All state-chartered banks are also regulated by their respective state banking agencies. This description only scratches the surface of regulatory overlap, especially with respect to bank and financial holding companies. Complicating matters even more is the fact that all publicly traded companies are regulated by the Securities and Exchange Commission (SEC).

While insurance companies have a long history of being regulated by state agencies, they typically have not been regulated at the federal level unless they are publicly traded.[19] Other nonbank financial companies, such as securities brokers and dealers, fall under the oversight of either the Commodity Futures Trading Commission (CFTC) or the SEC.

Dodd–Frank did very little to simplify this regulatory jumble, and the council actually makes matters worse.[20] For example, Section 120(a) of Dodd–Frank inserted the council into the middle of all these agencies by giving it the authority to require new regulations for any financial company it determines poses a threat to "financial markets of the United States, or low-income, minority, or underserved communities." Exercising this authority will invariably cross more than one regulatory agency's domain, yet the council has no binding authority to resolve any jurisdictional disputes.[21] On the other hand, the council has the very clear authority to designate certain firms for new regulations.

17. Ibid.
18. Federally chartered banks can expand nationally, whereas state-chartered banks operate only within a state.
19. Dodd–Frank created the Federal Insurance Office (FIO) and tasked it with studying whether there were regulatory gaps in the insurance industry that cause systemic risks. In other words, the FIO is a first step toward federal regulation of insurance companies.
20. Prior to Dodd–Frank, the Office of Thrift Supervision (OTS) was a separate regulator for savings and loan institutions, but the bill closed the OTS and moved its functions to the Office of the Comptroller of the Currency (OCC).
21. Aside from council-related expansions, Dodd–Frank also extended the Federal Reserve's reach into other agencies' territory with regard to holding companies' subsidiaries. Specifically, Section 604 gives the Fed the new authority to "write rules for, impose reporting obligations on, examine the activities and financial health of, and bring enforcement actions against subsidiaries, including entities regulated by the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC) and state-regulated entities." See Hester Peirce and Robert Greene, "The Federal Reserve's Expanding Regulatory Umbrella," Mercatus Center, April 2013, http://mercatus.org/publication/federal-reserves-expanding-regulatory-umbrella (accessed January 22, 2014).

Designating Firms for Heightened Fed Supervision and Regulation. The council can require supervision by the Federal Reserve's Board of Governors for nonbank financial companies if it determines that these firms pose a risk to the financial stability of the United States. The idea behind this authority is to identify companies which are so important that their financial failure (or even just their activities) could cause economy-wide disaster. Once identified, the firms are to be regulated extra stringently so as to prevent future financial crises. These firms are commonly referred to as SIFIs, even though Dodd–Frank does not label these companies with any special name.

Focusing on the term "SIFI" obscures two important facts. First, there simply is no such legal distinction in the U.S. Second, the council can do much more than impose new Fed-supervised regulations on so-called SIFIs. For instance, Section 120(a) of Dodd–Frank allows the council to require new heightened regulations (not necessarily supervised by the Fed) for virtually any financial company for nearly any stability-related reason.

Thus, the council is not tied to any specific definition of a "systemically important financial institution" when it designates firms for heightened supervision or regulation.[22] As of this writing, the council has designated three firms—the American International Group, General Electric Capital Corporation, and Prudential Financial—for regulatory supervision under the Fed, though none was officially labeled an SIFI. The council's final determination that General Electric Capital will now be supervised by the Fed does not even include the term "systemically important."[23]

How Are Firms Designated for Fed Supervision? The voting members of the council ultimately determine which nonbank financial companies will be subjected to heightened regulations under the Federal Reserve. A two-thirds vote is required to single out a firm, but the Treasury Secretary's affirmative vote must be among the two-thirds in favor of the designation.[24] In general, the council identifies companies for heightened supervision based on how its members believe financial distress at the company or "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" at the company could threaten financial stability in the United States.

Companies have virtually no recourse to challenge the Financial Stability Oversight Council's decisions.

While Dodd–Frank does not define financial stability and Section 113 does give the council some discretion in naming these firms, Dodd–Frank also provides specific criteria that the council must consider during the process. The council's final rules, published in April 2012, incorporate these requirements into a three-stage procedure.

In the first stage, the council applies six criteria to a "broad group of nonbank financial companies" simply to narrow the group of firms that might eventually fall under Fed supervision.[25]

In the second stage, the council uses a "six-category analytic framework" to further analyze a firm's threat to U.S. financial stability based on the requirements in Section 113 of Dodd–Frank.[26] Similar to the first stage, this second-stage analysis narrows the field of firms that warrant further consideration for special supervision.

In the third stage, the council builds on its earlier investigation, now using "quantitative and qualitative information collected directly from the nonbank financial company, generally by the Office of Financial Research."[27]

22. Section 102 requires the Federal Reserve to define, by rule, the terms "significant nonbank financial company" and "significant bank holding company," but neither of these terms is used to legally define a company that has been designated by the council for heightened regulations.
23. U.S. Department of the Treasury, "Basis of the Financial Stability Oversight Council's Final Determination Regarding General Electric Capital Corporation, Inc.," July 8, 2013, http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20General%20Electric%20Capital%20Corporation,%20Inc.pdf (accessed January 10, 2014).
24. A two-thirds vote is not required for the Section 120 regulations (outside the Fed framework) discussed above.
25. "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," *Federal Register*, Volume 77, No. 70 (April 11, 2012), Rules and Regulations, pp. 21642–21643.
26. Ibid., p. 21661.
27. Ibid., p. 21642. The Office of Financial Research (OFR) was created mainly to assist the council and its members; it is, however, a fairly autonomous agency within the U.S. Treasury.

Formally, after a two-thirds affirmative vote (including an affirmative vote by the Treasury Secretary), the council can make a Proposed Determination. The company in question then has 30 days after being notified to request a private hearing to contest the determination. After the hearing, the council has 60 days to make its final determination.[28]

No Way Out for Firms Designated. One major concern with this process is that it gives companies virtually no recourse to challenge the council's decision successfully. The council's designation for Fed supervision can be challenged in Federal court, but Section 113(h) of Dodd–Frank limits this legal challenge to "whether the final determination made under this section was arbitrary and capricious." As long as the council follows its three-stage process, there is virtually no chance any court will rule that the council acted in an arbitrary and capricious manner.[29]

Further, the council does not provide designated firms with many details of its decisions, and there is no standard procedure for a company to have itself undesignated for this special supervision. Regardless, there is no objective way to determine that a firm's demise could (or could not) pose a threat to U.S. financial stability—a concept that, on its own, is difficult to define. Firms designated for special supervision under the Fed will have little choice but to submit to the new regulatory environment regardless of the subjectivity of the process.

The New Regulatory Regime

The special regulatory framework in Title I of Dodd–Frank is something of a joint effort between the Fed and the Financial Stability Oversight Council. While the council can make recommendations to the Fed, the Fed has the ultimate responsibility for developing specific rules and regulations. This framework applies to nonbank financial firms (both foreign and domestic) that the council identifies for heightened Fed supervision, as well as certain firms that received Troubled Asset Relief Program (TARP) funds and all bank holding companies with assets of more than $50 billion.[30] As mentioned, these firms are often referred to collectively as SIFIs though Dodd–Frank confers no such legal distinction.

Section 165 of Dodd–Frank requires the new standards to include the following:

- Risk-based capital requirements and leverage limits;[31]
- Liquidity requirements;
- Overall risk-management requirements;
- Resolution plan and credit-exposure-report requirements;[32] and
- Concentration limits.

Section 165 also allows these regulations to be developed based on any criteria the Fed or the council believes is proper.[33] Additionally, Section 165 requires the Fed to differentiate between firms' riskiness and, as it sees fit, apply even stricter standards on a case-by-case basis. The Fed is also authorized

28. If no hearing is requested, the council has 10 days (after the time when a hearing could have been requested) to make its final determination. 12 CFR 1310.21(c).

29. At least one lawsuit argued that limiting the rights of the company to challenge the council in this manner is unconstitutional, but the case was dismissed due to lack of standing. John M. Pachkowski, "Challengers to Constitutionality of Dodd–Frank Lacked Standing," *Banking and Finance Law Daily*, August 2, 2013, http://news.wolterskluwerlb.com/test/crush/banking-finance/news/challengers_to_constitutionality_of_dodd_frank_lacked_standing (accessed March 18, 2014), and Elizabeth Festa, "Prudential Concedes SIFI Designation," LifeHealthPro, October 18, 2013, http://www.lifehealthpro.com/2013/10/18/prudential-concedes-sifi-designation (accessed January 7, 2014).

30. Section 102 of Dodd–Frank states, "A foreign bank or company that is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956, pursuant to section 8(a) of the International Banking Act of 1978 (12 U.S.C. 3106(a)), shall be treated as a bank holding company for purposes of this title."

31. Section 165 does allow the Fed, in consultation with the council, to forgo these risk-based capital requirements and leverage limits if it deems them to be inappropriate for a particular company. However, in these cases, the Fed must develop standards that "result in similarly stringent risk controls."

32. Based on the resolution plan or the failure to submit a resolution plan, the Fed or the FDIC can force a company to divest certain assets or operations in order to facilitate an orderly bankruptcy proceeding in the event the firm should fail.

33. Section 165(b)(3)(A)(iv).

to establish regulations that include (1) contingent capital requirements (hybrid capital that converts from, for example, debt to equity in the event of a crisis); (2) enhanced public disclosures; (3) short-term debt limits; and (4) any other standards that the Fed (on its own or in consultation with the council) deems appropriate.

> There has been a great deal of confusion concerning how the Fed will impose capital standards that were designed for banks on nonbank insurance companies.

As of this writing, the Fed has proposed to adopt some version of all of the required standards and to simply consider whether to adopt the additional standards.[34] For instance, the Fed will likely study whether to impose enhanced public disclosures on nonbank financial firms, but it is planning to impose risk-based capital requirements and leverage limits on these companies. Essentially, the core of these new regulations consists of the Basel III regulatory framework, the third round of bank capital requirements under the Basel framework first implemented in 1988.[35]

There has been a great deal of confusion concerning exactly how the Fed will impose capital standards that were designed for banks on nonbank insurance companies. Former Fed chairman Ben Bernanke has suggested that a legislative fix is necessary because Dodd–Frank requires the Fed to impose these standards on insurance companies. Senators Sherrod Brown (D–OH) and Mike Johanns (R–NE) have drafted a bill to exempt insurance companies from these requirements, but others, such as Senator Susan Collins (R–ME), have suggested that Dodd–Frank does give the Fed the authority to exempt insurance companies from these capital standards.[36] As of this writing, no action has yet been taken to clarify this situation.[37]

What Congress Can Do

Risk is inherent to all financial transactions, and socializing the costs of risky behavior makes it more likely that individual firm managers will take on too much risk. The best way to ensure that firms do not take undue risk is to credibly state that owners and creditors—not taxpayers—will be responsible for financial losses. Such a commitment is not possible in the current environment, so the best way to lessen the impact of the too-big-to-fail problem is to make structural changes that can eventually lead to a believable policy of no bailouts. Going forward, Congress's best course of action includes the following:

- **Repeal** the Dodd–Frank Wall Street Reform and Consumer Protection Act.
- Short of a full repeal of the Dodd–Frank act, **repeal** Title I of Dodd–Frank.
- Short of a full repeal of Title I, **eliminate** the Financial Stability Oversight Council.
- **Stipulate** that the Federal Reserve serve as a lender of last resort only to banks, thus prohibiting it from lending to any financial companies other than depository institutions.
- Not make a bad situation worse by providing insurance companies a special exemption from Dodd–Frank's new capital requirements. Instead, **recognize** that Dodd–Frank's one-size-fits-all approach to financial regulation does not work and, at the very least, eliminate the new regulations that the law imposed.

34. "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies," *Federal Register*, Proposed Rules, Volume 77, No. 3 (January 5, 2012), pp. 595–596.
35. This portion of the capital requirements and leverage limits evolved from the Basel II requirements, the framework that U.S. banking agencies had been working to implement prior to the 2008 crisis. A full discussion of these capital requirements is beyond the scope of this *Backgrounder*.
36. Donna Borak, "Senators to Push Fed to Loosen Insurer Rules," *American Banker*, March 7, 2014, http://www.americanbanker.com/issues/179_46/lawmakers-to-push-fed-to-loosen-insurer-rules-1066097-1.html (accessed March 10, 2014).
37. Part of this confusion stems from Section 171 of Dodd–Frank, which directs federal banking agencies to apply minimum leverage and capital standards typically used for banks to nonbanks. See Diane Katz, "Clumsy Regulation Puts Insurance at Risk," Heritage Foundation *Issue Brief* No. 4174, March 19, 2014, http://www.heritage.org/research/reports/2014/03/clumsy-regulation-puts-insurance-at-risk.

Conclusion

The 2010 Dodd–Frank act was Congress's response to the 2008 financial crisis and represents the government's latest effort to expand a safety net over the financial sector while simultaneously trying to extend credit availability to everyone. Socializing financial firms' costs while leaving profits mainly privatized makes it more likely that managers will take on too much risk.

Rather than addressing this issue, Dodd–Frank essentially provided more of the same. Even though banks received most of the TARP bailout funds, Dodd–Frank expanded the federal regulatory net over nonbank financial companies as well. Much of this expansion takes place through a multi-regulator Financial Stability Oversight Council.

The Financial Stability Oversight Council's role of identifying large financial companies for special regulatory supervision under the Fed increases the likelihood of future financial crises and bailouts. The council's designations for these firms minimize the extent to which potential losses figure into managers' decisions and increase the chances that managers will undertake greater financial risks. The best way to ensure that firms do not take undue risk is to state credibly that owners and creditors—not taxpayers—will be responsible for financial losses. A great first step toward this goal would be to acknowledge that a lack of regulation did not cause the 2008 financial crisis and that more regulation is not the solution to ending future government bailouts.

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