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“Systemically Important” Designation is a Tool That Should Be Used Sparingly

By Paul Schott Stevens

This morning, I participated in a panel discussion addressing the business community’s concerns with the Financial Stability Oversight Council’s (FSOC) proposal on the criteria to measure a company’s systemic risk. It was a lively and timely conversation; I wanted to share here some of the perspective that I brought to the panel on behalf of ICI.

ICI was an early supporter of establishing a system to monitor and manage systemic risks to the financial system. In Senate testimony, I was among the first to call for the formation of a council of regulators to serve this purpose.

Early on, however, we also identified the possible pitfalls of such an arrangement. Two years ago, in a March 2009 white paper, ICI cautioned that a body like the FSOC must “avoid imposing undue constraints or inapposite forms of regulation on normally functioning elements of the financial system, or stifling innovations, competition or efficiencies.” We also warned of the possible anticompetitive effects that could result from designation as a systemically important financial institution (SIFI), if that were viewed by the marketplace as implying that an institution would not be allowed to fail.

Two years later, these cautions and concerns are all the more important. And they have led us to urge that the FSOC reserve designation of non-bank SIFIs for those circumstances where other regulatory measures are clearly inadequate to address the perceived risks of a given institution or activity to the financial system at large.

Such an approach seems consistent with the intent of Congress, judging from floor statements by Sen. Christopher Dodd (D-CT), then Banking Committee Chairman. It also comports with Federal Reserve Board Chairman Ben S. Bernanke’s comments about limited application of this designation authority. It remains to be seen, however, precisely how the FSOC will view the world now that it is operational. Its public pronouncements to date shed little light on how it sees this issue.

As a result, Washington’s latest parlor game involves guessing what non-bank institutions will be designated as SIFIs. The comment file before the FSOC is replete with argument about why myriad elements of the financial system—other, of course, than the commenter’s own—merit SIFI designation.

The focus on SIFI designation misses an important point, however. Quite apart from its designation authority, the FSOC also is in a position to influence oversight of risks to the financial system through its interactions with primary regulators. Ultimately this may prove to be one of its most significant roles—and, in practice, it should minimize the need for using the blunt instrument of SIFI designation except as a last resort.

The Dodd-Frank Wall Street Reform and Consumer Protection Act clearly entrusts the FSOC with a responsibility to coordinate and integrate the efforts of the front line regulators.

For example, Section 112 of the Dodd-Frank Act gives the FSOC the authority to, among other things:

- Facilitate information sharing and coordination among the FSOC member agencies and other Federal and State agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions.

- Recommend general supervisory priorities and principles to the member agencies.
- Identify gaps in regulation that could pose risks to the financial stability of the United States.

The Dodd-Frank Act also established the Office of Financial Research to support the work of the FSOC and its member agencies, collect and maintain data and perform research on systemic risk-related topics. To the extent that the FSOC is concerned about the risks a particular company may pose, it has this powerful new tool to monitor the financial health and activities of the company.

Under Section 120 of the Dodd-Frank Act , the FSOC may issue recommendations to one or more primary financial regulatory agencies to apply “new or heightened standards and safeguards” upon determining that the conduct of a financial activity or practice “could create or increase the risk of significant liquidity, credit, or other problems spreading among back holding companies and nonbank financial companies or the financial markets of the United States.”

The primary regulator(s) must impose the recommended standards or similar standards acceptable to the FSOC, or explain in writing why the regulator has determined not to follow the FSOC’s recommendation.

I believe the FSOC’s authority, in these and other respects, is very important. Why? Because there clearly will be circumstances in which designation of non-bank institutions as SIFIs will be ill suited as a way to address the perceived risks they present.

One class of institutions often raised in this context is money market funds. They illustrate the point. Designating each of the 652 money funds or even the 277 prime money funds offered in the U.S. market as a SIFI and subjecting each to ongoing prudential supervision by the Federal Reserve and discrete capital requirements makes no sense. Nor does it make sense to pick and choose among money market funds or complexes for this purpose.

Additional industry-wide measures to address the kind of risks that emerged in 2008 do make sense, however. These would be best devised by the SEC as money market funds’ front-line regulator, in consultation with the FSOC and in coordination with other regulators.

The point here is that the Dodd-Frank Act, by design, provides an array of new regulatory tools. SIFI designation is only one among them, and one that can and should be reserved for those circumstances in which the risks to the financial system as a whole are both large and quite plain, and nothing less than designation will suffice to address them.

- Visit ICI’s resource center on financial services regulatory reform.
- Visit ICI’s resource center on money market funds.

Paul Schott Stevens was President and CEO of ICI.
