

Treasury's Recommendation for FSOC: No CHOICE but to Play Double Duty

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The Trump Treasury Department's vision for how the FSOC should fulfill its mission is emerging.[1] Ironically, this new, and we think better vision, may be closer to how the Obama Treasury Department originally conceived the FSOC's role. In essence, we read the implicit Treasury viewpoint to be that the over-focus on SIFI designations has been a mistake and hence the pivot to a view that the FSOC would better achieve its purpose if it spent its time looking at activities-based risks on an industry-wide basis. In our view, this pivot implies that the FSOC should also have a role as a coordinator of the priorities and actions of its member agencies.

It should not escape our attention that the Treasury FSOC Report is, in fact, pushing back against those in Congress who would eliminate the SIFI designation power.[2] By suggesting a more tempered exercise of that power, in a more transparent manner that also incorporates cost-benefit analysis, Treasury is saving the designation power for use when it might really be needed.

The recommendations to keep a broad role for the FSOC in the Treasury FSOC Report are in line with the Treasury Bank and Credit Union Report in which the Treasury Department recommended that Congress expand the FSOC's authority to play a larger role in the coordination and direction of regulatory and supervisory policies, including by giving it the power to appoint a lead regulator on issues on which multiple agencies may have conflicting and overlapping regulatory jurisdiction. We believe that even without any Congressional change, however, the FSOC already has the ability to encourage changes in policy, including the ability to promote a regulatory reform agenda and to avoid conflicts among multiple agencies with overlapping jurisdiction. With respect to its member agencies, the FSOC serves as a deliberative forum with name-and-shame powers which have been used effectively in the past to nudge action at a member agency. One benefit of more emphasis on the coordination of supervisory priorities would be to mitigate the traditional fragmentation and turf wars endemic among the financial regulatory agencies. As a result, with just a bit more focus on coordination, with or without the Congressional change of having the power to appoint a lead regulator, the FSOC could have substantial influence on regulatory and policy directions.

The pivot from SIFI designation as a primary focus means that Treasury recommends the FSOC prioritize activities-based or industry-wide risk identification, rather than singling out individual firms. In the Treasury FSOC Report, Treasury begins by identifying five policy goals that the FSOC's designation processes should achieve: (1) to leverage the expertise of primary financial regulatory agencies; (2) to promote market discipline; (3) to maintain a level playing field among firms; (4) to appropriately tailor regulations to minimize burdens; and (5) to ensure the designation analysis is rigorous, clear and transparent.[3] The report then suggests that the FSOC implement a number of measures that would make the SIFI designation process fairer and more transparent. Such measures include (1) a cost-benefit analysis, (2) revisions of its assessments for risk exposure and asset liquidation transmission to be more rigorous, clear and comprehensible, and (3) enhancements of its communications with nonbank financial companies under review and their primary financial regulators earlier in the designation process.[4] Taken together, these measures would make SIFI designations less frequent, more transparent and, when they occur, key to financial stability.

A key point in Treasury's recommendations, however, is that the over-focus on SIFI designations may have led to an under-focus on other areas of risk in the financial sector. Thus, the FSOC should not limit its "broad discretion" in determining how to respond to potential threats to financial stability granted by the Dodd-Frank Act to only addressing risks at certain nonbank financial companies that may be designated. Instead, the FSOC should focus on activities and products to identify the underlying sources of risks to financial stability. The suggested activities-based or industry-wide approach, according to the Treasury FSOC Report, addresses potential limitations that could arise from entity-based

designations, including competitive disadvantages and unnecessary regulatory burden.

[1] On November 17, 2017, in response to the Presidential Memorandum of April 2017, the Treasury Department released a report on its review of the FSOC's SIFI and SIFMU determination and designation processes under section 113 and section 804 of the Dodd-Frank Act ("Treasury FSOC Report"). Before the Treasury FSOC Report, the Treasury Department partially previewed its view on the FSOC's role in its report on banks and credit unions in June 2017 ("Treasury Bank and Credit Union Report") and its report on asset management and insurance in October 2017.

[2] For instance, a revised version of the Financial CHOICE Act (commonly referred to as CHOICE Act 2.0) passed by the House Financial Services Committee in May on a strictly partisan vote would, among other things, repeal the FSOC's authority to designate nonbank financial companies as nonbank SIFIs and to identify systemically important FMUs and payment, clearing and settlement activities. Critically, Treasury's pushback against the Financial CHOICE Act provisions would preserve the option for the FSOC to consider designation of an individual institution that could clearly pose a threat to financial stability but for which no primary regulator has taken or can take adequate steps to address the risk, such as Fannie Mae or Freddie Mac.

[3] In its report, the Treasury Department seeks to refocus the FSOC's designation processes in alignment with the Administration's Core Principles.

[4] Some of Treasury's recommendations involve structural changes to the FSOC's designation process. Treasury suggests that the FSOC combine certain pre-designation review stages and amend the \$50 billion threshold to appropriately tailor it to the risk that an institution could pose to financial stability. Treasury also asks Congress to consider amending section 113 of the Dodd-Frank Act to increase the statutory deadline for a company under review to request a hearing from 30 days to 60 days, and increase the FSOC's deadline for making a final designation after any hearing from 60 days to 90 days.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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