FSOC: Early Years To Lasting And Evolving Role

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A decade after we saw the first signs of the credit crisis in 2007, the financial industry continues to grapple with the regulatory reforms, litigation and enforcement actions that have followed. This Expert Analysis series explores the crisis' profound impact and where we stand today.

Financial crises happen. They have been a recurring feature of all modern financial systems.

In the wake of the global financial crisis, which caused so much human and economic damage in the United States over the last decade, the Financial Stability Oversight Council was created to bring U.S. federal and state regulators together both to prevent and mitigate future crises. Despite this mission, the FSOC has been a central point of controversy about the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. In this article, we review the motivation for the FSOC's formation, its structure, what it does, what it does not do, and why we think the FSOC, with its current array of tools, has an important role in the financial regulatory structure. In sum, because the FSOC is designed to pursue a straightforward and central objective of our financial regulatory system, it should remain a part of the post-financial crisis regulatory landscape, and we are optimistic that it will.

The FSOC's Beginning

The FSOC emerged from the global financial crisis as a product of three interlocking insights. First, the U.S. financial regulatory system is one of specialization and patchwork regulation. Second, in the United States, we do not attempt to impose prudential and risk-and-solvency regulation on all financial services companies all the time. And, third, as a policy we care far more about false negatives than false positives, meaning that we place a priority on identifying potential financial stability concerns, even if they ultimately do not materialize, given the significant adverse effects of failing to identify these risks.
This third insight is underscored by the aftermath of the global financial crisis. The Government Accountability Office estimates that the 2007-2009 financial crisis cost the U.S. economy between approximately $10 trillion and $22 trillion. Most financial crises are not typically followed by snapback recoveries. As we have seen from the post-crisis period, our most recent experience is no exception. That cost is one that, as a policy, we generally should seek to avoid, even if it means identifying false negatives.

One way in which to address the issue of false negatives would be to create a financial regulatory system in which all participants are required to be regulated all the time. Another approach would be to define and regulate a rigid set of activities ex ante, hoping that we can define those activities well enough to protect the public, even as the financial system inevitably changes and evolves. In the United States, we have not adopted either of these approaches.

Instead, the FSOC embodies a perspective that is a balance of these approaches. It is designed to be relatively targeted in its regulatory interventions, but flexible in its reactions to change and evolution. It seeks to synthesize the three insights mentioned above from the perspective of a mission focused on downside risk. And its perspective and accountability is placed in the collective, rather than individual, judgment of the specialized policymakers that comprise the FSOC.

**Structure and Function of the FSOC**

As context for our view of the FSOC’s future, below we briefly review the FSOC’s statutory structure, functions and its actions since its formation.

The FSOC has 10 voting members, including the secretary of the Treasury, who serves as the chairperson of the FSOC. The other voting members are: the chairman of the Federal Reserve; the comptroller of the currency; the director of the Consumer Financial Protection Bureau; the chairman of the U.S. Securities and Exchange Commission; the chairperson of the Federal Deposit Insurance Corp.; the chairperson of the U.S. Commodity Futures Trading Commission; the director of the Federal Housing Finance Agency; the chairman of the National Credit Union Administration Board; and an independent member with insurance expertise appointed by the president, with the advice and consent of the Senate. The FSOC also has five nonvoting members: the director of the Office of Financial Research; the director of the Federal Insurance Office; a state insurance commissioner; a state banking supervisor; and a state securities commissioner.

With this broad membership, the FSOC has three statutory purposes: identifying risks to U.S. financial stability, including risks that could arise from the failure or ongoing activities of financial institutions; promoting market discipline; and responding to emerging threats to U.S. financial stability. This mandate illustrates that the FSOC was created to fill gaps between the jurisdictions of its member agencies and to provide a formal body whose purpose is to look across the range of activities in the financial system and seek to identify emerging risks and threats. Simply put, the FSOC provides its member agencies with a view of the financial services sector as a whole.

In furtherance of its statutory purposes: the FSOC has a number of statutory duties. To highlight a few, the FSOC is meant to: monitor the financial services marketplace to identify threats to U.S. financial stability; monitor regulatory developments and make recommendations to enhance the integrity, efficiency, competitiveness and stability of U.S. financial markets; facilitate information sharing and coordination across its member agencies; identify gaps in regulation that could lead to financial stability risks; and prepare annual reports that note emerging threats to financial stability and recommendations
to enhance the integrity, efficiency, competitiveness and stability of U.S. financial markets, to promote market discipline, and to maintain investor confidence. Of course, as discussed below, another important mandate of the FSOC is, when it determines necessary, to designate nonbank financial companies for consolidated supervision by the Federal Reserve.

Since its formation, the FSOC has taken a wide range of actions to fulfill its statutory purposes and duties, including:

- completing studies and reports on the Volcker Rule, financial sector concentration limits, risk retention requirements, contingent capital, and prompt corrective action requirements, among other topics;
- designating financial market utilities as systemically important;
- proposing a recommendation to the Securities and Exchange Commission on reforms to address the structural vulnerabilities associated with money market funds; and
- analyzing and issuing a report regarding potential vulnerabilities in the asset management industry, as well as creating a working group to consider whether the activities of hedge funds pose financial stability risks.

As is well-known, the FSOC also has designated four nonbank financial companies for consolidated supervision by the Federal Reserve. One of these companies, GE Capital, took significant steps to reduce its size and complexity, and the FSOC subsequently rescinded its designation. As also is well-known, MetLife is challenging its designation through judicial processes.

The reason we list above the FSOC’s mandate and the various actions it has taken is to highlight that the designation tool is but one of its authorities. Further, when viewed in light of the FSOC’s full range of mandates, designation authority is a natural extension of the FSOC’s gap-filling role. That is, designations can be used to step in when a gap has emerged that allows a large, complex firm to operate outside the regulatory perimeter and the FSOC’s member agencies are not otherwise, individually, able to address the issue.

In our view, it is untenable that after the global financial crisis, our regulatory system would not have a tool to bring a firm like Lehman Brothers under consolidated supervision and subject to prudential standards. Nevertheless, while the FSOC has a broad remit and its member agencies each has significant authority, it also has important limits.

**Limits of the FSOC**

Even taking into account the FSOC’s formation, the Dodd-Frank Act did not fundamentally change our financial regulatory system. Said differently, the Dodd-Frank Act did not eliminate the authority of independent regulatory agencies to write rules and exercise jurisdiction within their statutory mandates. The agencies remain accountable for fulfilling their individual missions. This framework was a deliberate choice by Congress and one that animates the FSOC’s work and structure. Ultimately, the FSOC is a body that does not exist separate from its member agencies. It really is not an “uber” regulator, but rather is more of a supercommittee. So, the FSOC by design operates within our financial regulatory structure, not separate from it. And, as discussed below, we think this design is a feature, not a bug.
The Future of the FSOC

Where does its brief, not-quite-inconspicuous history leave the FSOC?

As we reviewed, there are inherent challenges built into the FSOC’s structure. It does not have the ability to directly supervise or regulate financial firms. It cannot force any of its member agencies to act or implement particular policies. Instead, other than by designating nonbank financial companies for consolidated supervision, the FSOC largely is limited to identifying potential threats to financial stability without any direct power to address those threats. In many ways, this is a thankless and impossible task. For the FSOC, success means being correct 100 percent of the time. The efficacy of its actions may never be known; its analyses, recommendations and efforts are prone to being labeled false alarms. As a result, the FSOC serves as an easy scapegoat for any market instability.

Despite these challenges, the FSOC’s structure also has inherent benefits. The FSOC’s voting members are the heads of various agencies, who, over time and as administrations change, will have different perspectives and agendas. To underscore this point, the FSOC’s chairperson is the Treasury secretary, who is a part of the president’s cabinet. Arguably, the Treasury secretary is more responsive to an administration’s political goals than the heads of independent agencies. For this reason, we are doubtful that future Treasury secretaries would want to cede the FSOC’s bully pulpit. We are seeing this dynamic play out today. Certainly the FSOC seems to have survived the initial days of a new administration and is being used as a vehicle to move forward a new financial services agenda.

Indeed, one way to conceptualize the FSOC is as a forum where regulators constantly revisit the question of how to strike the balance between stability and growth. The view on where that balance lies will and should change between administrations and as there are changes in our economy and markets. A robust dialogue about the right balance is important and we welcome it. Of course, there will be disagreements, not just between political parties but within them. That said, the fact that there are valid disagreements on this issue does not mean that the FSOC itself, its structure, purposes and duties are somehow unnecessary and should be vitiated. To the contrary, the FSOC is an agency that uniquely can help move forward the policy agenda that emerges from that debate.

The three insights that led to the FSOC’s creation have not changed and the mission to monitor changes in the financial system for potential risks remains as urgent, even as the last crisis recedes from view. Furthermore, each of the FSOC’s member agencies will, by design, continue to focus on their individual statutory mandates. We believe, however, that these members need a forum to be able to step back and collectively evaluate larger trends in the financial system. This collective engagement is necessary not only to assess the impact of these trends on financial stability, but also to supervise and regulate financial activity within their spheres with maximum effectiveness through business cycles. The FSOC meets this precise need.

The FSOC was born during the Obama administration and, by its nature and during the early years of its life, it focused on the agenda of that administration. There can be disagreements over that agenda and the actions taken and process followed in furtherance of it. Nevertheless, the FSOC’s core attributes should be lasting, including the ability to bring together the various agencies to address important issues and to focus on a collective agenda. This group must aim to ensure that the economy and financial system is not threatened by firms operating outside the regulatory perimeter and to consider and respond to market changes (including as regards competitiveness and efficiency), while promoting
market discipline. Our view is that time will prove that the core purposes and duties of the FSOC are important and will be valued across the market, the regulatory community and administrations.

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