Sifting for SIFIs

BY DAVID A. PRICE

Federal regulators face challenges in identifying "systemically important" financial institutions

No one, it seems, wants a sequel to TARP — the $700 billion Troubled Asset Relief Program carried out by the federal government starting in the fall of 2008 to rescue large financial institutions. Although the program mitigated the effects of the financial crisis as intended, it also raised serious concerns about the fairness and prudence of bailing out private institutions to spare them the consequences of their own risk-taking. One of the ways Congress has sought to prevent further bailouts is by requiring federal regulators to exercise greater oversight of systemically important financial institutions, or SIFIs: nonbank financial institutions whose failure "could pose a threat to the financial stability of the United States."

Responsibility for identifying SIFIs falls on the Financial Stability Oversight Council (FSOC), created by the 2010 Dodd-Frank Act. The Council — made up primarily of the heads of federal financial regulatory agencies, including Fed chairman Ben Bernanke — is now determining how it will sort SIFIs from other institutions. Depending on the criteria that FSOC adopts, tighter federal standards could apply to major mortgage companies, insurance companies, private equity firms, hedge funds, mutual funds, and captive finance companies. (In addition, the Dodd-Frank Act mandates that the largest bank holding companies, those with $50 billion or more in assets, are automatically subject to the tighter standards.)

Bernanke noted in testimony before the House Committee on Financial Services in March that there are different views within the Council about how widely the SIFI net should be cast. "The Federal Reserve has indicated that we think that a relative handful of firms will be so designated," he said. "We don't want to overextend this definition. That being said, we want to be sure to include every firm that would be a serious threat to systemic stability in case of its failure."

Is it Better to Be a SIFI?

The precise implications of being designated as a SIFI are not known yet because the new regulatory regime has not yet been defined. The Dodd-Frank Act directs the Fed to supervise SIFIs; among the measures that Congress authorized the Fed to impose are liquidity requirements, enhanced public disclosure requirements, and short-term debt limits. At the center of the new regime, however, are likely to be new capital requirements. Capital held by financial institutions serves as a buffer against losses and also creates incentives for an institution not to engage in excessive risk-taking. At the same time, many observers worry that capital requirements can slow overall economic activity by curbing the amount of lending that an institution can do.

In a speech on June 3, Federal Reserve Board member Daniel K. Tarullo stated that among various approaches to setting capital requirements for SIFIs, the approach that "has had the most influence on our staff's analysis" would yield a sizable boost in minimum capital. The increase would range from about 20 percent to more than 100 percent compared with the minimum capital standards agreed upon by bank regulators worldwide in the 2010 Basel III framework. In turn, the standards of Basel III, which have not yet been implemented, represent significant increases over those of Basel III's predecessor, the Basel II framework of 2004. To avoid an undue macroeconomic effect from reduced lending, Tarullo said, "we contemplate a fairly generous transition period to the SIFI capital regime."

On the plus side, SIFI designation may confer benefits on a company by reducing its cost of capital. Creditors may believe that enhanced supervision lowers an institution's credit risk. In addition, creditors may assume they will receive better protection if a SIFI fails than if a non-SIFI fails. The Dodd-Frank Act provides that systemically important institutions can be subject to an "orderly liquidation" process to be carried out by the FDIC if they are in default or are in danger of defaulting. The extent of this benefit to creditors, if any, is not clear at this point, however.

"The law says that, in general, creditors are not to be treated any better than they would be treated in bankruptcy," says Richmond Fed economist John Walter. "On the other hand, the law also says that the FDIC is supposed to protect against systemic risk, and if you're going to protect against systemic risk, it's hard to imagine doing that without treating some creditors better than they would be treated in bankruptcy. Indeed, the law allows some creditors, those providing funding necessary to continue essential operations, to be paid more than they would likely get in bankruptcy."

So far, institutions appear to believe that they would be worse off as SIFIs. In public comments filed with FSOC and in public statements, large nonbanks and their trade associations have argued that they should not be considered systemically important. "They might perceive that higher capital standards and regulations of what they can and can't do will cost them more than any benefit they might receive in terms of lower interest rates," Walter says.

The institutions' concerns about the regulatory regime for SIFIs may be heightened by a fear that the as-yet-unwritten rules will turn out to be overly restrictive, according to economist Robert Litan of the Brookings Institution. "In the wake of the crisis, a lot of private sector people are afraid of overreaction by regulators," Litan says. "There has been a significant increase in risk-aversion in the regulatory community, for obvious reasons."

Who's Systemically Important?

The Dodd-Frank Act requires the Financial Stability Oversight Council (FSOC) to designate a nonbank financial company as systemically important — and therefore subject to regulation by the Fed — "if the Council determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States."

The statute sets out a lengthy list of factors that FSOC must consider in deciding whether a company is systemically important:

- **A** the extent of the leverage of the company;
- **B** the extent and nature of the off-balance-sheet exposures of the company;
- **C** the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies;
- **D** the importance of the company as a source of credit for households, businesses, and State and local governments and as a source of liquidity for the United States financial system;
- **E** the importance of the company as a source of credit for low-income, minority, or underserved communities, and the impact that the failure of such company would have on the availability of credit in such communities;
- **F** the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse;
- **G** the nature, scope, size, scale, concentration, interconnectedness, and mix of the activities of the company;
- **H** the degree to which the company is already regulated by 1 or more primary financial regulatory agencies;
- **I** the amount and nature of the financial assets of the company;
- **J** the amount and types of the liabilities of the company, including the degree of reliance on short-term funding; and
- **K** any other risk-related factors that the Council deems appropriate.

SOURCE: Dodd-Frank Wall Street Reform and Consumer Protection Act, sec. 113(a)

Designation Transparency and Designation Parity

FSOC must resolve a plethora of issues in determining its process for designating firms. Among them is "designation transparency" — that is, whether to make its process confidential and whether to keep designations confidential once they have been decided. The Financial Services Roundtable, a trade group of large financial institutions, has requested in public comments that the consideration process remain confidential to prevent adverse reactions by investors. The Richmond Fed, in its November 5, 2010, public comment letter on the issue, urged FSOC to maintain transparency and eliminate guesswork by making public both the names of the institutions it evaluates for SIFI status and the names of those it actually designates. Only if markets know which firms are receiving enhanced supervision, and which firms are not, can markets factor in the additional risk of the latter.

In practice, while it may be possible to conceal the consideration process from public view, the actual designation of a firm would be unlikely to remain secret. As James Thomson of the Cleveland Fed notes in an August 2009 paper, markets would probably be able to infer which firms are on the SIFI list by looking at differences in capital structure, balance sheet entries and footnotes, and intensity of regulatory scrutiny.

Another issue is "designation parity," which arises from the structure of the Dodd-Frank Act: Congress created one process for designating firms as systemically important for purposes of being subject to higher regulatory standards and another for determining whether a firm is systemically important for purposes of being eligible for orderly liquidation. The Act sets out a complex procedure, involving multiple agencies, for deciding whether a firm should be put into the orderly liquidation process. Even though FSOC has deemed a firm not to be systemically important, the Act allows the federal government to treat it as systemically important anyway if it starts to fail.

This potential for inconsistency has a significant practical implication: It may lead to moral hazard by creating ambiguity as to the availability of orderly liquidation. If FSOC does not subject an institution to enhanced supervision, but creditors believe that they may still get protection unavailable in a normal bankruptcy, then the institution may take excessive risks. It will benefit from a reduced cost of capital even though its risk-taking is disciplined neither by regulation nor by creditors' fear of bankruptcy.

For that reason, the Richmond Fed recommended to FSOC that it pursue parity between its designation of SIFIs and the designations in the orderly liquidation process. The Richmond Fed argued that a credible commitment to parity in designations would avoid the market distortions and excessive risk-taking that would otherwise occur. (Although there are two distinct processes, the agencies involved generally overlap.)

Finding the Right Criteria

Apart from issues of process, there is also, of course, the question of how FSOC should determine which firms are systemically important. Asset size alone is not necessarily enough to create systemic risk; for example, large firms that hold only safe assets such as Treasury bills are unlikely to threaten the stability of the financial system. Observers generally agree that systemic risk comes not just from a firm's scale, but from its scale plus its leverage and its degree of interconnection with other firms. Highly leveraged firms, by definition, have only a thin layer of capital with which to absorb losses. Interconnection means the extent to which firms' risks are correlated with one another's: whether through formal exposures (such as credit or derivatives contracts) or through *de facto* exposures to similar market risks or operational risks. Asset size, leverage, and interconnection are among the numerous criteria that the statute requires FSOC to consider. (See box.)

A recent Richmond Fed *Economic Brief* ("Identifying Systemically Important Financial Institutions") argued that the criteria for determining SIFI status should give significant weight to an institution's degree of maturity mismatch — that is, whether an institution has long-term assets matched with liabilities that are subject to short-term redemption. The classic case is a bank that funds mortgages (long-term assets) with demand deposits (short-term liabilities). In the absence of deposit insurance, if depositors become nervous, there may be a stampede to the door, since only the first depositors to demand their money are sure to get 100 cents on the dollar. The same may occur with nonbanks funded largely by short-term debt: If the institution cannot roll over its debt, it may be forced to engage in fire sales of its assets, which in turn may lead to system-wide problems.

Another issue FSOC will confront is whether to set a higher standard for designating nonbanks that are in certain categories. For example, some large nonbanks already have primary regulators — such as insurance carriers that are regulated for solvency by state insurance commissioners and mutual funds that are regulated by the Securities and Exchange Commission. FSOC could elect to defer to those regulators to some degree. FSOC could also choose to treat mutual funds differently from other nonbanks on the basis that losses from mutual funds are borne by the funds' accountholders rather than the mutual fund companies themselves; in effect, they are 100 percent equity funded. These factors arguably render the funds less likely to create systemic losses.

Complicating the picture for money-market mutual funds in particular is that the Treasury Department did come to the rescue of money-market funds during the recent financial crisis with a guarantee to avoid a run on those funds. Treasury stepped in on September 19, 2008, after one money-market fund, the Reserve Primary Fund, "broke the buck" (its shares fell to 97 cents). Mutual funds and investment companies other than money-market funds do not promise a stable net asset value, however.

To some extent, the size of the net used by federal regulators to select financial institutions for greater regulation is likely to reflect not only technical issues, but also differences of opinion about the effects of regulation — its costs and its ability to prevent future crises.

"Your attitude toward risk and your confidence in government regulation are going to influence where you draw the line," says Litan of Brookings. "There is no technocratic way out. People are trying to measure with great precision how much systemic risk institutions pose. I think these are interesting academic exercises, but the decisions are not going to be based on technocratic criteria. They are going to be based on these larger philosophical worldviews that people have." **RF**

Readings

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