



Changes to “Too Big To Fail”?: Treasury Recommends Revisions to Dodd-Frank SIFI Designation Process for Non-Banks (Part II)

Jay B. Sykes

Legislative Attorney

December 1, 2017

As discussed in [Part I](#) of this two-part Sidebar, on November 17, the Treasury Department issued a [report](#) recommending a number of changes to the [Financial Stability Oversight Council](#)'s (FSOC's) process for designating non-bank financial companies as “systemically important financial institutions” (SIFIs) (colloquially known as institutions that are “Too Big to Fail”) under the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Dodd-Frank). While [Part I](#) provides a general background on the SIFI designation process, this Sidebar discusses the legal debate over the designation process, the Treasury Department's recommended changes for the process, and how those changes may affect the Senate's consideration of the [Financial CHOICE Act of 2017](#), which would repeal FSOC's authority to designate non-banks as SIFIs altogether.

The Debate over the SIFI Designation Process

The SIFI designation process has been the subject of much legal debate. As discussed in [Part I](#) of this Sidebar, FSOC is currently [engaged](#) in litigation over its designation of MetLife as a SIFI, which was [overturned](#) by the U.S. District Court for the District of Columbia. Moreover, some legal [commentators](#) have [criticized](#) FSOC for what they regard as its lack of transparency and failure to adequately communicate with companies being considered for designation. [Other](#) critics [argue](#) that the standards FSOC uses to designate companies as SIFIs are excessively vague. Along these lines, the House Committee on Financial Services issued a report in February concluding that FSOC has [failed](#) to follow its own guidance for SIFI designations and evaluated companies using [inconsistent](#) standards.

Congressional Research Service

7-5700

www.crs.gov

LSB10040

On the other hand, [defenders](#) of FSOC have argued that the “malleable standard[s]” FSOC applies in deciding whether to designate companies as SIFIs effectively deter companies from seeking out systemically risky activities. According to these commentators, the adoption of precise mathematical formulas for distinguishing between safe and risky companies would encourage companies to seek out activities with risks that are not adequately reflected in such rigid standards. They contend that vesting FSOC with “broad discretion” to designate firms as SIFIs is appropriate given the inherent difficulty of identifying systemic risks and the perils of failing to identify such risks.

Treasury’s Recommended Changes

The Treasury Department’s latest Report outlines four general recommendations for changing the SIFI designation process for non-bank financial companies. First, the Report recommends that FSOC adopt an “[activities-based](#)” or “[industry-wide](#)” approach to assessing potential risks posed by non-banks. Under this approach, FSOC would prioritize identifying specific financial activities and products that could pose risks to financial stability, work with the primary financial regulatory agencies to address those specific risks, and consider individual firms for designation as SIFIs only as a matter of last resort if more limited actions aimed at mitigating discrete risks are insufficient to safeguard financial stability.

Second, the Treasury Department [recommends](#) that FSOC “increas[e] the analytical rigor” of its designation analyses. Specifically, the Report recommends that FSOC: (1) consider any factors that might mitigate the exposure of a firm’s creditors and counterparties, (2) focus on “plausible” (and not merely “possible”) asset liquidation risks, (3) evaluate the likelihood that a firm will experience financial distress before evaluating how that distress could be transmitted to other firms, (4) consider the costs *and* benefits of designations, and (5) collapse its three-stage review process into two steps—notifying companies that they are under active review during Stage 1 and voting on proposed designations after the completion of Stage 2.

Third, the Treasury Department [recommends](#) enhancing engagement between FSOC and companies under review and improving the designation process’s transparency. Specifically, the Report recommends that FSOC: (1) engage earlier with companies under review and “explain . . . the key risks” that FSOC has identified, (2) “undertake greater engagement” with companies’ primary financial regulators, and (3) publicly release explanations of its SIFI designation decisions.

Fourth, the Treasury Department [recommends](#) that FSOC provide “a clear off-ramp” for non-banks designated as SIFIs. Dodd-Frank mandates that FSOC re-evaluate its designations annually, allowing the agency to rescind a designation if it determines by a two-thirds vote that includes the Secretary of the Treasury that the company no longer meets the standards for designation. The Treasury Department recommends that FSOC: (1) as an initial matter, highlight the key risks that led to a company’s designation, (2) “adopt a more robust and transparent process for its annual reevaluations” that “make[s] clear how companies can engage with FSOC . . . and what information companies should submit during a reevaluation,” (3) “develop a process to enable a designated company to discuss potential changes it could make to address the risks it could pose to financial stability,” and (4) “make clear that the standard it applies in its annual reevaluations is the same as the standard for an initial designation of a nonbank financial company.”

The Treasury Department’s recommendations may prove significant if and when the Senate considers the [Financial CHOICE Act of 2017](#), which passed the House of Representatives in June. Among other

changes to Dodd-Frank, the CHOICE Act [repeals](#) FSOC's authority to designate non-banks as SIFIs. It remains to be seen whether the proposed changes will resolve current concerns over FSOC's SIFI authority. It also remains unclear whether FSOC will act on the Treasury Department's recommendations. Finally, it is uncertain how the recommendations, if they were to be adopted by FSOC, would affect the litigation over MetLife's designation as a SIFI. As discussed in Part I of this Sidebar, that litigation is currently pending before the U.S. Court of Appeals for the District of Columbia Circuit, and implicates many of the concerns raised by critics of the SIFI designation process.