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Designation of Global 'Too Big To Fail' Firms

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Hearings in both the House and the Senate have examined the role and processes for U.S. financial regulators and the international standard-setting body—the Financial Stability Board (FSB)—for designating large financial institutions as systemically important (or "too big to fail"). Members of Congress and various witnesses have raised concerns that the process of FSB designation for global firms, including U.S. firms, is opaque, and that it has potentially costly implications for large U.S. financial firms without affording them U.S. legal means of redress or U.S. "due process." This CRS Insight provides background on the FSB's designation process for systemically significant financial institutions, but takes no position on any potential benefits or shortcomings of that process.

Background

The FSB was established by G-20 nations in April 2009 to help strengthen the global financial system following the 2008 financial crisis. Its members comprise financial regulatory agencies of G-20 nations. The United States is represented at the FSB by the Department of the Treasury, the Federal Reserve Board, and the Securities and Exchange Commission. The FSB's functions include assessing vulnerabilities to the global financial system; coordinating with financial authorities of member nations; and recommending measures to protect and strengthen the global financial system. The FSB's recommendations and decisions are not legally binding on any of its member nations. Rather, the FSB "operates by moral suasion and peer pressure, in order to set internationally agreed policies and minimum standards that its members commit to implementing at national level."

As part of its monitoring of global financial stability, the FSB designates a number of financial institutions as globally systemically important. Although the FSB has its own legal identity, its Secretariat is housed within the Bank for International Settlements (BIS), and it also relies on the Basel Committee on Banking Supervision (BCBS) to help create methodologies for assessing certain risks for banks, on the International Association of Insurance Supervisors (IAIS) for insurers, and on the International Organization of Securities Commissions (IOSCO) for non-bank non-insurers. An FSB designation is meant to indicate that the failure of an individual institution could have a negative impact on the global financial system. Initially, the designation focused on global systemically important banks (G-SIBs), but it now includes global systemically important insurers (G-SIIs), and non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs), such as large asset managers, broker-dealers and hedge funds. Designated institutions are expected to meet higher qualitative and quantitative regulatory and capital standards to help ensure they will not need government support during a crisis. FSB designations are not self-executing, however, meaning they would only take effect if national regulators implement them. Domestically, the Financial Stability Oversight Council (FSOC) designates financial firms as systemically important, and the Federal Reserve oversees these firms. The FSOC was created in 2010 by the Dodd Frank Act to monitor systemic risk in the financial system and coordinate among federal financial regulators. Whether, and to what degree, the FSB designations influence FSOC designations has been an issue of congressional interest.

Designations

The current process for identifying G-SIBs comprises a combination of numerical benchmarks and the judgment of FSB member regulators according to five criteria: size, interconnectedness, available substitutes, cross-jurisdictional activity, and complexity. Banks that score above a certain threshold number are placed in one of five broad categories representing a required level of additional capital.

In November 2014, the FSB classified 30 banks as G-SIBs, including 8 U.S. banks. In July 2013, the FSB designated nine large international insurers, including three large U.S. insurers—American International Group, Inc., Prudential Financial, Inc. and MetLife, Inc.—as G-SIIs. The FSB to date has not designated any asset managers. The FSB is still refining its methodology for identifying G-SIIs (insurers) and NBNI G-SIFIs (such as asset managers).

The FSB's designation process is aimed at reducing vulnerabilities in the financial system globally and creating a more harmonized global response to such potential vulnerabilities broadly. A 2010 FSB document spelled out that "financial institutions that are clearly systemic in a global context (G-SIFIs) should have higher loss-absorbency capacity than the minimum levels agreed in Basel III" and be "subject to more intensive coordinated supervision and resolution planning to reduce the probability and impact of their failure." The FSB is not unique in that the United States participates in other multilateral bodies aimed at harmonizing financial standards whose guidelines are not legally binding. Examples include U.S. participation in BCBS, IOSCO, the International Accounting Standards Board (IASB) and IAIS.

Debate over FSB Designation Process

Some observers contend that the designation process is necessarily flexible to account for variations in financial entities operating across national boundaries, whereas some industry groups and members of Congress have questioned the FSB process as arbitrary and unnecessary. Witnesses from the asset management industry testified at a Senate Banking Committee hearing in July 2015 that the FSB designation process relied too heavily on banking regulators and central bankers, who, they said, viewed non-bank activities as inadequately regulated compared with banks. An insurance industry witness testified that there was a potential for inconsistent capital standards to be applied to insurers through the FSB designation process and recommended an "activities-based" approach to stricter requirements on insurers rather than a "designation" approach of individual companies.

Senate Banking Committee Chair Senator Shelby sent a letter dated September 29, 2015, to U.S. financial regulators stating that the FSB reviews and designates U.S. entities as systemically risky without the due process intrinsic in the U.S. regulatory framework. House Financial Services Committee Chair Representative Hensarling and the subcommittee chairmen sent a letter dated May 9, 2014, to financial regulators arguing, among other things, that the FSB designations might influence or supersede the judgments of U.S. regulators before designated entities had presented all their own evidence.

Other Members of Congress, such as Senate Banking Committee Ranking Member Senator Brown, have stated that, with the increased interconnectedness of global financial markets, internationally harmonized standards such as those of the FSB's, are even more crucial. Other witnesses have argued that the FSB can act as an additional non-binding "check and balance" on domestic regulators.