



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

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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). The Treasury Department issued the recommendations in response to President Trump's [memorandum](#) issued in April directing the Secretary of the Treasury to conduct a review of the SIFI designation process.

Part I of this two-part Sidebar provides general background on the SIFI designation process. [Part II](#) of this Sidebar discusses the debate over the designation process and the Treasury Department's recommended changes for the process.

The 2008 Financial Crisis and Section 113 of Dodd-Frank

As background, during the 2008 financial crisis, financial distress at certain non-bank financial companies—including Bear Stearns, Lehman Brothers, American International Group (AIG), Fannie Mae, and Freddie Mac—“[contributed](#),” according to FSOC, “to a broad seizing up of financial markets and stress at other financial firms.” Ultimately, Lehman Brothers [declared](#) bankruptcy, the federal government committed funds to facilitate JP Morgan's [acquisition](#) of Bear Stearns and to [rescue](#) AIG, and Fannie Mae and Freddie Mac [entered](#) conservatorships. These events, [according](#) to the report of the Financial Crisis Inquiry Commission, “marked the beginning of the worst market disruption in postwar American history” as “[c]reditors and investors suspected that many other large financial institutions were on the edge of failure” and rushed to sell and withdraw their assets.

In 2010, in response to the crisis, Congress passed and President Obama signed [Dodd-Frank](#). Among

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other things, Dodd-Frank created FSOC, whose voting members consist of the Secretary of Treasury, the heads of other federal financial regulatory agencies, and an independent insurance expert. The statutory purposes of FSOC are to (1) identify risks to the financial stability of the United States, (2) promote market discipline by eliminating expectations of government bailouts, and (3) respond to emerging threats to the stability of the United States financial system.

Section 113 of Dodd-Frank granted FSOC the authority to designate certain non-bank financial companies as SIFIs and subject them to the supervision of the Federal Reserve under enhanced prudential standards. These standards include, among other things, stricter capital requirements, leverage limits, and liquidity requirements, and a mandate that SIFIs submit plans for their orderly resolution in the event of distress or failure (so-called “living wills”). As discussed in more detail in Part II of this Sidebar, while some have defended these additional requirements, other commentators have characterized them as “onerous” and “burdensome.” For example, in challenging its designation as a SIFI, MetLife alleged that its designation would result in “billions of dollars” of additional regulatory costs.

Section 113 provides that FSOC may designate non-bank financial companies as SIFIs under either of two standards: (1) when “material financial distress” at a non-bank financial company itself “could pose a threat to the financial stability of the United States,” or (2) when the “nature, scope, size, scale, concentration, interconnectedness, or mix of the [non-bank financial company’s] activities” could pose that same threat. FSOC must consider a list of ten non-exhaustive factors, including the extent of a company’s leverage and the importance of the company as a source of liquidity for the U.S. financial system, when evaluating whether a non-bank should be designated as a SIFI.

FSOC Guidance

In 2012, FSOC issued guidance concerning the SIFI designation standards and process. In the guidance, FSOC organized the ten statutory factors guiding SIFI designations into several different factors to assess both “the potential for spillovers from [a] firm’s distress” and “how vulnerable a company is to financial distress.” The FSOC guidance also outlined a three-stage process leading up to a proposed SIFI designation. FSOC begins the process by applying “a set of uniform quantitative metrics” to the entire market. During Stage 2, FSOC focuses on individual companies that are of particular concern. Finally, during Stage 3, FSOC evaluates any information submitted by a company under consideration and decides whether to designate the company as a SIFI. If FSOC makes such a proposal, the company may request a hearing to challenge that decision.

Designations

To date, FSOC has designated four non-bank financial companies as SIFIs: AIG, GE Capital, Prudential, and MetLife. However, FSOC later rescinded its designations of AIG and GE Capital, and the U.S. District Court for the District of Columbia overturned FSOC’s designation of MetLife as “arbitrary and capricious” (the standard of review for SIFI designations provided by Dodd-Frank). Specifically, the court found that FSOC failed to: (1) assess MetLife’s vulnerability to financial distress, (2) adhere to its guidance concerning the circumstances in which a non-bank could threaten financial stability through the identified “transmission channels,” and (3) consider the costs of the designation. FSOC appealed the district court’s decision, and the litigation is currently pending before the U.S. Court of Appeals for the District of Columbia Circuit.