CRS Insights

Designating Systemically Important Financial Institutions (SIFIs)
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The 2008 financial crisis resulted in government assistance to rescue several financial firms that were considered "too big to fail" (TBTF) because their failure would cause unacceptable disruptions to the overall financial system. Some of these were non-bank financial firms, including Bear Stearns, Fannie Mae, Freddie Mac, and AIG. A number of approaches (detailed in this CRS report) have been suggested to solve the "too big to fail" problem, some of which were enacted in the Dodd-Frank Act (P.L. 111-203).

Central to the Dodd-Frank approach was the creation of a heightened prudential regulatory regime for "systemically important" financial firms to be administered by the Federal Reserve (the Fed). Under this regime, the Fed is required to set heightened standards for capital, liquidity, risk management, resolution plans, stress tests, early remediation, and concentration limits. The Fed may tailor these standards to account for differences between different types of firms. All bank holding companies with $50 billion or more in assets are automatically subject to the heightened prudential regime. In addition, the Financial Stability Oversight Council (FSOC), a council of regulators, was authorized to designate non-bank financial firms as systemically important by a qualified two-thirds vote. FSOC is headed by the Treasury Secretary, and a designation requires his approval. To date, FSOC has designated three non-banks as systemically important financial institutions (SIFIs)—the insurers AIG and Prudential and the non-bank lender GE Capital. Reportedly, another insurer, MetLife, is formally being considered for designation. FSOC is considering whether to designate firms in other sectors of the financial system, and recently held a conference on the potential systemic importance of asset managers.

Economic theory suggests that expectations that the government will prevent a firm from failing creates moral hazard—if the creditors and counterparties of a TBTF firm believe that the government will protect them from losses, they have less incentive to monitor the firm's riskiness because they are shielded from the negative consequences of those risks. If successful, heightened prudential regulation could offset the moral hazard problem by limiting risk taking. If financial firms are perceived as "too big to fail," they may be able to borrow at lower rates than other firms. In principle, heightened prudential regulatory standards could offset this funding advantage, thereby creating a level playing field for small and large firms. To date, the Fed has not promulgated regulations for the non-bank SIFI prudential regime.

Some Members of Congress have expressed concerns with the SIFI regime. Congressional concerns related to non-bank SIFIs include

- Does the SIFI regime reduce or increase moral hazard?
- Do financial actors view FSOC designation as explicitly identifying which firms the government considers to be TBTF, thereby increasing expectations of future government assistance?
- Will the Fed's heightened regulatory regime be tough enough to penalize systemic importance? If not, and if SIFI-designation confers a funding advantage, firms could find it advantageous to be designated.
- Is the FSOC sufficiently accountable?
- Is the FSOC designation process transparent enough? The FSOC has finalized a rule explaining in general terms the criteria it considers when making a designation, and once a designation is made, it releases a document explaining why that firm was designated. Public disclosure of more information is complicated by the confidential nature of some of the information involved.
- Is the designation process objective? Is FSOC open to evidence presented by firms under consideration that they are not systemically important? The Dodd-Frank Act allows a non-bank SIFI to request a hearing before the FSOC before the designation is made and appeal its designation in federal court after the fact.

- Has the FSOC designation process been superseded by a similar process for global financial firms carried out by the Financial Stability Board (FSB), an intergovernmental body in which the United States participates in? Are the FSB standards compatible with U.S. statute? To date, the FSB has designated 29 banks and nine insurers as globally systemically important, and is in the process of designating other types of financial firms. The FSB designation is being used to determine which banks will be assessed a capital surcharge under Basel III.
- How can systemic risk best be mitigated?
- Might types of firms that were not central to the recent crisis, such as asset managers, be a source of systemic risk in the future? The Office of Financial Research recently noted that there were ten asset management firms with over $1 trillion of assets under management. Critics claim that their size does not pose systemic risk because they are only custodians of their clients' funds and they are not prone to disorderly failures, as was evidenced in the crisis.
- Does systemic risk primarily stem from individual firms or activities? If the latter, it would arguably be appropriate to regulate the activity directly. Otherwise, systemic risk might migrate to less regulated firms.
- How should non-banks be regulated?
- Does the Fed have the expertise to effectively regulate non-banks? Does each industry need its own regulatory model or can banking regulations be adapted to match the business models of non-banks?
- Are insurance firms already adequately regulated for safety and soundness at the state level, thus obviating the need for the Fed's heightened regime? Are state insurance regulators taking into account systemic risk concerns?
- Will the Fed's heightened prudential regime increase or reduce financial innovation, credit growth, and credit availability?

H.R. 4881, as ordered to be reported by the House Financial Services Committee, would place a one-year moratorium on FSOC designations. The FY2015 Financial Services and General Government appropriations bill (H.R. 5016), as passed by the House, would not allow any appropriated funds to be used to designate a non-bank as systemically important or as posing a systemic threat to financial stability. S. 2270, as passed by the Senate, allows the Fed to exempt insurers from the "Collins Amendment"—bank capital standards that would otherwise apply because the insurers are SIFIs or bank holding companies.