

First Designations of ‘Systemically Important’ Firms

BY DAVID A. PRICE

The Dodd-Frank Act, passed in 2010, created an interagency group called the Financial Stability Oversight Council, or FSOC, to identify risks to the country’s financial stability. Among its tasks is designating nonbank financial institutions as systemically important financial institutions, or SIFIs — that is, determining which institutions, in the event of distress, would pose a threat to the stability of the financial system. FSOC has recently made its first three designations: In July, it designated General Electric Capital Corp. and American International Group (AIG), and in September, it designated Prudential Financial, Inc.

Following the designations, the institutions become subject to supervision by the Fed and must comply with certain financial standards. They must also undergo periodic stress tests and develop a “living will” (a plan for winding down without government aid). Prudential had sought to head off designation; it was designated after it unsuccessfully appealed a preliminary decision by FSOC. GE Capital and AIG did not object to their designations.

FSOC has stated that it uses a three-stage process to flag institutions that may be systemically important. Its first stage, highly preliminary, is to use publicly available data and regulatory data on various quantitative factors to narrow the list of firms; among these are asset size, credit default swaps (CDS), outstanding debt, and leverage. (In looking at CDS, the Council considers all CDS for which the firm is the reference entity.) In stage two, it further analyzes the threat posed by each of the remaining firms to financial stability using both quantitative and qualitative information. Each company that proceeds to stage three is notified that it is under consideration and is offered the opportunity to provide information before FSOC reaches a decision.

For each of the designations, the Council released detailed analyses of what it saw as the relevant facts. With regard to GE Capital, a General Electric subsidiary with \$539 billion in assets, FSOC emphasized that the scale of its activities as a provider of credit and as an issuer of commercial paper and other debt gave it strong interconnections with financial markets. It suggested that because money market mutual funds are major purchasers of GE Capital’s commercial paper, financial distress at the firm could cause those funds to “break the buck,” leading to a run on money market funds in general.

In addition, if distress at GE Capital impaired its ability to borrow, it might have to liquidate assets rapidly, possibly leading to a fire sale that would drive down the prices of assets held by other large financial firms. FSOC also noted that some 52 percent of GE Capital’s assets were based abroad and 42 percent of its revenues came from abroad,

making it more difficult to resolve rapidly and thereby increasing the threat to U.S. financial stability.

In designating AIG, the Council determined that AIG’s traditional insurance and annuity products could be the basis of systemic risk. (AIG was rescued by the federal government during the 2007-2008 financial crisis after suffering major losses on CDS, a nontraditional insurance product.) It found that the traditional products offered by AIG could give rise to systemic risk in several ways. First, many firms are connected to AIG in its role as insurer. FSOC acknowledged that losses to policyholders would be reduced by state guaranty associations, but noted that distress at AIG could put “unprecedented strain” on that system.

Second, many of AIG’s life insurance and annuity products “have features that would make them vulnerable to rapid and early withdrawals by policyholders,” creating a possible need for AIG to liquidate assets quickly. Finally, AIG’s critical role in certain commercial insurance markets would be difficult to replace within a short time. FSOC also noted that holders of CDS for which AIG is the reference entity would be at risk from distress at the company, as would holders of its securities.

FSOC set out rationales for its designation of Prudential similar to those for its designation of AIG. Several FSOC members dissented. The dissenters were two voting members of the Commission — Edward DeMarco, acting director of the Federal Housing Finance Agency, and S. Roy Woodall, a former Kentucky insurance commissioner and a former president of the National Association of Life Companies — and one nonvoting member, John Huff, head of the Missouri Department of Insurance. They argued that FSOC had misunderstood the business of insurance and overstated Prudential’s risks to the financial system.

The effect of designation on the firms and their markets remains an open question, observes Richmond Fed bank structure manager Sabrina Pellerin. For some firms, designation as a SIFI could prove beneficial in that it may be interpreted by investors and customers as an implicit federal guarantee — despite provisions in the Dodd-Frank Act limiting federal rescues. For other firms, new capital, leverage, and liquidity requirements from designation may create a net burden.

“The idea of insurance companies being regulated similarly to banks raises questions about whether they will be at a competitive disadvantage next to other firms in the industry,” Pellerin says.

Whatever the effects, FSOC’s rationales for its first designations will likely be studied by insurers, asset management companies, and other nonbanks that may become candidates for SIFI-hood.

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