

# Audit of the Financial Stability Oversight Council's Efforts to Promote Market Discipline

Report to the Financial Stability Oversight  
Council and the Congress

PREPARED BY  
THE COUNCIL OF INSPECTORS GENERAL  
ON FINANCIAL OVERSIGHT



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## Abbreviations

<b>BHC</b>	Bank holding company
<b>CIGFO</b>	Council of Inspectors General on Financial Oversight
<b>Dodd-Frank Act</b>	Dodd-Frank Wall Street Reform and Consumer Protection Act
<b>FDIC</b>	Federal Deposit Insurance Corporation
<b>FMU</b>	Financial market utility
<b>FRB</b>	Board of Governors of the Federal Reserve System
<b>FSOC or Council</b>	Financial Stability Oversight Council
<b>GAO</b>	Government Accountability Office
<b>OFR</b>	Office of Financial Research
<b>SEC</b>	Securities and Exchange Commission
<b>TBTF</b>	Too big to fail
<b>Treasury</b>	Department of the Treasury



**DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C. 20220**

February 28, 2017

The Honorable Steven T. Mnuchin  
Chair, Financial Stability Oversight Council  
Washington, D.C. 20220

Dear Mr. Chairman:

I am pleased to present you with the Council of Inspectors General on Financial Oversight (CIGFO) report titled, *Audit of the Financial Stability Oversight Council's Efforts to Promote Market Discipline*.

One of the statutory purposes of the Financial Stability Oversight Council (FSOC) is to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties, of large, interconnected bank holding companies and nonbank financial companies that the United States Government will shield them from losses in the event of failure. Accordingly, CIGFO convened a Working Group to assess FSOC's efforts to promote market discipline.

In this resulting audit report, we concluded that FSOC has made progress in promoting market discipline. However, the wide range of views that still exist on the issue of "too big to fail" indicate that there is a lack of consensus regarding whether FSOC has eliminated expectations on the part of shareholders, creditors, and counterparties of large bank holding companies or nonbank financial companies that the federal government will shield them from losses in the event of failure. According to those we spoke with, FSOC faces challenges in meeting this purpose due to its limited authorities, having to rely on the actions of others, a difficulty in measuring whether expectations have been eliminated, and the recent legal challenge to its designation authority. We are not making any recommendations to FSOC as a result of this audit.

I would like to take this opportunity to thank the the FSOC members for their support, especially those Treasury officials who assisted with this effort.

CIGFO looks forward to working with you on this and other issues. In accordance with the Dodd-Frank Wall Street Reform and Consumer Protection Act, CIGFO is also providing this report to Congress.

Sincerely,

/s/

Eric M. Thorson

Chair

Council of Inspectors General on Financial Oversight

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# Executive Summary

## Why and How We Conducted this Audit

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) created a comprehensive regulatory and resolution framework designed to reduce the likelihood, and severe economic consequences, of financial instability. The Dodd-Frank Act established the Financial Stability Oversight Council (FSOC or Council) and charged it with identifying risks to the nation's financial stability, promoting market discipline, and responding to emerging threats to the stability of the nation's financial system. Among other duties, Title I of the Dodd-Frank Act requires FSOC to report to Congress annually about: (1) its activities; (2) significant financial market and regulatory developments; (3) potential emerging threats to the financial stability of the U.S.; and (4) recommendations to: (i) enhance the integrity, efficiency, competitiveness, and stability of U.S. financial markets; (ii) promote market discipline; and (iii) maintain investor confidence.

The Dodd-Frank Act also created a Council of Inspectors General on Financial Oversight (CIGFO), whose members include the Inspectors General with oversight authority for the majority of FSOC member agencies. The Dodd-Frank Act authorizes CIGFO to convene a Working Group of its members to evaluate the effectiveness and internal operations of FSOC. In October 2015, CIGFO convened a Working Group to assess FSOC's efforts to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of large bank holding companies (BHC) and nonbank financial companies that the government will shield them from losses in the event of failure.

To accomplish CIGFO's objective, the Working Group reviewed the Dodd-Frank Act to determine FSOC's statutory purposes and duties. It reviewed FSOC's governance documents, annual reports, and meeting minutes. It also interviewed staff from the FSOC Secretariat at the Department of the Treasury (Treasury) as well as other FSOC member agency representatives to develop a better understanding of FSOC's efforts to promote market discipline. In addition, the Working Group interviewed knowledgeable parties outside of FSOC to obtain their perspectives of FSOC and its efforts to promote market discipline.<sup>1</sup> The Working Group conducted fieldwork from October 2015 through August 2016 in accordance with generally accepted government auditing standards. On December 1, 2016, the Working Group briefed FSOC representatives on the overall results of our audit. Appendix I provides additional details about the objective, scope, and methodology of this audit.

## What We Learned

FSOC has made progress in promoting market discipline; however, the wide range of views that still exist on the issue of "too big to fail" (TBTF) indicates that there is a lack of consensus regarding whether FSOC has eliminated expectations on the part of shareholders, creditors, and counterparties of large BHCs or nonbank financial companies that the federal government will shield them from losses in the event of

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<sup>1</sup> Knowledgeable outside parties included banking and law professors, public policy research analysts, and economists. See Appendix I for more detail

failure.<sup>2</sup> According to those we spoke with, FSOC faces challenges in meeting this purpose due to its limited authorities, having to rely on the actions of others, a difficulty in measuring whether expectations have been eliminated, and the recent legal challenge to its designation authority. We are not making any recommendations to FSOC as a result of our audit.

## **FSOC Response**

In a written response, FSOC stated that it has used its existing authorities to make progress in promoting market discipline following the financial crisis. FSOC also stated it has used its authorities to make progress in identifying risks to the United States financial stability and in responding to emerging threats to the stability of the nation's financial system.

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2 The term "too big to fail" (TBTF) is a market notion that the federal government would intervene to prevent the failure of a large, complex financial institution to avoid destabilizing the financial sector and the economy. This definition of TBTF is taken from the Government Accountability Office (GAO) report, *Large Bank Holding Companies: Expectations of Government Support* (GAO-14-621; July 2014), <http://www.gao.gov/assets/670/665162.pdf>, page 2 of 94.



## CIGFO Working Group Audit

This report presents the results of the CIGFO Working Group's audit of FSOC's efforts to promote market discipline. This is the fifth audit report that CIGFO has issued to FSOC and Congress as part of CIGFO's responsibility to oversee FSOC under the Dodd-Frank Act. CIGFO issued its first four audits in June 2012,<sup>3</sup> July 2013,<sup>4</sup> July 2014,<sup>5</sup> and July 2015.<sup>6</sup>

### BACKGROUND

The Dodd-Frank Act established FSOC to create joint accountability for identifying and mitigating potential threats to the stability of the nation's financial system. By creating FSOC, Congress recognized that protecting financial stability would require the collective engagement of the entire financial regulatory community. As shown in Figure 1<sup>7</sup>, the Council consists of 10 voting members and 5 non-voting members and brings together the expertise of federal financial regulators, state regulators, an insurance expert appointed by the President with Senate confirmation, and others. The voting members of FSOC provide a federal financial regulatory perspective as well as an independent insurance expert's view. The non-voting members offer different insights as state-level representatives from bank, securities, and insurance regulators or as the directors of offices within Treasury — the Office of Financial Research (OFR) and the Federal Insurance Office.

Within Treasury, a dedicated policy office, led by a Deputy Assistant Secretary, functions as the FSOC Secretariat and assists in coordinating the work of the Council among its members and member agencies.

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3 CIGFO, Audit of the Financial Stability Oversight Council's Controls over Non-public Information, June 2012, [https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO Document/Audit of the Financial Stability Oversight Council's Controls over Non-public Information.pdf](https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO%20Document/Audit%20of%20the%20Financial%20Stability%20Oversight%20Council's%20Controls%20over%20Non-public%20Information.pdf).

4 CIGFO, Audit of the Financial Stability Oversight Council's Designation of Financial Market Utilities, July 2013, [https://www.treasury.gov/about/organizational-structure/ig/OIG Sorter/CIGFO\\_AUDIT\\_71713.pdf](https://www.treasury.gov/about/organizational-structure/ig/OIG%20Sorter/CIGFO_AUDIT_71713.pdf).

5 CIGFO, Audit of the Financial Stability Oversight Council's Compliance with Its Transparency Policy, July 2014, [https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO Audit July 2014.pdf](https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO%20Audit%20July%202014.pdf).

6 CIGFO, Audit of the Financial Stability Oversight Council's Monitoring of Interest Rate Risk to the Financial System, July 2015, [https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO Document/Audit of the Financial Stability Oversight Councils Monitoring of Interest Rate Risk.pdf](https://www.treasury.gov/about/organizational-structure/ig/Documents/CIGFO%20Document/Audit%20of%20the%20Financial%20Stability%20Oversight%20Councils%20Monitoring%20of%20Interest%20Rate%20Risk.pdf).

7 12 U.S.C. § 5321(b).

Figure 1: FSOC Council Membership	
Federal and Independent Members	State Members
<ul style="list-style-type: none"> <li>• Secretary of the Treasury, Chairperson (v)</li> <li>• Chairman of the Board of Governors of the Federal Reserve System (v)</li> <li>• Comptroller of the Currency (v)</li> <li>• Director of the Consumer Financial Protection Bureau (v)</li> <li>• Chairman of the Securities and Exchange Commission (v)</li> <li>• Chairperson of the Federal Deposit Insurance Corporation (v)</li> <li>• Chairperson of the Commodity Futures Trading Commission (v)</li> <li>• Director of the Federal Housing Finance Agency (v)</li> <li>• Chairman of the National Credit Union Administration Board (v)</li> <li>• Director of the Office of Financial Research</li> <li>• Director of the Federal Insurance Office</li> <li>• Independent member with insurance expertise (v)</li> </ul> <p>(v) Indicates Voting Member</p>	<ul style="list-style-type: none"> <li>• State Insurance Commissioner</li> <li>• State Banking Supervisor</li> <li>• State Securities Commissioners</li> </ul>

The statutory purposes of FSOC are to:

- identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected BHCs or nonbank financial companies, or that could arise outside the financial services marketplace;
- promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the United States Government will shield them from losses in the event of failure; and
- respond to emerging threats to the stability of the U.S. financial system.<sup>8</sup>

<sup>8</sup> 12 U.S.C. § 5322(a)(1).

FSOC's duties under the Dodd-Frank Act include:

- collecting information from member agencies, other federal and state financial regulatory agencies, the Federal Insurance Office and, if necessary to assess risks to the U.S. financial system, directing OFR to collect information from BHCs and nonbank financial companies;
- providing direction to, and requesting data and analyses from OFR;
- monitoring the financial services marketplace in order to identify potential threats to U.S. financial stability;
- monitoring domestic and international financial regulatory proposals and developments, including insurance and accounting issues, and advising Congress and making recommendations in such areas to enhance the integrity, efficiency, competitiveness, and stability of the U.S. financial markets;
- facilitating information sharing and coordination among the member agencies and other federal and state agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements and enforcement actions;
- recommending to the member agencies general supervisory priorities and principles reflecting the outcome of discussions among the member agencies;
- identifying gaps in regulation that could pose risks to the financial stability of the U.S.;
- requiring supervision by the Board of Governors of the Federal Reserve System (FRB) for nonbank financial companies that may pose risks to the financial stability of the U.S. in the event of their material financial distress or failure, or because of their activities;
- making recommendations to FRB concerning, among other things, the establishment of heightened prudential standards, resolution plans, and enhanced public disclosures for nonbank financial companies and large, interconnected BHCs;
- identifying systemically important financial market utilities (FMUs) and payment, clearing, and settlement activities;
- making recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of problems spreading among BHCs, nonbank financial companies, and United States financial markets;
- reviewing and, as appropriate, submitting comments to the Securities and Exchange Commission (SEC) and any standard-setting body with respect to an existing or proposed accounting principle, standard, or procedure;
- providing a forum for discussion and analysis of emerging market developments and financial regulatory issues as well as resolution of jurisdictional disputes among the members of the Council, and
- annually reporting to and testifying before Congress.<sup>9</sup>

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<sup>9</sup> 12 U.S.C. § 5322(a)(2).

Each year, FSOC is to issue an annual report to fulfill its Congressional mandate to report on the activities of the Council, significant financial market and regulatory developments, potential emerging threats, and its recommendations.

One of the purposes of the Dodd-Frank Act is to end TBTF. As noted above, FSOC's statutory purpose in this area is focused on eliminating expectations that the United States Government will shield shareholders, creditors, and counterparties of large BHCs and nonbank financial companies from losses in the event of failure. This report focuses on FSOC's activities related to eliminating those expectations.

## **AUDIT APPROACH**

Our audit objective was to assess FSOC's efforts to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of large BHCs or nonbank financial companies that the government will shield them from losses in the event of failure. Our audit scope focused on FSOC's efforts to promote market discipline from the Council's establishment, in 2010, through August 2016. To accomplish our objective, participating Offices of Inspector General collected information from FSOC members and/or FSOC member representatives regarding their views on FSOC's efforts to promote market discipline as well as each FSOC member agency's involvement in those efforts. Also, we obtained perspectives from knowledgeable outside parties regarding their views on FSOC's efforts to promote market discipline. Where available, we reviewed public statements of pertinent entities, such as credit rating agencies. In addition, we interviewed officials of the FSOC Secretariat and reviewed past FSOC annual reports and laws applicable to FSOC's authority to promote market discipline. We conducted our audit fieldwork from October 2015 through August 2016 in accordance with generally accepted government auditing standards. We provided an exit briefing on the results of our work to FSOC representatives on December 1, 2016.

## **FSOC'S ACTIVITIES TO PROMOTE MARKET DISCIPLINE**

We identified four primary areas where FSOC has taken steps to promote market discipline. These areas relate to FSOC's designations, convening authority, annual reporting, and consulting responsibilities.

### FSOC Designations

FSOC has the authority to designate nonbank financial companies for heightened supervision and enhanced prudential standards. FSOC also has the authority to designate FMUs, and payment, clearing, and settlement activities for enhanced risk management standards. On July 8, 2013, the Council voted to designate American International Group, Inc. and General Electric Capital Corporation, Inc.,<sup>10</sup> for supervision by FRB and enhanced prudential standards.<sup>11</sup> On September 19, 2013, the Council voted to so designate Prudential Financial, Inc., and on December 18, 2014, the Council voted to so designate MetLife, Inc.<sup>12</sup> Previously, on July 18, 2012, FSOC

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10 General Electric Company reorganized in 2015, which resulted in General Electric Capital Corporation, Inc. being replaced by GE Capital Global Holdings.

11 On June 28, 2016, the Council voted to rescind the designation of GE Capital Global Holdings.

12 A federal district court rescinded the designation of MetLife, Inc. on March 30, 2016. The Department of Justice has appealed this decision.

voted to designate eight FMUs as systemically important.<sup>13</sup> The Council conducts annual re-evaluations for nonbanks, or periodic re-evaluations for FMUs, of these designations. The Council has not designated any payment, clearing, and settlement activities as systemically important.

#### Convening Authority

FSOC has a statutory duty to facilitate information sharing and coordination among its member agencies.<sup>14</sup> Through this role, FSOC works to reduce gaps and weaknesses within the regulatory structure, and to promote a safer and more stable financial system. FSOC exercises its convening authority both through meetings of FSOC members and through its staff-level committee structure. FSOC reports that it operates under a committee structure to promote shared responsibility among the member agencies and to leverage the expertise that already exists at each agency. These committees consist of senior or staff level representatives from each of the FSOC members and member agencies. FSOC has formed committees around its various statutory responsibilities and core issues that relate closely to financial system risks where more than one agency has a significant interest. For example, FSOC's Regulation and Resolution Committee is tasked with identifying potential gaps in regulation that could pose risks to the financial stability of the U.S. All FSOC member agencies that we interviewed or coordinated with indicated that their agency participated in the Regulation and Resolution Committee. As another example, FSOC's Systemic Risk Committee supports FSOC in identifying risks to, and in responding to emerging threats to, the stability of the U.S. financial system. An FSOC Secretariat official stated that the committee structure helps the dialogue around TBTF to continue by allowing the full Council to meet about 10 times per year although the Dodd-Frank Act requires the principals to meet only four times per year.<sup>15</sup>

#### Annual Reporting

FSOC has issued six annual reports since its inception, each containing recommendations to various financial regulators and entities in the financial industry. Some of these recommendations relate to the issue of TBTF, such as risk-taking by large, complex institutions. One FSOC member stated that the annual report, among other ongoing FSOC communications, has worked to raise public awareness of the issues FSOC is working on and concerned about. This member stated that he believes that FSOC's focus on topics like interest rate risk and cybersecurity are resulting in financial firms taking steps to address these issues, which in turn is mitigating the likelihood of TBTF bailouts in the future.

#### Consulting Authority

FSOC has the authority to make recommendations to FRB concerning the establishment of prudential standards in regards to the reporting and disclosure requirements applicable to certain nonbank financial companies and large, interconnected BHCs supervised by the FRB.<sup>16</sup> An FSOC Secretariat official stated that FSOC has on several occasions provided consulting input/feedback to FRB on the development of

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13 The designated FMUs are: The Clearing House Payments Company, L.L.C., on the basis of its role as operator of the Clearing House Interbank Payments System; CLS Bank International; Chicago Mercantile Exchange, Inc.; The Depository Trust Company; Fixed Income Clearing Corporation; ICE Clear Credit LLC; National Securities Clearing Corporation; and The Options Clearing Corporation.

14 12 U.S.C. 5322(a)(2)(E).

15 FSOC meetings are publicly announced and open to the public, whenever deemed possible.

16 12 U.S.C. 5322(a)(2)(I)

these standards. FSOC also has the authority to issue recommendations to regulators to apply new or heightened standards and safeguards for a financial activity or practice conducted by financial institutions. FSOC has issued one proposed recommendation, regarding reforms of money market mutual funds. In addition, one FSOC member agency representative stated that FSOC has conducted studies on and issued recommendations related to the implementation of the Volcker Rule,<sup>17</sup> concentration limits among financial institutions, and risks related to industry-wide products and activities across the asset management sector.

## **FSOC HAS MADE PROGRESS IN PROMOTING MARKET DISCIPLINE**

Most FSOC members and/or representatives and some knowledgeable outside parties that we spoke with stated that FSOC has made progress in promoting market discipline. One FSOC member representative stated that FSOC's purpose of promoting market discipline is a continuous effort. Other FSOC member representatives stated that FSOC has fulfilled or is fulfilling its purpose related to TBTF. One knowledgeable outside party stated that FSOC has made progress in promoting market discipline through various steps such as analyzing and assessing risk throughout the financial system.

### ***Changing Behavior of Companies***

In response to its designation by the Council, General Electric announced in April 2015 that it would work closely with its regulators to take the actions necessary to seek rescission of the designation of General Electric Capital Corporation, Inc. The announcement included plans to create a simpler, more valuable company by reducing the size of its financial businesses through the sale of most General Electric Capital Corporation assets. Those efforts resulted in the Council rescinding the designation of GE Capital Global Holdings in June 2016. The Treasury Secretary stated that "the Council designated GE Capital in 2013 after identifying a number of key concerns, including the company's reliance on short-term wholesale funding and its leading position in a number of funding markets. Since then, GE Capital has made fundamental strategic changes that have resulted in a company that is significantly smaller and safer, with more stable funding." A knowledgeable outside individual told us that as some companies are reorganizing or selling parts of their business, she is encouraged that the footprints of these larger institutions will become smaller, and they will cease to be designated allowing for a reduction in systemic risk overall.

### ***Credit Rating Agencies***

Three major credit rating agencies<sup>18</sup> removed the expectation of government support from their company ratings for the eight U.S. global systemically important financial institutions.<sup>19</sup> Specifically, in November 2013, Moody's Investor Service considered the systemic support assumptions in its ratings and removed all uplift<sup>20</sup>

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17 The Volcker rule generally restricts insured depository institutions and any company affiliated with an insured depository institution from engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring, or having certain relationships with a hedge fund or private equity fund.

18 The three credit rating agencies are Standard & Poor's Global Ratings, Moody's Investors Service, and Fitch Ratings.

19 The eight U.S. global systemically important banks are Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup, Inc., The Goldman Sachs Group, Inc., JP Morgan Chase & Co., Morgan Stanley, State Street Corporation, and Wells Fargo & Company.

20 Uplift is the difference between the stand-alone credit rating assigned by a credit rating agency to an issuer, based on that issuer's intrinsic financial strength, and the higher credit rating that considers the possibility of implicit external (e.g., government) support.

from United States Government support in the ratings for BHC debt. In May 2015, Fitch Ratings downgraded the support ratings for the eight U.S. global systemically important banks from '1' (a bank for which there is an extremely high probability of external support) to '5' (a bank for which there is a possibility of external support, but the support cannot be relied upon). In December 2015, Standard and Poor's Global Ratings considered the likelihood that the United States Government would provide extraordinary support to be "uncertain" and removed the uplift from its ratings.

### **Regulatory Changes**

Section 120 of the Dodd-Frank Act states that FSOC may issue recommendations to a primary financial regulatory agency to apply new or heightened standards for a financial activity or practice conducted by financial companies under the regulator's jurisdiction.<sup>21</sup> In November 2012, FSOC issued for public comment a proposed Section 120 recommendation to the SEC to implement reforms in money market mutual funds to address structural weaknesses in this market. In July 2014, the SEC adopted structural and operational reforms to the rules governing money market mutual funds.<sup>22</sup> Representatives from one FSOC member agency stated that this was an example of FSOC not needing to complete the exercising of its Section 120 recommendation authority because its consultative and facilitating role functioned appropriately. Several knowledgeable outside individuals also stated that they believed that FSOC played a role in encouraging the SEC to adopt reforms of its regulation of money market mutual funds.

## **FSOC FACES CHALLENGES IN ELIMINATING EXPECTATIONS OF GOVERNMENT SUPPORT**

There are a wide range of views on the issue of TBTF. On one side of the argument, some believe that the Dodd-Frank Act ended TBTF as a matter of law while others believe that it only made it more likely the United States Government would provide support. One FSOC member commented that the best way to demonstrate that the era of TBTF has ended will occur when a financial firm is allowed to fail in accordance with the rules put in place by the Dodd-Frank Act, including the execution of a living will to unwind the firm.

When asked whether they believed that FSOC has fulfilled its purpose of promoting market discipline by eliminating expectations of government support in the event of a company failure, FSOC member agency representatives and knowledgeable outside parties stated the following:

- FSOC has fulfilled its purpose in eliminating expectations of government support.
- FSOC has not fulfilled its purpose in eliminating expectations of government support.
- FSOC is making a good faith effort in meeting this purpose.
- FSOC has made significant progress.
- FSOC has fulfilled this purpose to the extent feasible given its legal authorities.

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21 12 U.S.C. § 5330

22 Money Market Fund Reform; Amendments to Form PF; 79 FR 47736

- FSOC cannot eliminate the expectation of TBTF, but instead only reduce those expectations.
- FSOC's ability to eliminate TBTF is limited and that despite its authorities, FSOC is not able to control what market participants think and perceive to be true based on experience, regardless of its actions.

These responses indicate a lack of consensus regarding whether FSOC has eliminated expectations of government support. FSOC faces several challenges in fulfilling this purpose.

### **FSOC's Mandate is Broad but its Authority is Limited**

Our review focused on FSOC's efforts to promote market discipline by eliminating expectations of government support. However, several FSOC member agencies were granted authorities related to this issue. For example, Title I, Section 165(b) of the Dodd-Frank Act directs FRB to establish prudential standards for nonbank financial companies designated by FSOC and BHCs with total consolidated assets of \$50 billion or more.<sup>23</sup> These standards are to include (1) risk-based capital requirements and leverage limits, (2) liquidity requirements, (3) overall risk management requirements, (4) resolution plan and credit exposure report requirements, and (5) concentration limits. Further, Title I, Section 165(d)(3) requires the Federal Deposit Insurance Corporation (FDIC), and FRB, to review the resolution plans of these companies.

We solicited input from FSOC members and/or representatives and knowledgeable outside parties as to whether they believed that FSOC, by its actions alone, could eliminate expectations of government support. The members and/or representatives and outside parties stated the following:

- FSOC cannot, by its actions alone, fulfill its purpose related to TBTF.
- FSOC has limited direct authority to address threats to U.S. financial stability by its actions alone. However, FSOC member agencies have taken actions under their own authorities to address systemic issues such as TBTF.
- By statute, FSOC may only make recommendations, coordinate discussions, and designate financial firms for supervision by others. FSOC does not have authority to supervise or regulate any financial companies.
- FSOC has to rely on the member agencies to fulfill this purpose; therefore, FSOC alone is not sufficient.
- The ultimate responsibility for regulation rests with the FSOC member agencies.
- Other entities such as FDIC, FRB, and Congress have an impact on whether FSOC can fulfill its purpose, and FSOC's actions alone are not sufficient.

An FSOC Secretariat official stated that FSOC is not a "super regulator" and cannot require the regulators to take specific actions. Similarly, in the Government Accountability Office's (GAO) report *Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness*,<sup>24</sup> GAO concluded that "FSOC has authorities to designate certain entities or activities for enhanced supervision by a specific regulator, but these authorities may not allow FSOC to address certain broader risks that are not specific to a particular entity. For such risks, FSOC can recommend but not compel action."

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23 12 U.S.C. § 5365

24 GAO, Financial Regulation: Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness (GAO-16-175; February, 2016), <http://www.gao.gov/assets/680/675400.pdf>.



### ***Difficulty in Measuring Perceptions or Expectations***

An FSOC Secretariat official stated that there is difficulty surrounding this topic in terms of what to measure and that there could never be a permanent answer to the question of whether TBTF has been eliminated. The same official further stated that some people may think that Congress can and will change laws to support banks in the event of failure; however, one can only look at the law as it stands today. One FSOC member agency representative stated that empirical research suggests that this expectation [of government support] cannot be eliminated and questioned how it could ever be measured.

### ***Challenge to FSOC's Authority***

In March 2016, a decision by a federal district court rescinded FSOC's designation of the nonbank financial company MetLife, Inc. One knowledgeable outside individual stated that this decision, if upheld, could be debilitating for FSOC and the Dodd-Frank Act, and could encourage risky behavior among the remaining nonbank financial institutions and weaken one of FSOC's primary authorities related to the issue of TBTF. On behalf of the United States Government, the Department of Justice has appealed the federal district court's decision.

## **Conclusion**

According to knowledgeable parties we interviewed, FSOC has made progress in promoting market discipline. However, there is a lack of consensus regarding whether FSOC has eliminated expectations on the part of shareholders, creditors, and counterparties of large BHCs or nonbank financial companies that the government will shield them from losses in the event of failure. According to the FSOC members, FSOC member agency representatives and knowledgeable outside parties we spoke with, FSOC faces challenges in meeting this purpose due to its limited authorities, having to rely on the actions of others, and a difficulty in measuring whether expectations have been eliminated. Also, as noted above, the legal decision involving its designation authority is another challenge FSOC faces.

We believe that the divergent views on TBTF and FSOC's role and success in meeting its statutory purpose of promoting market discipline requires sustained FSOC attention to manage expectations as to what the United States Government will or will not do in the event large financial institutions fail. We are not making any recommendations to FSOC as a result of our audit.

### **FSOC Response**

In a written response, FSOC stated that it has used its existing authorities to make progress in promoting market discipline following the financial crisis. FSOC also stated it has used its authorities to make progress in identifying risks to the United States financial stability and in responding to emerging threats to the stability of the nation's financial system.

## **Appendix I: Objective, Scope, and Methodology**

### **Objective**

The audit objective was to assess the Financial Stability Oversight Council's (FSOC) efforts to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of large bank holding companies (BHC) and nonbank financial companies that the government will shield them from losses in the event of failure.

### **Scope and methodology**

The scope of this audit included FSOC's efforts to promote market discipline from its establishment, in 2010, through August 2016.

To accomplish our objective, we:

- reviewed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) to determine FSOC's statutory purposes and duties;
- interviewed staff from the FSOC Secretariat to determine FSOC's efforts to promote market discipline;
- interviewed or coordinated with FSOC members and staff from FSOC member agencies to obtain their views and to determine their involvement in FSOC's efforts to promote market discipline;
- interviewed knowledgeable outside parties regarding their views on FSOC's efforts to promote market discipline, including the following:
  - a professor and former high ranking official at the Department of the Treasury, as well as a writer on domestic and international financial regulation issues;
  - a professor, and member of several private and public sector councils and committees that deal with financial regulatory issues;
  - a professor and author of numerous articles and book chapters in the fields of banking law and American constitutional history;
  - a dean at a private university, and former high ranking officer at the National Association of Insurance Commissioners; and
  - a member of a think tank who focuses on banking regulation, and a former senior staffer on a Congressional committee that deals with banking issues;
- reviewed public statements of pertinent entities, such as the credit rating agencies; and
- reviewed past FSOC annual reports, governance documents, meeting minutes, and laws applicable to FSOC's authority to promote market discipline.

We performed fieldwork from October 2015 through August 2016. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings

and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

## Appendix II: FSOC Response



DEPARTMENT OF THE TREASURY  
WASHINGTON, D.C.

January 11, 2017

The Honorable Eric M. Thorson  
Chair, Council of Inspectors General  
on Financial Oversight  
1500 Pennsylvania Avenue, NW  
Washington, D.C. 20220

Re: Response to CIGFO's Draft Audit Report: Audit of the Financial Stability Oversight Council's Efforts to Promote Market Discipline

Dear Mr. Chairman:

Thank you for the opportunity to review and respond to your draft audit report, *Audit of the Financial Stability Oversight Council's Efforts to Promote Market Discipline*, (the Draft Report). The Financial Stability Oversight Council (Council) appreciates the Council of Inspectors General on Financial Oversight (CIGFO) working group's review of the Council's efforts to promote market discipline. This letter responds on behalf of Secretary Lew, as Chairperson of the Council, to the Draft Report.

As the Draft Report notes, the Council has used its existing authorities to make progress in promoting market discipline following the financial crisis. The Draft Report cites several specific tools the Council has used to meet this statutory purpose, including its authority to designate nonbank financial companies for heightened supervision and enhanced prudential standards, its power to convene federal and state regulators, its annual reports identifying risks to financial stability, and its consultations with regulators. The Council has used these authorities to make progress in identifying risks to U.S. financial stability, promoting market discipline, and responding to emerging threats to the stability of the nation's financial system. CIGFO also noted challenges the Council faces in promoting market discipline, including that the Council's mandate in this area is broad in contrast to its limited direct authorities. CIGFO made no recommendations as a result of the working group's review.

Thank you again for the opportunity to review and comment on the Draft Report. We value CIGFO's ongoing input and look forward to working with you in the future.

Sincerely,

/s/

Jonah Crane  
Deputy Assistant Secretary  
Financial Stability Oversight Council

## Appendix III: CIGFO Working Group

<b>Department of the Treasury Office of Inspector General, Lead Agency</b>		
Eric M. Thorson, Inspector General, Department of the Treasury, and CIGFO Chair		
Deborah Harker	Lisa Carter	Jeffrey Dye
Eduardo Coney	Susan Marshall	Clyburn Perry III
<b>Board of Governors of the Federal Reserve System and the Consumer Financial Protection Bureau Office of Inspector General</b>		
Mark Bialek, Inspector General, Board of Governors of the Federal Reserve System and Consumer Financial Protection Bureau		
Charlene Fadirepo	Saurav Prasad	Sam Withers
<b>Federal Deposit Insurance Corporation Office of Inspector General</b>		
Fred W. Gibson, Jr., Acting Inspector General, Federal Deposit Insurance Corporation		
Robert Fry	Travis Sumner	
<b>Federal Housing Finance Agency Office of Inspector General</b>		
Laura Wertheimer, Inspector General, Federal Housing Finance Agency		
Marla Freedman	Bob Taylor	Tara Lewis
Terese Blanchard	Pamela L. Williams	
<b>National Credit Union Administration Office of Inspector General</b>		
James Hagen, Inspector General, National Credit Union Administration		
Marvin Stith		
<b>Securities and Exchange Commission Office of Inspector General</b>		
Carl Hoecker, Inspector General, Securities and Exchange Commission		
Rebecca Sharek	Colin Heffernan	Lee Richardson