Testimony of

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Director of the Committee on Capital Markets Regulation

Before the

Subcommittee on Oversight and Investigations

Committee on Financial Services

United States House of Representatives

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Thank you, Chairman Duffy, Ranking Member Green, and members of the Subcommittee for permitting me to testify before you today at this hearing on "Oversight of the Financial Stability Oversight Council ("FSOC"): Due Process and Transparency in Non-Bank SIFI Designations." I am testifying in my own capacity and do not purport to represent the views of any organizations with which I am affiliated, although some of my testimony is consistent with the publicly stated views of the Committee on Capital Markets Regulation ("Committee"). My testimony will focus on three distinct points. First, the FSOC is an inadequate substitute for real reform of the regulatory structure, which is badly needed. Second, FSOC's principle role, to designate non-banks as systemically important financial institutions ("SIFIs"), is ill-advised. Third, FSOC actions are subject to the Administrative Procedure Act ("APA") and the non-bank SIFI designation process should accordingly be revised to provide the public with the opportunity for notice and comment, including a cost-benefit analysis, and to provide the non-bank designee with full transparency of decision-making.

The U.S. financial regulatory framework is highly fragmented and ineffective, as multiple agencies have responsibilities for the same or closely related entities and markets. The fragmentation of regulators is not the product of careful design. It has evolved by layers of accretion since the Civil War. The 2008 crisis demonstrated that this dysfunctional system comes at a very high cost. In response to the crisis, the Committee issued a report entitled "The Global Financial Crisis: A Plan for Regulatory Reform"[1] with 57 specific recommendations to reform our financial system. In particular, we supported regulatory reorganization so that there would be sensible, efficient, non-duplicative regulation of financial firms.

Although other leading financial centers, including the United Kingdom and the European Union, reorganized and consolidated their regulatory structure in response to recent financial crises, the U.S. has not.[2] As a result, interagency jurisdictional overlap and conflicts continue to result in inconsistent rulemakings and delays or inaction on critical matters, including the implementation of Dodd-Frank. For example, the SEC and CFTC's implementation of Dodd-Frank's Title VII requirements for cross-border OTC derivatives would apply distinctly different registration, clearing and margin requirements to the same entities.[3] The Volcker rule[4] is a notable example of conflict

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[1] Comm. On Capital Mkts. Reg., The Global Financial Crisis: A Plan for Regulatory Reform (May 26,

[2] See generally Sabrina Pellerin, John R. Walter, and Patricia Wescott, The Consolidation of Financial Regulation: Pros, Cons, and Implications for the United States, FRB Richmond Economic Quarterly, vol. 95, no. 2 (2009), http://ssrn.com/abstract=2188499.

[3] http://www.sec.gov/rules/final/2014/34-72472.pdf; and http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2013-17958

[4] 12 C.F.R. §44, 12 C.F.R. §248, 12 C.F.R. §351, 17 C.F.R. §255, and 17 C.F.R. §75.

among regulators, as disagreements between the SEC and banking regulators reportedly contributed to the more than one-year delay in its finalization.[5] Additionally, it is difficult for agencies with related responsibilities to share data, as doing so requires strong protections for confidentiality of information obtained by a particular agency for supervisory purposes.[6] Limits in data sharing increase the possibility that regulators will fail to identify risks that exist across institutions and markets.

In addition to retaining the fragmented structure, the Dodd-Frank Act created new regulatory agencies, including the FSOC,[7] Bureau of Consumer Financial Protection,[8] and Office of Financial Research,[9] with authorities that overlap the existing agencies. As you know, the FSOC consists of 10 voting members: the Secretary of the Treasury (the Chair), and the heads of the CFTC, SEC, Federal Reserve, OCC, FDIC, CFPB, FHFA, NCUA, and an independent insurance expert appointed by the President.[10] The Council meets at least quarterly[11] and its general purpose is to identify and respond to risks to the stability of the U.S. financial system.[12]

The FSOC has several authorities that purport to address the fragmented nature of the regulatory structure, but its real ability to do so is severely limited given the fact that many of its members are independent agencies not beholden to the commands of the Secretary of the Treasury.

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[5] See Scott Patterson, Volcker Rule Could Be Delayed – Again, W.S.J. (Feb. 27, 2013).
[6] See, e.g., the Federal Reserve's regulations on Confidential Supervisory Information, 12 C.F.R. §261.20.
[7] 12 U.S.C. §5321(a).
[8] 12 U.S.C. §5491.
[9] 12 U.S.C. §5342.
[10] 12 U.S.C. §5321(b)(1)(A)-(J).
[11] 12 U.S.C. §5321(e)(1).
[12] 12 U.S.C. §5322(a).

First, the FSOC has authority to mediate disagreements between regulators over rulemakings or overlapping supervisory authorities[13] and issue related recommendations, but this requires an affirmative vote of 2/3 of the members of FSOC.[14] Even if FSOC is able to make recommendations, it has no mechanism for enforcing them. Second, the FSOC can issue recommendations that another agency issue a specific rulemaking, if the FSOC determines that such a rulemaking is necessary to mitigate risk to the financial system.[15] This only requires a simple majority of the FSOC members.[16] However, the FSOC cannot require that the agency actually implement these rulemakings. In November 2012, the FSOC exercised this authority by proposing recommendations for money market mutual fund reforms to the SEC.[17] In its recommendation, the FSOC argued that capital requirements would mitigate systemic risk posed by the funds, but the SEC ultimately decided not to implement capital requirements for money market funds.[18]

The FSOC non-bank SIFI designation process itself has also served to exacerbate conflict among regulators. If 2/3 of the members of FSOC determine that a non-bank is systemically important, then they may designate that non-bank as a SIFI providing the Federal Reserve with supervisory and regulatory authority over that non-bank.[19] Although the primary regulator of that entity would still retain its jurisdictional authority, it must now share those responsibilities with the Federal Reserve. This source of conflict recently surfaced in connection to the potential designation of large asset managers as

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[13] See 12 U.S.C. §5329.
[14] Id.
[15] 12 U.S.C. §5322(a)(2)(K).
[16] 12 U.S.C. §5321(f).
[17] Press Release, Financial Stability Oversight Council Releases Proposed Recommendations for Money Market Mutual Fund Reform (Nov. 13, 2012), http://www.treasury.gov/press-center/press-releases/Pages/tg1764.aspx.
[18] 17 C.F.R. §§230, 239, 270, 274, and 279.
[19] 12 U.S.C. §5323.

SIFIs. Chair Mary Jo White[20] and Commissioners Aguilar and Gallagher[21] have expressed skepticism that non-bank SIFI designation is appropriate for asset managers, believing that the SEC is best positioned to identify and address any risks posed by large asset managers.[22] This is reasonable considering that the SEC is the only agency on the FSOC with regulatory authority, and expertise, in this field.[23]

Indeed, it is worth noting that publicly held equities and debt in the United States capital market total approximately $57 trillion, as compared to just $15.9 trillion in banking assets.[24] But the SEC, which has jurisdiction over these markets, only gets one vote on the FSOC.

The flaws with the rationale for non-bank SIFI designation go far beyond regulatory conflict or a lack of relevant subject matter expertise. Indeed, the fundamental principle underlying these designations is fatally flawed. Designating non-banks as systemically important and then subjecting these institutions to more stringent regulation simply does not reduce systemic risk. Moreover, singling out certain firms for SIFI designation potentially increases moral hazard, and could introduce competitive

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[20] See https://www.ici.org/viewpoints/view_14_gmm_white; and https://www.ici.org/viewpoints/view_15_gmm_white

[21] See SEC Commissioner Daniel M. Gallagher, Bank Regulators at the Gates: The Misguided Quest for Prudential Regulation of Asset Managers: Remarks at the 2015 Virginia Law and Business Review Symposium (April 10, 2015), http://www.sec.gov/news/speech/041015-spch-cdmg.html; and Mark Schoeff Jr., SEC commissioners push back against systemic designation for mutual funds, Investment News (April 3, 1014), http://www.investmentnews.com/article/20140403/FREE/140409958/sec-commissioners-push-back-against-systemic-designation-for-mutual.

[22] See generally Andrew Ackerman and Ryan Tracy, SEC Fights Turf War Over Asset Managers, W.S.J. (Jan. 28, 2014).

[23] See generally Commissioner Michael S. Piwowar, Remarks at AEI Conference on Financial Stability (July 15, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370542309109.

[24] International Monetary Fund, Statistical Appendix to the Global Financial Stability Report (April 2015), https://www.imf.org/External/Pubs/FT/GFSR/2015/01/pdf/statapp.pdf.

distortions into the marketplace if these designees enjoy reduced funding costs, a subject of some debate.[25]

Designating and then regulating large non-banks as SIFIs does not reduce systemic risk, because systemic risk is not confined to or concentrated in a few discrete entities. Regulating systemic risk requires a focus on systemically risky activities and products. Shoehorning a few large insurance companies or asset managers into a regulatory schema designed for the banking industry accomplishes little with potential high cost[26] and is unsupported by any empirical data.

In the 2008 financial crisis, no large financial firms failed as a direct result of their exposures to Lehman Brothers.[27] Analyses also show that direct losses due to the failure of AIG would also not have caused the bankruptcy of its large counterparties.[28] Instead, in 2008, systemic risk existed due to contagion, which is an indiscriminate run by short-term creditors across the entire financial system. Thus, there is no evidence for the principle underlying SIFI designations--that large financial institutions are so interconnected to each other that the bankruptcy of one will cause the bankruptcy of others.

Furthermore, as the Committee has previously commented, the activities of certain types of financial institutions, including traditional insurance companies, do not

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[25] See generally, GAO Report, Large Bank Holding Companies: Expectations of Government Support, (July 2014), http://www.gao.gov/assets/670/665162.pdf.

[26] Letter from Comm. on Capital Mkts. Reg. to the Financial Stability Oversight Council (March 16, 2015), http://capmktsreg.org/app/uploads/2015/03/2015_03_16_FSOC_Notice_on_Asset_Management_Products_Activities.pdf.

[27] See Hal S. Scott, Interconnectedness and Contagion - Financial Panics and the Crisis of 2008 (June 26, 2014), http://ssrn.com/abstract=2178475 [hereinafter Interconnectedness and Contagion] Comm. on Capital Mkts. Reg., What to Do About Contagion? A Call by the Committee on Capital Markets Regulation for a Public Debate (Sept. 3, 2014), http://capmktsreg.org/app/uploads/2014/09/2014-09-03-WDAC.pdf.

[28] See Interconnectedness and Contagion, supra note [27]; see also Peter J. Wallison, On regulating and resolving institutions considered 'too big to fail' (May 6, 2009), https://www.aei.org/publication/on-regulating-and-resolving-institutions-considered-too-big-to-fail/.

generally pose systemic risk.[29] During the 2008 financial crisis, no insurer was in danger of failing due to traditional insurance activities. The risk posed by AIG was not from its traditional life and property insurance activities. Rather, AIG's large losses and liquidity crisis were due to the credit protection that AIG Financial Products sold on multi-sector collateralized debt obligations that were exposed to U.S. subprime mortgages and reinvestment of cash collateral in mortgage backed securities by AIG's securities-lending subsidiary.[30] Engaging in these activities on a significant scale should be subject to regulation; it does not require SIFI designation.

One problem with the activities approach in the insurance sector is that there is currently no federal regulator for large U.S. insurance companies to identify and control non-traditional activities—state insurance company regulation may not be sufficient. I would therefore recommend serious consideration of an optional federal charter program for insurance companies, and possibly making such a charter mandatory for the largest companies.[31] It is important to note recent efforts by the International Association of Insurance Supervisors to identify "non-traditional" insurance activities.[32] Once defined, this would facilitate efforts by state or federal insurance supervisors to prevent insurers from engaging in these non-traditional activities on any dangerous scale. Further, if

[29] Letter from Comm. on Capital Mkts. Reg., to Acting Chairman of the Financial Stability Oversight Committee, the Hon. Neal S. Wolin (Feb. 15, 2013), http://capmktsreg.org/app/uploads/2013/02/FSOC.floating.NAV_.comment.ltr_.pdf.

[30] Frank M. Keane, Securities Loans Collateralized by Cash: Reinvestment Risk, Run Risk, and Incentive Issues, Federal Reserve Bank of New York Current Issues in Economics and Finance, vol. 19, no.3 (2013), http://www.newyorkfed.org/research/current_issues/ci19-3.pdf.

[31] Regulatory Modernization: Perspectives on Insurance: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs, 111th Cong. (2009) (statement of Hal S. Scott, Nomura Professor of International Financial Systems, and Director, Committee on Capital Markets Regulation, Harvard Law School), http://capmktsreg.org/news/hal-s-scott-testifies-on-regulatory-modernization-as-it-relates-to-the-insurance-industry/.

[32] Comm. on Capital Mkts. Reg. Response to Public Consultation Document of International Association of Insurance Supervisors (July 31, 2012), http://capmktsreg.org/app/uploads/2014/10/2012.07.3_IAIS_comment_letter.pdf.

FSOC believes that a federal regulator for insurance companies is necessary to regulate such activities, then FSOC should itself recommend the implementation of a federal charter program for insurance companies. SIFI designation is not the answer to this problem.

The recent designation of MetLife (a member of the Committee) as a non-bank SIFI is a trenchant example of the lack of empirical justification for non-bank SIFI designations.[33] The rule for FSOC non-bank SIFI designations sets forth two channels by which a non-bank may pose systemic risk.[34] The first is through interconnectedness, referred to by FSOC as the "exposure" channel, and the second is the "liquidation channel," whereby the failure of a non-bank would drive down asset prices and thus weaken other firms holding the same or similar assets. In response to the first, MetLife has demonstrated that in the event of its failure, no other large firms would incur significant losses.[35] For example, the losses to the largest U.S. banks would be less than 2% of their capital. In response to the second, MetLife demonstrated that even if all of its life insurance policyholders ran, an unprecedented occurrence and one which could be blocked by the state powers of insurers to suspend massive withdrawals, then the resulting price impact on its assets and similar assets held by other financial institutions would not disrupt financial markets.[36]

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[33] Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc. (Dec. 18, 2014), http://www.treasury.gov/initiatives/fsoc/designations/Documents/MetLife%20Public%20Basis.pdf.
[34] 12 C.F.R. §1310.
[35] See MetLife, Inc.'s (Plaintiff) Cross Motion For Summary Judgment, No. 1:15-cv-45 (RMC) (D.D.C. June 16, 2015), https://www.metlife.com/assets/cao/sifiupdate/Motion_for_Summary_Judgment_As_Filed.pdf [hereinafter MetLife Cross-Motion].
[36] Id.

Fortunately, the FSOC's ability to make non-bank SIFI designations is subject to an important APA limitation. Indeed, MetLife is challenging its non-bank SIFI designation on the basis that the FSOC's determination that the failure of MetLife would pose systemic risk fails to comply with the arbitrary and capriciousness standard of the APA and thus should be overturned by the courts.[37] The APA[38] subjects all agency decision making to the arbitrary and capricious clause of APA § 706(2)(a).

The Supreme Court has interpreted this provision of the APA to require that agencies "examine the relevant data and articulate a satisfactory explanation for its action[,] including a rational connection between the facts found and the choice made."[39] An agency action is arbitrary and capricious if the agency "entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise."[40] The D.C. Circuit has interpreted this to mean that agencies must consider evidence that contradicts their determination and to explain why they rejected such evidence.[41] Thus, the FSOC's discretion to issue non-bank SIFI designations is not limitless.

The non-bank SIFI designation *process* is also in need of reform. This is because an individual non-bank SIFI determination is not subject to the APA's requirements for public notice and comment, since it does not constitute a rulemaking.[42] As a result, the general public, including potential future designees, receive very little information

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[37] Id.
[38] 5 U.S.C. §500 *et seq*.
[39] Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)
[40] Id.
[41] See Int'l Union, United Mine Workers of Am. v. Mine Safety & Health Admin., 626 F.3d 84, 93-94 (D.C. Cir. 2010); see also Swiss Airlines Co. v. Transportation Sec. Admin., 650 F.3d 752, 759-60 (D.C. Cir. 2011)
[42] See 5 U.S.C. §553.

regarding the basis for the FSOC's designations, despite the significant market impact of these designations. Indeed, the designations of Prudential, AIG, GE Capital and MetLife were each accompanied solely by a ten-to-forty page public release that lacked any meaningful empirical data supporting the designation.[43] By excluding the public from involvement in the designation process, the FSOC is unnecessarily limiting the opportunity to receive data and input from outside experts.

The FSOC also does not conduct a cost-benefit analysis when making non-bank SIFI designations, as it is not statutorily required to do so.[44] This is despite President Obama stressing in a 2011 Executive Order that cost-benefit analyses are a crucial part of the regulatory process and recent remarks by Secretary of the Treasury Jack Lew to the same effect.[45] Indeed, I strongly believe that cost-benefit analyses are an important tool that regulators should use to enhance the economic efficiency of their rulemakings. Such economic analyses are particularly relevant to non-bank SIFI designations, as the FSOC should be required to analyze the benefit of preventing the failure of a potential SIFI (will other firms actually fail if it does?) against the cost to the financial system from such a

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[43] These releases by the Financial Stability Oversight Council of its designations thus far are available at: http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.

[44] See Financial Stability Oversight Council (Defendant), Memorandum in Support of Defendant's Motion to Dismiss Or, In the Alternative, For Summary Judgement, No. 15-45 (RMC) (D.D.C. May 11, 2015).

[45] President Obama, Executive Order 13579--Regulation and Independent Regulatory Agencies, https://www.whitehouse.gov/the-press-office/2011/07/11/executive-order-13579-regulation-and-independent-regulatory-agencies:
("Section 1. Policy. (a) Wise regulatory decisions depend on public participation and on careful analysis of the likely consequences of regulation. Such decisions are informed and improved by allowing interested members of the public to have a meaningful opportunity to participate in rulemaking. To the extent permitted by law, such decisions should be made only after consideration of their costs and benefits (both quantitative and qualitative)."); and Ira Hammerman, Lew: Administration Opposed to Any Corrections that Undermine Financial Reform (Nov. 11, 2015), http://www.sifma.org/blog/lew-administration-opposed-corrections-undermine-financial-reform/ ("Lew stressed the importance of financial reforms made following the damage of the financial crisis to the U.S. economy. "I have worked on regulatory issues from a number of different perspectives and I very much believe that when you look at regulation, you have to look at the costs and the benefits. And I think that the benefits of financial reforms are just enormous," he said.").

designation. One difficulty in estimating costs or benefits is that we do not know at the point of designation how the Fed will actually regulate a given SIFI, e.g. how will the capital requirements of SIFI insurance companies be determined. Without knowing the consequences of designation it is almost impossible to make a rational designation choice.

I believe that the FSOC should of its own volition provide the public with the opportunity for notice and comment in the non-bank SIFI designation process and that this should include a cost benefit analysis. If the FSOC does not do so, then Congress should revise Dodd-Frank so that the FSOC has these statutory obligations.

The designation process is also very opaque from the perspective of the potential designee.[46] The designee does not receive an opportunity to present its position to the FSOC until the FSOC is nearly complete with its process.[47] The FSOC also does not provide the designee with the opportunity to review the record upon which its decision is based or with the details of any prior designations that could assist the potential designee in efforts to revise its business in order to avoid designation.[48]

I believe that the FSOC should involve potential designees in its process at the very start and should provide the designee with complete transparency into the basis for any potential designation. If the FSOC does not do so on its own accord, then I recommend that Congress revise Dodd-Frank so that the FSOC is required to do so.

In conclusion, I believe that the FSOC is an inadequate substitute for real reform of our fragmented regulatory structure and that FSOC's primary role, to designate non-banks as SIFIs would not reduce systemic risk and threatens to introduce competitive

[46] See e.g., MetLife Cross-Motion, supra note [35].
[47] See e.g., id.
[48] See e.g., id.

distortions and increase moral hazard. Finally, the non-bank SIFI designation process should be revised to provide the public with the opportunity for notice and comment, including a cost-benefit analysis, and to provide the non-bank designee with full transparency of decision-making.

Thank you and I look forward to your questions.