THE FINANCIAL STABILITY BOARD'S IMPLICATIONS FOR U.S. GROWTH AND COMPETITIVENESS

HEARING

BEFORE THE

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OF THE

COMMITTEE ON FINANCIAL SERVICES

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THE FINANCIAL STABILITY BOARD'S IMPLICATIONS FOR U.S. GROWTH AND COMPETITIVENESS

Tuesday, September 27, 2016

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON MONETARY POLICY AND TRADE,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2 p.m., in room 2128, Rayburn House Office Building, Hon. Bill Huizenga [chairman of the subcommittee] presiding.

Members present: Representatives Huizenga, Mulvaney, Pearce, Pittenger, Schweikert, Guinta; Moore, Foster, Himes, Murphy, and Heck.

Chairman HUIZENGA. The Subcommittee on Monetary Policy and Trade will come to order. Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Today's hearing is entitled, "The Financial Stability Board's Implications for U.S. Growth and Competitiveness."

Just for notification, they have called votes. We are going to keep an eye on this. We are going to try to get as far as we can. We will do some opening statements here of the two members and we will kind of be assessing our timing. And then, we would just ask for members and for staff who are with members to try to get people back here as soon as possible right after votes and we will continue.

So, with that, I now recognize myself for 5 minutes to give an opening statement.

The 2007–2008 financial crisis and subsequent global economic turmoil underscored the interconnectedness of the global financial system as well as its weaknesses. Following the crisis, leaders from the United States and other countries have pursued a wide range of reforms to the international financial regulatory system.

In 2009, the Group of 20, or G20, created the Financial Stability Board (FSB) as a group of finance ministers, central bankers, and financial regulators tasked with promoting international financial stability. Primary U.S. representatives to the FSB are the Board of Governors of the Federal Reserve System, the Securities and Exchange Commission, and the Treasury Department. The FSB is charged with a very broad mandate to address vulnerabilities affecting the global financial system and to develop and promote im-

plementation of effective supervisory and regulatory policies promoting financial stability.

According to the FSB, while its decisions are not legally binding on its members, "The organization operates by moral suasion and peer pressure in order to set internationally agreed-upon policies and minimum standards that its members commit to implementing at national level." However, to ensure domestic implementation of FSB standards, the FSB has adopted measures to pressure jurisdictions to comply with these criteria.

Since 2008, the FSB has aggressively designated large banks and insurers as global systemically important financial institutions, or G-SIFIs. In fact, in July of 2013, the FSB designated nine large insurance groups as G-SIFIs, including three from the United States: American International Group; Prudential Financial; and MetLife, Incorporated. Shortly thereafter, the Financial Stability Oversight Council (FSOC) appeared to rubber-stamp the FSB's decision and named AIG, Prudential, and MetLife as SIFIs.

Although the AIG decision was expected by many, since the company had famously been bailed out by the Treasury and the Federal Reserve during the financial crisis, it is unclear as to why Prudential and MetLife were deemed SIFIs. If the FSOC SIFI designation has any validity, it must have the ability to act independently, meaning without interference from international regulatory entities, and describe how each decision was reached.

For example, the Prudential decision was the first designation of a nonbank financial institution as a SIFI, although the firm had not yet suffered any significant financial distress during the financial crisis. However, the available evidence indicates that rather than exercising its own independent judgment about SIFI designations and other regulatory initiatives, the FSOC, led by the Treasury and the Federal Reserve, instead outsourced its regulatory authority to the FSB.

It is very troubling that American regulators would relinquish any regulatory authority to unelected European bureaucrats who meet behind closed doors in a secretive fashion to determine the fate of U.S. financial institutions. Because very little is known about the FSB, I have very serious concerns about the arbitrary decision-making process used to formulate policy that is devoid of any and all public participation.

It is important to note that the FSB has no supervisory authority or regulatory power to compel compliance with internationally agreed-upon standards. However, it appears the FSB has become a shadow regulatory agency, using backdoor channels to determine a one-size-fits-all approach to applying European standards on American financial institutions.

Even in today's challenging economic environment, America has consistently outperformed our friends across the Atlantic. I find it mind-boggling that U.S. regulators would allow themselves to be "pressured into ceding regulatory sovereignty to the very bureaucrats who have crippled innovation and ground economic growth to a halt in Europe." It is completely unacceptable, and I look forward to hearing from our witnesses today on these issues.

The Chair now recognizes the ranking member of the subcommittee, the gentlelady from Wisconsin, Ms. Moore, for 5 minutes for an opening statement.

Ms. MOORE. Thank you so much, Mr. Chairman.

And I just want to thank this distinguished panel. We do apologize ahead of time for having to run off, but we will return eager to hear your testimony.

You guys are veterans on this subject, and so I just want to begin with some perspective. We have learned, kind of the hard way, that there is nothing as global as capital, and it moves and it moves very fast. We have literally drilled holes in the sides of mountains so that we could lay the fiberoptic cable from Chicago to New York to facilitate trades at near the speed of light. And the cost to lay that cable was $300 million, built to arbitrage the difference in price between New York Stock Exchange and CME option prices. And it got trades down from 13.1 milliseconds to 12.98 milliseconds.

What is my point here? Global markets are moving in nanoseconds, and weaknesses in our financial regulation will be exploited with the same ruthless efficiency.

The reality today is that these firms operate globally and have trillions of dollars in assets under management. We talk a lot about size, but neither Lehman Brothers nor Bear Stearns were the largest players, but in the post-Dodd-Frank Wild West of Wall Street, they were able to cause untold financial pain on untold Americans.

And I think that the overarching regulatory goals of the FSOC and FSB are exactly on point. I have listened and I have been very sympathetic to some of the concerns regarding both the domestic FSOC designation process and the FSOC–FSB coordination with respect to differences in U.S. and European regulatory models, primarily in the area of insurance and also in the mutual fund industry.

Specifically, I pushed back against money market mutual fund rules that require floating the net asset value of funds by introducing bipartisan legislation. We are seeing a five-time increase in borrowing costs for our State and local governments as a result of this floating NAV, and it is just not acceptable in Europe. And Europe abandoned a similar proposal already.

But overall, we need to collectively breathe and understand that the decisions of the FSB are not binding on the United States. Equivalent does not mean identical, though, and the FSOC/FSB have generally moved cautiously and worked with tremendous coordination among the various regulators, industry, and this Congress.

I have stated my strong support for State-based regulation of insurance. And I think we all clearly understand the different approaches to regulation in the United States and Europe. What is more, U.S. regulators understand and appreciate the differences.

With that, I can tell you one thing: Going back to a pre-Dodd-Frank world does not help U.S. competitiveness nor growth. U.S. markets run on confidence. Savers want confidence that financial firms are being operated in a safe and sane manner and that their employees at those firms are acting on behalf of their clients.

Markets mean taking risks, yes. Tolerating and harboring schemes, fraud, and scams is something entirely different.

With that, I yield back, and I look forward to our continued discussion.

Chairman HUIZENGA. The gentlelady yields back.

And I, too, look forward to our continued conversation.

We are down to 5 minutes left in this vote across the street, so I believe we are going to have to hustle over there. I would like for any staff listening as well, if you could make sure that your Members know that at 5 minutes after the last vote, we would like to reconvene.

[recess]

Chairman HUIZENGA. The subcommittee will come to order.

Thank you for your patience. I appreciate that.

Today, we welcome the testimony of Mr. Paul Stevens, president and chief executive officer of the Investment Company Institute (ICI); Mr. Carter McDowell, managing director and associate general counsel for the Securities Industry and Financial Markets Association (SIFMA); Dr. Marcus Stanley, the policy director at Americans for Financial Reform; and Mr. Jonathan Bergner, assistant vice president for Federal policy, National Association of Mutual Insurance Companies (NAMIC).

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. And without objection, each of your written statements will be made a part of the record.

And with that, Mr. Stevens, you are now recognized for 5 minutes.

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE INVESTMENT COMPANY INSTITUTE (ICI)

Mr. STEVENS. Thank you, Chairman Huizenga, Ranking Member Moore, and members of the subcommittee. I am pleased to be here to testify on the role of the Financial Stability Board.

ICI supports appropriate regulation to ensure a resilient financial system, and that includes looking at potential risks in asset management. We also favor international regulatory coordination, and we have responded constructively to the FSB's efforts to date. Just last week, we filed a comment letter commending the FSB for its focus on activities across the asset management sector and for referring specific recommendations to the International Organization of Securities Commissions (IOSCO) and to its securities regulatory members. Here in the United States, we have supported SEC Chair Mary Jo White's examination of asset management practices and related rulemakings.

And all that having been said, the work of the FSB remains a cause for deep concern. Why? Because the FSB has promised to return to the question of designating institutions like large U.S. stock and bond funds as "systemically important," a step that could have grave implications for U.S.-regulated funds and the 90 million Americans who depend upon them.

From its inception, the FSB has been dominated by central bankers and a banking mentality. To these central bankers, capital markets activity constitutes "shadow banking," a risky, shadowy

form of finance. Why? Because it is not regulated like banks. While IOSCO and securities regulators are beginning to take a larger role, the FSB's work on asset management is still overseen by banking regulators who, frankly, lack understanding of capital markets. That is reflected in FSB's emphasis on distress and disorderly failure, concepts that are derived from banking. And the FSB's return to SIFI designation for funds could bring asset management under bank-style regulation, no matter how harmful or inappropriate that might be.

We have serious reservations about transparency, fairness, and accountability in the FSB's work. As members of this subcommittee know, Congress cannot even determine what positions the U.S. delegation takes in the FSB's deliberations. The FSB's work falls far short of being evidence-based. It disregards empirical data and analysis in favor of conjectures, conjuring up visions of fire sales and spillover effects to claim that regulated funds may pose threats to financial stability.

ICI and its members have provided extensive analysis that squarely rebuts the FSB's hypotheses about regulated funds and fund managers, and we have urged, thus far to no avail, that the FSB reexamine its work in light of empirical evidence. Taken together, all of these problems raise questions as to whether the FSB's work in asset management is simply results oriented, that is, intended to ensure the designation of the largest and most successful funds on the globe, almost all of them U.S. funds. After all, the FSB's very purpose is to influence and shape regulation in the United States and other countries.

We are concerned that the FSB's designation work could front run and prejudge issues at our Financial Stability Oversight Council. The U.S. representatives to the FSB are principal players on our FSOC. The FSB's designation of three U.S.-based insurance companies presaged FSOC's designation of those very same companies. Similarly, a flawed FSB methodology that identifies U.S. funds might very well lead to designation of those funds by the FSOC. If that happens, we believe the consequences for funds and their millions of investors will be serious indeed.

Under Dodd-Frank, designated funds would be subject to inappropriate bank-style regulation, including capital requirements. Investors will face higher costs and lower returns. Fed supervision could put the interests of the banking system ahead of the fund's fiduciary duty to their own shareholders, and America's retirement savers could be on the hook to help bail out other failing financial institutions.

For all of these reasons, we urge that Congress provide effective oversight of the U.S. agencies participating in the FSB and encourage constructive reforms. Congress must extend its oversight to multilateral bodies like the FSB that are expressly designed to shape domestic U.S. regulations.

Finally, Mr. Chairman, let me just note that the FSB's process, transparency, and analytical shortcomings are also apparent at the FSOC. That is why the ICI strongly supports H.R. 1550, the bipartisan Ross-Delaney FSOC Improvement Act, a bill that will codify improvements to the SIFI designation process and advance the goal of reducing systemic risk.

Thank you for your attention. I look forward to your questions.

[The prepared statement of Mr. Stevens can be found on page 49 of the appendix.]

Chairman HUIZENGA. Thank you.

With that, Mr. McDowell, you are recognized for 5 minutes.

STATEMENT OF CARTER MCDOWELL, MANAGING DIRECTOR AND ASSOCIATE GENERAL COUNSEL, THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION (SIFMA)

Mr. MCDOWELL. Thank you, Chairman Huizenga, Ranking Member Moore, and distinguished members of the subcommittee. Thank you for providing me the opportunity to testify today on behalf of SIFMA and to share our perspectives on the effect that international standard-setting bodies such as the FSB, the Basel Committee, and IOSCO have on the financial services industry and the U.S. economy.

I begin with an observation that echos what many on this committee have identified: U.S. financial markets are unparalleled in their size, depth, dynamism, diversification, and resiliency. These attributes and qualities are not a given, and SIFMA works with its members to preserve these attributes. Capital markets play a more significant role in the U.S. economy than they do elsewhere. In fact, here in the United States, about 80 percent of capital formation happens in the capital markets, and only about 20 percent of lending happens in the banking sector. In the rest of the world, those percentage are reversed.

As Ranking Member Moore stated in her opening statement, there is nothing more global than capital. And U.S. firms operate both domestically and globally in all of these markets, and they compete among themselves and with U.S. nonfinancial firms.

Our industry has worked with regulators since the financial crisis to make top-to-bottom reforms, implement the requirements of the Dodd-Frank Act, and establish other robust risk management practices to rebuild trust in the financial services industry.

One of the strengths of the U.S. financial markets has been the result of a regulatory system that has historically been transparent and collaborative, involved robust public participation, and considered the particular circumstances of U.S. markets. However, in recent times global policymakers have found it increasingly necessary to establish harmonized regulatory standards for financial institutions internationally with the goal of leveling the playing field among financial institutions based in different jurisdictions, minimizing the opportunity for cross-border arbitrage, and creating more consistent rules of the road for financial institutions and their customers and counterparts. SIFMA supports and shares these goals.

The result of this dynamic, however, is that major changes affecting the regulatory framework of the United States' prudential and market regulation increasingly originate in international regulatory standard-setting bodies. The process typically begins with the adoption of an international standard at the FSB, the Basel Committee, or somewhat less frequently, IOSCO. And only after final adoption of the international standards, do U.S. regulators typically initiate a notice-and-comment rulemaking procedure

under the Administrative Procedures Act to translate the international standard into U.S. law.

SIFMA recognizes that international standard-setting bodies have necessary and appropriate roles to play in coordinating global regulatory efforts. However, these bodies and the U.S. regulators' participation in them should be subject to much more robust scrutiny, transparency, and procedural requirements than they are currently. Procedural reforms that enhance public participation in the rulemaking process would improve the quality and fit of international and domestic regulation, ultimately to the benefit of U.S. financial markets and the businesses and customers who rely on these markets.

In light of the increasing internationalization of financial regulation and the many serious issues outlined in my written statement, SIFMA believes it is time for a critical examination of how U.S. regulators engage with international bodies because of the impact these bodies have on U.S. domestic policy.

We hope that Congress will use this opportunity to mandate improvements in the international standard-setting process in two ways. First, Congress should require the U.S. regulators to improve the process they use when they participate in international rulemaking. SIFMA strongly supports Section 10 of H.R. 3189, the Fed Oversight Reform and Modernization Act, or the FORM Act, which would require the U.S. banking regulators—the U.S. Treasury and the SEC—to notify the public before participating in a process of setting international financial standards and to seek public comment on the subject matter, scope, and goals of such process.

Secondly, Congress should require, through legislation, reforms in the standard-setting process of the international bodies themselves. These reforms could include requiring the holding of public meetings, publication of records, more reliance on data, public disclosure of the cost-benefit analysis, and republication of any material changes that are made to the accords prior to their adoption.

It is clear Congress does not have the authority to impose requirements directly on international regulatory bodies. However, you can impose conditions on the participation of U.S. regulators in these bodies. And participation of the United States is so important to the legitimacy and influence of these bodies that they would likely adopt any reasonable conditions that Congress imposed. The important role these bodies play can be coordinated, and we underscore the need for that. I look forward to your questions.

[The prepared statement of Mr. McDowell can be found on page 29 of the appendix.]

Chairman HUIZENGA. Thank you.

Dr. Stanley, you are recognized for 5 minutes.

STATEMENT OF MARCUS STANLEY, POLICY DIRECTOR, AMERICANS FOR FINANCIAL REFORM

Mr. STANLEY. Chairman Huizenga, Ranking Member Moore, and members of the subcommittee, thank you for the opportunity to testify today.

I believe our starting point in thinking about the implications of the Financial Stability Board for the U.S. economy should be the actual powers of the FSB. It is a nongovernmental association with

no statutory powers under U.S. law. Its output consists of reports and recommendations, not laws or regulations. The FSB's standards and recommendations can only be legally realized through the actions of legislative or administrative bodies in member states. In the United States, such actions require either laws to be made through the constitutional processes or regulations passed through notice-and-comment rulemaking.

Since the FSB does not have legal status under U.S. law, its direct impact on the U.S. economy is close to nonexistent. This is in sharp contrast to some other international discussions, such as those resulting in trade agreements. The negotiation process for trade agreements provides far less transparency than the FSB process, and such agreements become part of U.S. law once they are ratified. It is ironic that many who do not question the effect of trade agreements on U.S. sovereignty are expressing such concerns about the impact of the FSB.

At the same time, the standards set by the FSB do indicate the consensus of the international regulatory community. Elements of this consensus have come under strong attack from industry interests in the United States. These attacks are sometimes made, even when there is no strong difference in views on FSB policy recommendations. For example, the latest comment letter from the Investment Company Institute to the FSB states: "And large, we have few objections to the proposed policy recommendations."

The ICI's concern seems to be less with the FSB's actual recommendations than with the very fact that the FSB believes there is the possibility of systemic risk in the asset management sector.

It is useful to consider the general role of the FSB as a forum for international coordination of financial regulation. Given the globalized nature of financial markets, the need for such a forum is obvious. We regularly see industry calling for improvements in cross-border regulatory coordination. From a different perspective, public interest groups such as my own have fought for high standards of financial regulations across all global financial centers. If an international forum like the FSB did not exist, we would probably all be urging regulators to create it.

But international coordination should not mean a one-size-fits-all approach. National circumstances and preferences differ. AFR has consistently fought for super equivalence of U.S. regulations when the consensus of international regulators fell short of the level or type of oversight needed to ensure the safety of the U.S. financial system.

Much of the specific criticism of the FSB relates to regulation of nonbanks, particularly investment funds, and insurance companies. We support the efforts of the FSB to examine potential risks in these sectors. At the heart of the 2008 financial crisis was a comprehensive failure of capital market liquidity. As major players in the capital markets, asset managers and insurance companies can contribute to such failures of liquidity through disorderly forced selling of assets and/or an inability to execute on commitments to investors.

This concern is not simply theoretical. As outlined in my written testimony, we know that insurance companies played a major role in the 2008 financial crisis, both directly and indirectly. My written

testimony also outlines a variety of ways in which poor management of investment funds can contribute to systemic risk.

Investigating these potential threats to financial stability is exactly what we should be asking our regulators to do. International coordination can only help in that effort. Regulations should be tailored to the specific national markets being regulated. However, since the FSB does not directly regulate U.S. markets, FSB involvement does not remove control of these issues from the U.S. political or regulatory system. Specific regulation can be promulgated by U.S. agencies and, indeed, must be promulgated through U.S. agencies through the notice-and-comment process.

This is exactly what is happening today. The SEC has responded to concerns about asset management by issuing several proposed rules addressing issues ranging from fund disclosure to planning for investor redemptions. The Federal Reserve has issued proposals related to the oversight of insurance companies within their jurisdiction. Both industry and the public can respond to these proposals, and both industry and the public are currently doing so. The international dialogue facilitated through the FSB is a helpful supplement to this process.

Thank you for the opportunity to testify before you today, and I am happy to answer any questions you may have.

[The prepared statement of Dr. Stanley can be found on page 43 of the appendix.]

Chairman HUIZENGA. Thank you.

And Mr. Bergner, you are recognized for 5 minutes.

STATEMENT OF JONATHAN BERGNER, ASSISTANT VICE PRESIDENT FOR FEDERAL POLICY, NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES (NAMIC)

Mr. BERGNER. Good afternoon, Chairman Huizenga, Ranking Member Moore, and members of the subcommittee. Thank you for the opportunity to speak to you today. My name is Jonathan Bergner, and I am the assistant vice president for Federal policy for the National Association of Mutual Insurance Companies.

NAMIC is the largest property casualty insurance trade association in the country, with more than 1,400 member companies, representing 40 percent of the total market. We are very appreciative of this subcommittee's focus on the activities of the Financial Stability Board. Let me start by saying that NAMIC believes that international organizations which focus on joint monitoring, coordinating, and communicating among regulatory jurisdictions can play an important role in helping to protect a global economy.

However, NAMIC maintains that provisions in the FSB's charter go well beyond generally expressed objectives and have resulted in the FSB taking a more direct and prescriptive role in monitoring how various countries implement global rules at home. This extensive role has become particularly troubling for the U.S. property casualty insurance industry.

NAMIC has significant concerns with many of the activities at the FSB, as well as the opaque processes by which they are conducted. Little is known about the decision-making process at the FSB, and there is no formal process for communicating NAMIC members' concerns to the U.S. representatives, which are the

Treasury, the Fed, and the SEC. But most importantly, there are no U.S. State insurance regulators serving on the FSB. This calls into question their ability to effectively determine what is appropriate for insurance regulation. Nonetheless, this bank-centric organization is directly guiding the policy work and the timing of that work for the International Association of Insurance Supervisors (IAIS).

In 2013, the global insurance industry was informed that the FSB had directed the IAIS to develop a new group capital standard for all large internationally active insurance groups. These groups were arbitrarily defined and include over 50 companies that have not been designated as globally significant insurance institutions. The IAIS has been working on this capital standard since 2013, yet neither the FSB nor the IAIS have ever actually defined the problem they were trying to solve and have offered little substantive explanation as to why these decisions were made.

Despite the intentions of the FSB and the IAIS, the application of a global capital standard to individual companies that come from very different regulatory environments with very different economic and political objectives will not produce comparable indicators of capital adequacy. But in their zeal to achieve comparability, the FSB, through the IAIS, will succeed only in generating unnecessary costs to governments, insurers, and ultimately to the policyholders, and those costs to the United States could be substantial.

In this process, our country has had to consider major changes to our supervisory regulations, corporate law, and accounting systems in order to accommodate the proposed group capital requirements. These proposed standards are largely derived from existing European standards, which will result in U.S. insurers being placed at a competitive disadvantage relative to their European counterparts. Indeed, some experts have suggested that is entirely the point.

The FSB also appears to be having an undue influence on the Financial Stability Oversight Council's designation of systemically important financial institutions here in the United States. The FSB had already decided that two U.S. insurers, MetLife and Prudential, were global systemically important insurers prior to the FSOC conducting its own supposedly fair, objective, and evidence-based designation process.

These questionable designations of Prudential and MetLife were made over the objections of the single voting member of the Council who possessed insurance expertise, Roy Woodall, as well as the State insurance regulator on the FSOC, John Huff. Apparently, the Treasury, the Federal Reserve, and the SEC valued the findings of the foreign-dominated FSB over that of U.S. insurance experts. Even more concerning is that the FSB determinations did not include any involvement or consultation by the functional State insurance regulators of the actual U.S. insurance entities being designated.

Mr. Woodall has stated in congressional testimony that he has concerns about inappropriate FSB influence on the development of U.S. regulatory policy. NAMIC believes the evidence clearly demonstrates that he is right to be concerned.

In summary, it is the position of NAMIC that the impact of FSB actions on the U.S. insurance industry has not been positive and, in fact, may very well operate to inhibit the growth and competitiveness of the U.S. insurance industry in the future. Again, thank you for the opportunity to speak to you today, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Bergner can be found on page 22 of the appendix.]

Chairman HUIZENGA. Thank you.

The Chair now recognizes himself for 5 minutes for questions.

I personally believe the FSB has become a bit of a shadow regulatory authority. I had an opportunity to travel to Europe, with a bipartisan group that went last October, and that became pretty clear, I think, to many of us. It doesn't hold public hearings. It doesn't provide the public with any written record of its deliberations. In fact, neither Congress nor the American public even know the positions that U.S. regulators have taken on these critical regulatory decisions. And that was something that has been attempted to be made clear, our displeasure with Treasury and with others at various times.

I am curious. I am going to start with you, Mr. Stevens. Dr. Stanley asserts that—I think I wrote this down properly—there is "no real effect on the U.S. economy" from the FSB because they don't have direct regulatory and enforcement on that. Is it really that benign?

Mr. STEVENS. I find it really an extraordinary statement. It is not that benign. It is not an idle exercise. If it were, we wouldn't have some of the most senior financial regulators in the United States actively participating in every phase of it. It is intended to shape U.S. regulation.

And just to be clear, how we got concerned about this at the beginning was, the first of the consultations about asset management made it very clear the FSB was on a path to recommend for designation as SIFIs every fund over $100 billion in assets under management. As we sit here today, there are 17 such funds in the world. Sixteen of them are U.S. funds. One is a Chinese fund. So think about this. The head of the regulatory efforts at the Fed is over in Europe devising methodologies to designate SIFIs that would be recommended to the FSOC here in the United States on which the Fed is an important member, the decisions out of which would determine the Fed's jurisdiction over additional portions of the financial system. So, this is not an idle game.

Chairman HUIZENGA. Mr. McDowell, I will let you address that as well. But are firms, companies, given information about why they are designated or how to become dedesignated? That is a softball.

Mr. MCDOWELL. I wouldn't even dance around the designation. No. With the FSB, we know who sits on the FSB for the United States, but all of the work is done through committees. You can't even find out who's on the committees that are actually doing the work. It is very hard to get a schedule of when they are going to meet. So if you don't know who's on the committee, and you don't know when they are going to meet, it is hard to have any sort of influence—

Chairman HUIZENGA. That doesn't sound benign.

So, Mr. Stevens, in your testimony you stated that public comment has really been discarded and not taken in on consultation. Do you care to expand on that?

Mr. STEVENS. Well, to be fair, we have had the opportunity to submit comment letters. We have been invited to roundtables, sort of off-the-record discussions. The problem is that we submit extensive empirical data and analysis of our experience as an industry in one market crisis after another, none of which appears to be taken into account in the next consultation. So it just simply seems to be a process that is unhinged from any evidence-based approach.

Chairman HUIZENGA. Do you believe the FSB's sort of parameters really fit reality on sort of their hypotheses and what their assumptions are? Do you think they fit the reality of what—

Mr. STEVENS. I think the bank regulators at the table have preconceived notions, the very best evidence of which is they continue to refer to mutual funds, one of the most comprehensively regulated portions of our financial system, as shadow banks. We are not shadowy, and we don't bear any relationship to banks, except that is the way they begin. And, of course, if anything not regulated like a bank is dangerous, and we are not regulated as banks and never thought necessary to be, then to them we look dangerous. And I think in some ways it is as simple as that.

Chairman HUIZENGA. Okay.

Mr. McDowell, I am going to quickly move on. You mentioned, thank you, my Section 10 of the FORM Act. I appreciate that. But does Section 10 really go far enough or are there other reforms that you think Congress ought to be looking at?

Mr. MCDOWELL. It is a great start. As I said in the written testimony, probably the principal thing is there needs to be more cost-benefit analysis of what is happening at the FSB. Another big objection—I guess it echoes something that Mr. Stevens said—is we are given an opportunity to comment, but one of the things that we have noticed is there are, many times, material changes made in the final accord that is adopted, that we didn't have an opportunity to comment on. They will put a proposal out before something is finalized, so it is like they are throwing a lot of things on the wall.

We will write comments talking about all of those, and then when they put out the final proposal, it is materially different from what we even talked about, and we don't get a second chance to comment on what they are now proposing be adopted.

Chairman HUIZENGA. Okay. My time has expired.

With that, the Chair now recognizes the ranking member for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman. And once again, I thank the panel for sticking around.

I want to start with Mr. McDowell, just some clarification about your testimony. I was looking through it, and you talked on page 3 about the dynamic of a lot of the regulatory framework that we look at in the United States that starts from an international level. And I am wondering if you think that is somehow appropriate, given the rest of your testimony where you talked about—you listed a number of bullets here about how different international bod-

ies are, that they lack procedural safeguards, international bodies lacking public records, lacking public positions by members, lack of public comment, a little explanation for the basis of rules, the reliance on nonpublic data, no cost-benefit analysis, and yet in your testimony, you say that some of the regulatory framework that we eventually adopt comes from an international perspective. Can you just give me some clarification?

Mr. MCDOWELL. Yes, I will try. One of the most important things, I think, you have to realize is, in the United States, about 80 percent of lending happens in the capital markets and only about 20 percent happens through commercial bank lending. In the rest of the world, those percentages are reversed. So when Mr. Stevens talks about a bank-centric approach, we may have a bank-centric approach here in the United States, but it is even more bank-centric outside of the United States.

Another sort of anecdote. I have been at SIFMA for about 7 years. When I started, I would basically write comment letters on behalf of the industry in the prudential space. I would say that I spent about 85 percent of my time in the beginning writing domestic comment letters to the Fed or the OCC or the Treasury Department, and only about 15 percent would be spent writing letters to Basel or one of the international standard-setting bodies. Today, I would say it is about 50/50.

Almost everything that the U.S. regulators are doing in the prudential space is first being considered in the global arena. And look, we support the existence of the FSB, and we realize that there needs to be harmonization. And there is a role here. What we are arguing is there just needs to be more of a process in place for doing that.

Ms. MOORE. Let me ask Mr. Stevens some questions then. You have mentioned that it is so bank-centric—many of you have said that—and yet, as we heard Mr. McDowell explain, that the FSB and international bodies are kind of driving the train here. Can you just explain the impact of bank-like requirements of capital for mutual funds and the relationship of mutual fund companies to individual funds in a family and how stress in a particular fund would impact the other funds in a fund company?

Mr. STEVENS. Thank you, ma'am. It is an excellent question. We know from Dodd-Frank what happens to a financial institution that is designated as a SIFI in the United States. It is subject to capital requirements. Mutual funds have never been subject to capital requirements, because the best way to think of them is 100 percent capital. It is all risk capital. But bank regulators have a sense that, well, we need a cushion. So the capital requirement of 8 percent, or whatever it might be, is likely to be put into the fund as a cash cushion. Now, you put that into a fund as a cash cushion, it is going to be a fund that doesn't perform as well as other funds. So it is going to make it uncompetitive right from the beginning. It shows you how nonsensical a capital standard is with respect to a fund.

Secondly, they would be subject to enhanced prudential supervision by the Fed. We already have a thorough regime of regulation and oversight by the SEC. Enhanced prudential supervision by the Fed would mean that the Fed could come in and tell the fund's

portfolio manager how to manage the fund in a crisis, not in the best interests of the shareholders, but in the best interests of what the Fed thinks the financial system or the banking system or the issuers in the portfolio might need at a given moment.

Ms. MOORE. Okay.

Mr. STEVENS. That completely changes the nature of a fund's duties and obligations to their shareholders.

Ms. MOORE. Right. We just have a few seconds left. And so, Mr. Stevens, I just want you to—you predicted, and I was concerned, that floating the NAV here would raise the costs for State and local governments. And so now our municipalities and governmental entities are not having their bonds purchased. Can you just talk about the trillions of dollars that are being lost?

Mr. STEVENS. We estimate that about $910 billion so far has left prime and tax-exempt money market funds. The cost of municipal finance for short-term purposes has risen 77 basis points. So the predictions that we made about the impacts on markets, I think, have come true and much of that increase is as a result of changes in money market fund rules. The costs in the short-term borrowing space certainly have risen, as we feared.

Ms. MOORE. Sorry. My time has expired. Thank you. I think we had an objection from the other side.

Chairman HUIZENGA. I will resist any temptation to gavel down any outbursts on this side of the aisle at this point, but I would like to welcome Olivia Schweikert. I am not sure of her legal standing here as a voting member, but she certainly adds color and is welcome any time.

You are welcome.

With that, the Chair recognizes the Vice Chair of the subcommittee, Mr. Mulvaney of South Carolina, for 5 minutes.

Mr. MULVANEY. Thank you, Mr. Chairman. I thank each of you gentlemen for coming and doing this today.

One of the things—and you all have seen this, if you follow this at all—we have tried to do over the course of the last couple of years is to try and figure out exactly not only how you get to be a SIFI, but how you get to unbe a SIFI. Okay. I mean, because I think that is probably just as important a question. Yes, we are starting to understand, maybe, a little bit about the process of being designated, but what about the process of being undesignated? Or is it a lifetime sentence? And I think the MetLife case sort of raised the very real possibility for all of us that maybe this isn't permanent and that maybe one day you might be a SIFI and then the next day you aren't.

So here is one of my questions. That seems like a fairly reasonable thing to ask of the FSB, tell us how you get to be one and then tell us how you get to unbe one?

Mr. Bergner, I will start with you. Why haven't they done that?

Mr. BERGNER. I think the transparency question answers that. We don't know why they haven't done it. We don't know much of why they do anything. I would just start by pointing that out. I would also note that they haven't de-designated MetLife, although as we know, the Federal case has a—

Mr. MULVANEY. That is a great point, and we don't know why they haven't.

Mr. BERGNER. No, we don't. And I think the point was made, perhaps by Mr. McDowell earlier, that Congress can't pass a law to direct the FSB to do something. However, there may be options that Congress can pursue to work with the U.S. representatives to say, listen, we need you to abide by ABC and XYZ before you are permitted to go participate at these international forums.

Mr. MULVANEY. Dr. Stanley, since you are sort of the sacrificial lamb here to try and defend the FSB today, why haven't they done this? Why haven't they made a transparent and reasonable, rational explanation of what it takes to be undeclared a SIFI?

Mr. STANLEY. We have seen that GE Capital has been undeclared a SIFI, and I think FSOC explained the set of things that GE did in order to reduce its systemic significance. And the FSOC is required to reexamine its SIFI designations on a regular basis. So I think we do have a roadmap for how to become undesignated a SIFI.

And I just want to say something about this issue, the impact of the FSB on the U.S. economy. What I said in my testimony is that there is no direct impact of the FSB because the FSB's recommendations only take effect when U.S. regulators act on them. And we have not seen, despite the FSB's discussion of asset manager designation, any indication that the FSOC is going to designate any entity as any asset manager as systemically significant. And to me that is a good example that if U.S. regulators don't pick up on it, the FSB's lists or whatever they come up with don't make a difference within the U.S. regulatory system.

Mr. MULVANEY. We get lost here in the alphabet soup. I know that I do. I asked my staff a question. I think we are right about this. I think while GE came off of the FSOC list, they didn't come off of the FSB list. Let's see if there is something we can agree on in a bipartisan basis.

Is there any objection, from your point of view, to having the FSB codify the things that would go into the decisionmaking about de-identifying or delisting a SIFI? Is there any objection to doing that, writing it down so we know what the law is or know what the rules are? That is a good idea, right?

Mr. STANLEY. We don't have an objection to it, but I don't think it is necessary because the FSB's lists are not U.S. law. For the FSOC, it makes sense, but for the FSB, I don't see that it is called for.

Mr. MULVANEY. Generally speaking, isn't it a good idea to let everybody here, on both sides of the aisle, whether you are a banker or a politician, know what the rules are that you play by and to maybe have those written down? You would agree with that generally, right?

Mr. STANLEY. Sure.

Mr. MULVANEY. Okay, good. That is progress. We might be able to build on that.

I want ask you, Mr. Stevens, a couple of questions about your industry because you said something that caught my attention, which is that they are dealing with you as shadow banks, which frightens me because I know this much about mutual funds and I know they are not banks. I know that a capital requirement for a

mutual fund is a non sequitur, that you are using language to talk about something that is completely unrelated.

What happens if a mutual fund gets designated as a SIFI? What is it going to mean to the folks in my district who invest in those facilities?

Mr. STEVENS. As I said, capital requirements, which will make the fund perform worse and less competitive. Prudential regulations by the Fed, which can mean the fund is no longer being run solely in the interests of its investors, but instead in the interests of whatever the Fed's policy concerns are at a given time. If a SIFI bank or some other systemically important institution were to fail, that fund would have to put money, according to Dodd-Frank, into a pool to help bail it out. From my point of view, a fund that is designated as a SIFI is not going to be too-big-to-fail. It is going to be too-burdened-to-succeed.

Mr. MULVANEY. Thank you for that. Let me do this in wrapping up, well, as long as some of my Democrat friends are here. I think this is one of the things we might be able to work on. Because understanding what the rules are, having people play by the rules, probably just makes sense. Sooner or later, hopefully, my party is going to be in charge of this organization. My guess is, at that time, you all will want to know what the rules are that we are playing by. So maybe that is one of those little things we can do.

By the way, the other thing we do that surprises me, which is I have heard this story many times about the AIG—I can't remember whether it was AIG designation or MetLife designation, that the one person that we put on there—by "we," I mean you, because you all created this—who actually knew about insurance said we should not have designated those folks. We should look at possibly allowing the people that we put on there to have influence in the field they actually know something about.

Thank you, Mr. Chairman, for your indulgence.

Chairman HUIZENGA. The gentleman's time has expired.

With that, the Chair recognizes Mr. Heck of Washington for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman. Let's keep talking some about insurance.

Mr. Bergner, let me pick on you. I have some legislation I am working on and it is predicated on a couple of principles, and I want to get your reaction to those. The first is that when we, the United States, discuss insurance in an international forum, that our representatives should include our primary insurance regulators. Does that make sense to you?

Mr. BERGNER. It is a great principle.

Mr. HECK. And why do you agree with me on that?

Mr. BERGNER. Because they are the ones that know how to regulate insurance companies.

Mr. HECK. So I imagine that it would not be too far of a stretch if I were to ask you that we ought to actually include that requirement statutorily, that they should be included and at a minimum consulted?

Mr. BERGNER. I think it is a wonderful idea.

Mr. HECK. So here is what I believe. I believe that if we fail to do that, we literally are undermining the very national framework

for insurance regulation, which is McCarran-Ferguson, and that we have done it through the back door without actually having come back here and asking the Congress to do that. Your reaction, sir?

Mr. BERGNER. I think, certainly, Congress exercising its legitimate authority to be involved in the creation of regulatory standards that are ultimately going to impact your constituents should never be viewed as somehow inappropriate. And I know NAMIC very much supports the idea of legislation that will ensure that our U.S. representatives seek standards that are reflective of U.S. practice and law and that, ultimately, are not going to require changes to that practice or law.

Mr. HECK. So it would follow that if members of this committee had an opportunity to support or co-sponsor legislation as such, that you would encourage them to do so?

Mr. BERGNER. Strongly encourage them, yes.

Mr. HECK. Thank you. But let's not be hasty. There is a second principle, a little bit more straightforward, which is that U.S. financial policy should be made in the United States.

Mr. BERGNER. I agree, 100 percent, and particularly in the insurance context given how different the regulatory models are in other jurisdictions.

Mr. HECK. Do you think we are adhering to these two principles now?

Mr. BERGNER. I think there are many reasons to believe that we could do better at adhering to those principles.

Mr. HECK. So if we, in fact, engage in international discussions and do not have these people at the table, we are, by implication, not setting U.S. financial policy in the United States and are not adhering to either of those principles?

Mr. BERGNER. That would seem to be the case to me, yes.

Mr. HECK. And as with the first one, does it make sense to you that we codify the statement that U.S. financial policy should be set in the United States?

Mr. BERGNER. Absolutely.

Mr. HECK. Mr. McDowell, I liked your body language. If I am misreading you, go ahead and feel free to pass, but if you have something to add with respect to this line—

Mr. MCDOWELL. I was just saying that I think your principles apply beyond just insurance. I don't represent insurance companies, but I think one of the things that we are talking about is there ought to be an opportunity for notice and public comment on what the U.S. regulators are going to do in these international bodies. So, before they get on a plane and start discussing something, they ought to know what people think about the topic that they are going to be discussing.

Mr. HECK. So since I agreed with the principles that my good friend from South Carolina expressed, and since he went so far over his own time, and I have time left, I will gladly yield back the balance of my time, Mr. Chairman, and thank you.

Chairman HUIZENGA. Thank you. I think a number of us over here are looking forward to working with you on this principle, and I am sure we will make great progress.

The Chair recognizes Mr. Pittenger of North Carolina for 5 minutes.

Mr. PITTENGER. Thank you, Mr. Chairman. Thank you for this important hearing, and I thank each of you for your participation.

Given that the U.S. economy is quite different than the rest of the world and that we have more reliance on capital markets rather than on traditional bank lending, do you think we are put at a disadvantage, Mr. McDowell, with our domestic regulations?

Mr. MCDOWELL. That possibility certainly exists. And, we see it where in Europe and in Asia, they have a universal bank model where they are doing insurance, capital markets, bank lending, under one charter. Here we have functional regulation. So in the broker-dealer space or asset management space, we have the SEC. We have the banking agencies. We have the States involved in insurance. It is just a different setup. We have the Fed with a holding company structure, and others don't have that at all. And so people just come at it from a different perspective.

And I am not saying that there isn't something to be gained from a diversity of perspectives. I guess I just come back to what I was saying earlier. I think that before the United States signs on to any of these principles, it would be nice if we had the opportunity to apply something like the Administrative Procedures Act, which happens domestically, so that we have a chance to really weigh in and know that the points we are going to make will have to be considered.

A lot of the commenting that happens at the global level—and I would love to know what others think—is it just seems like a lot of window dressing. We are writing letters, but I am not sure that they are really being read or considered.

Mr. PITTENGER. So, you are in total agreement then that our domestic regulators follow too closely the international standards for us without taking into account our own markets?

Mr. MCDOWELL. They take into account the markets, but they have competing interests too. One thing I would say here is that the goal is harmonization, but we need to be very clear, that is a goal that we are never going to achieve and for some very simple reasons. One, we have different legal systems. We have different tax systems, different corporate structures, as I have described. And so, it just depends on where you put the emphasis and the balance. And I think what Congress needs to do is help sort of weigh in on this balancing that takes place.

Mr. PITTENGER. We have heard a lot of concerns about transparency with the international groups and their standards, having the potential of locking up tens of billions of dollars or credit in the U.S. economy. Should this be a concern to policymakers?

Mr. MCDOWELL. Absolutely. We are spending billions and billions of dollars on compliance. And in a lot of cases, we are having to build new systems. We haven't talked much about it, but also, the timelines that are done for some of these things are often very arbitrary and don't take into account what is necessary in order to build compliance.

Mr. PITTENGER. What type of measures would you have to improve the transparency that would benefit the entire process?

Mr. MCDOWELL. We made two recommendations. One was there could be more process around what the U.S. regulators do when they go to these meetings. So the principal one would be if they are

going to, say, talk about international capital standards, before the United States goes, they ought to do a notice and public comment about the types of things that they are going to be proposing so that we are seeing it in advance so that it is not vague. So that would be one area where you can change what the regulators are doing in the bodies.

The other thing is you could order the U.S. regulators to argue for a change in the international body itself. Congress doesn't have the ability to force your will on other countries, but we are an important player in these bodies. And something akin to what we are talking about with the FORM Act or with the Administrative Procedures Act, requiring more cost-benefit analysis to take place at the global level, I think would go a long way towards improving the process.

Mr. PITTENGER. The regulatory standards that have been developed since the crisis, what does it mean on a community basis in terms of our economy?

Mr. MCDOWELL. We can't get to the bottom of that. There is nobody out there that is looking at the cumulative impact, at the global or the domestic level. It is one of the things that we have been calling for. They are starting to do some of this work in Europe and in the UK. We have been calling for it to be done here. A lot of these rules that are written—the other thing about the FSB or the Basel Committee, is that it isn't just one committee. There are different silos within each of these bodies working on individual regulation, and oftentimes they don't talk to each other and they don't coordinate. Sometimes you get policies that are divergent, and that don't work in harmony together, and no one is looking at the cumulative impact, whether it be the FSB or the FSOC here in the United States. And it is one of the things that we think need to happen.

Mr. PITTENGER. Should we?

Mr. MCDOWELL. We absolutely should.

Mr. PITTENGER. Thank you. My time is up.

I yield back.

Chairman HUIZENGA. The gentleman's time has expired.

This has been very helpful. I think this has been very enlightening. I appreciate your time and your patience as we had a little 40-, 45-minute interruption there.

So with that, I would like to thank our witnesses for their testimony today, both written and oral. And without objection, I would also like to submit the following statements for the record: the Property Casualty Insurers Association of America; and the American Council of Life Insurers.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And again, I appreciate your time and your patience today, and your insight. So with that, the hearing is adjourned.

[Whereupon, at 3:43 p.m., the hearing was adjourned.]

A P P E N D I X

September 27, 2016

NAMIC®

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of the

National Association of Mutual Insurance Companies

to the

United States

House Financial Services Subcommittee

On Monetary Policy and Trade

Hearing on

The Financial Stability Board's Implications for U.S. Growth and Competitiveness

September 27, 2016

The National Association of Mutual Insurance Companies (NAMIC) is pleased to provide comments to the House Financial Services Subcommittee on Monetary Policy and Trade on the Financial Stability Board's implications for U.S. growth and competitiveness, in particular the growth and competitiveness of the property/casualty insurance industry.

NAMIC is the largest property/casualty insurance trade association in the country, with more than 1,400 member companies representing 39 percent of the total market. NAMIC supports regional and local mutual insurance companies on main streets across America and many of the country's largest national insurers. NAMIC member companies serve more than 170 million policyholders and write more than $230 billion in annual premiums. Our members account for 54 percent of homeowners, 43 percent of automobile, and 32 percent of the business insurance markets.

Introduction

Over the last several years, the Financial Stability Board (FSB) has become an increasingly important and influential regulatory organization for the global financial services sector. Re-established in 2009 in the wake of the financial crisis, the FSB's core mission is to promote regulatory standards that ensure the stability and soundness of the world's financial system. Pre-crisis, the precursor organization the Financial Stability Forum had a role of monitoring, coordinating, and communicating between regulatory jurisdictions. However, the mandates provided in the FSB's charter go well beyond generally-expressed objectives and require that the FSB assume a direct role in monitoring how various countries implement global rules at home.

Beyond the overreach of a group of mostly foreign policymakers exerting their vision of regulation on our banking system, it is particularly troubling for the U.S. property/casualty insurance industry. During a Senate Banking Committee hearing in July of 2015, Dr. Adam Posen – testifying in support of many of the FSB's activities and decisions – said, "Where the FSB at present is getting things wrong, in my opinion, largely has to do with its approaches to coordinating regulation of the non-bank parts of the financial system."[1] NAMIC wholeheartedly agrees.

Multilateral organizations like the FSB have always been intended to promote and foster economic growth, not to regulate financial services markets everywhere in the world. NAMIC and its members firmly believe the FSB actions on insurance regulation have in fact inhibited, and are likely to continue to inhibit, growth and competitiveness for the U.S. insurance industry.

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[1]Dr. Adam Posen, Testimony before the U.S. Senate Banking Committee, July 2015, Page 8. http://www.banking.senate.gov/public/_cache/files/b9f2617a-7440-45a8-8632-58b5c2206739/33A699FF535D59925B69836A6E068FD0.posentestimony7815.pdf

Specifically, NAMIC has significant concerns with many of the activities at the FSB, to say nothing about the opaque processes by which they are conducted. Two of the chief concerns we would like to focus on include:

- The FSB's review and guidance of the policy development work of international standard setting bodies, specifically the International Association of Insurance Supervisors (IAIS) and;
- The designation process of Global Systemically Important Insurers (G-SIIs) and its influence on the Financial Stability Oversight Council's (FSOC) designation of Systemically Important Financial Institutions (SIFIs) here in the U.S.

NAMIC believes the current U.S. state-based insurance regulatory system is robust and well-positioned to meet the needs of the nation's insurance marketplace. All NAMIC member companies – those that are domestic-only and those that are internationally active – will feel the impact of the international standards and regulatory decisions being imported to the U.S. Indeed, the movement toward more formulaic, prescriptive standards from abroad seems to be accelerating.

The FSB Structure and Process

The Plenary of the FSB is housed in Basel, Switzerland, in the Bank for International Settlements, and has been chaired by various central banks. It is the sole decision-making body of the board and operates on the basis of consensus instead of actual voting. That, however, is all that is known about the decision-making process at the FSB. The U.S. is represented on the FSB by the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission (SEC). Interestingly, there are no U.S. state insurance regulators or lawmakers represented on the FSB, and there is no formal process for communicating the concerns of NAMIC members, or anyone else, to those U.S. representatives.

Further, the Plenary is dominated by central banks and political appointees. Consequently, there is ample reason to doubt that the Board fully understands how its decisions affect insurance markets, or that the critical differences between banking and insurance are fully appreciated. As a result, most of the regulatory concerns and proposed solutions tend to be very bank-centric. The decisions to designate G-SIIs and to craft a new global consolidated capital standard for all Internationally Active Insurance Groups (IAIGs) are being made by an organization with almost no insurance expertise from the U.S. and little expertise from other countries other than the IAIS representatives that report to them.

This lack of insurance expertise is best illustrated by an FSB meeting in 2016 when representatives of U.S. Guaranty Funds and companies were invited to participate in discussions about potential resolution strategies and plan requirements. During the questioning of the invited experts it was clear that the basic guaranty fund structure and U.S. insurer assessments for deficiencies were unknown to the FSB members charged with decision-making on insurance issues. Incredibly, some were even surprised to learn that the guaranty fund system was funded by the insurance companies rather than

taxpayers. This was further evidence that this board is not equipped with the facts and the understanding of our robust insurance regulatory environment.

Finally, it is important to note that neither the FSB nor the IAIS are bound by due process and neither formally considers the costs of the changes they are making to international insurance standards relative to the presumed benefits of these changes. With each new or revised standard, costs are added from international regulatory enforcement and compliance with seemingly little regard for the impact of these costs on governments, insurers, and consumers.

Financial Stability Board Driving Action on New Insurance Capital Requirements

In 2012, the G-20 and FSB were focused on banks as well as identifying Global Systemically Important Financial Institutions (G-SIIs) and developing a new regulatory framework for them. The FSB enlisted the help of the IAIS in identifying G-SIIs for designation and with the crafting of new regulations for them. Without warning or clear reasons, in the summer of 2013 the FSB met with IAIS leadership and informed them that, in addition to G-SIIs, other large IAIGs should also adhere to a global consolidated capital requirement similar to the Basel II and III requirements for banks. The IAIS was ordered to design, field test and adopt such global capital requirements first for G-SIIs by the end of 2014 and then for the IAIGs by 2016. The pace of this edict was unreasonable and unworkable, but IAIS leaders indicated they had no choice but to comply.

Since the FSB's mandate, the IAIS Executive Committee has made numerous decisions regarding the structure and design of the International Capital Standard (ICS) for the IAIGs without actually stating the problem the FSB was trying to solve, and without explaining why the decisions were made. The most troublesome of these decisions include:

- the insistence on a highly detailed, prescriptive formula for the ICS that would be applied to all countries;
- the requirement that all countries use the same valuation/balance sheet without regard to the costs and implications; and
- the insistence that the capital resources that companies use to meet the obligation be identical even when the capital instruments available to companies vary across countries.

Since 2013, NAMIC has submitted comments and testified at the IAIS on numerous occasions to encourage IAIS members to listen to a different perspective. We have met with state regulators and federal officials to urge them to make these arguments as well. While there has been some recent success resulting in a delay in the "ultimate" standard, the IAIS is holding firm on many of the major policy decisions it made in 2013.

Despite the goal of the IAIS to achieve a comparable ICS for all IAIGs around the globe, the application of the same capital standard to unique companies that come from very

different regulatory environments with very different economic and political objectives will not produce comparable indicators of capital adequacy or solvency. Every country has a unique regulatory system with features that influence the solvency of the companies doing business in that regulatory environment. Similarly, every insurance group has unique characteristics that cannot be fully captured by a single, one-size-fits-all formula. In their zeal to achieve comparability, the FSB – through the IAIS – will succeed only in generating unnecessary costs to governments and insurers.

The costs to the U.S. will be substantial. In fact, through this process our country is being asked to consider major, unnecessary, and ill-fitting changes to its supervision, corporate law, and accounting systems to accommodate the new group capital requirements. Because the new standards being contemplated are largely derived from existing European standards, U.S. insurers will be placed at a competitive disadvantage relative to their European counterparts. Indeed, some have suggested that is entirely the point:

> The insurers in Europe for the most part rightly hate [European Standards], but since it seems inevitable to be imposed on them, they have given up fighting Solvency II, and instead back using the FSB to impose it on the US, Japanese, and other competing insurers. They figure if they will be limited, they want to be sure their global competitors are as well. The US needs to stand up against this in the FSB.[2]

NAMIC has asserted that a *successful* global effort should not create unnecessary competitive asymmetries between companies domiciled in different, but equally well-supervised, jurisdictions. Instead, what is needed is a flexible and dynamic capital assessment that would recognize and improve understanding of diverse, successful approaches to solvency regulation. Such an approach would be principle-based and outcomes-focused. Under this approach, supervisors could achieve the desired goals of policyholder protection and insurer solvency without the costs of implementing new global systems in nearly every country in the world.

Unfortunately, the IAIS still seems to be fighting the idea of flexibility. For the time being they are willing to field test options that include a variety of accounting systems, but they have not agreed that the ultimate ICS could include differing approaches. Implementation of the ICS may well favor the local approach of one jurisdiction over another, creating further disproportionate costs between similarly situated companies. The potential market disruptions could be unintended, but very significant. Although they originally were not going to, it now appears that the IAIS is moving forward with a cost benefit analysis, though the FSB did not bother to do so.

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[2] Dr. Adam Posen, Testimony before the U.S. Senate Banking Committee, July 2015, Page 10. http://www.banking.senate.gov/public/_cache/files/b9f2617a-7440-45a8-8632-58b5c2206739/33A699FF535D59925B69836A6E068FD0.posentestimony7815.pdf

The FSB Influence on the FSOC SIFI Designation Process

Following the financial crisis, the FSB determined to identify large, international, non-bank financial firms whose failure could threaten the global financial system and designate them for enhanced regulation. These designations and enhanced standards would be developed in consultation with the IAIS and presumably then implemented by the countries of domicile for the designated company. Following the passage of the Dodd-Frank Act in 2010, the U.S. established its own process for this type of designation of Systemically Important Financial Institutions by the Financial Stability Oversight Council. The FSOC would vote and the designated company would be subjected to supervision and enhanced regulation by the Federal Reserve.

We believe that designations of systemic importance should be made by individual jurisdictions with appropriate due process, transparency, and accountability. This is to avoid what we have seen happening at the FSB. Through incredibly opaque processes, the Board appears driven to designate a group of the largest insurers as G-SIIs just for the sake of designating insurers. Designations should be based on actual systemic risk, not just a selection of the largest companies in each sector. The entire FSB process requires more sunshine, clearer focus on actual systemic risk, and a clear path towards adequately de-risking to avoid a designation or to get out from under one in the future.

There is further reason to be concerned about FSB influence on the FSOC designation process. Despite the fact that most insurance experts agree that traditional insurance activities are not systemically risky, on July 18, 2013, the FSB designated nine large international insurers – including U.S. insurers AIG, Prudential, and MetLife – as G-SIIs. Although the FSOC had just days before designated AIG, Prudential was not designated a SIFI until September 2013, and MetLife was not designated until December 2014. We have significant concerns that the sort of deliberative process put in place by Congress when it authorized the FSOC to make SIFI designations was circumvented and instead processes with pre-determined outcomes were implemented.

As mentioned above, the Plenary of the FSB makes its decisions by consensus. It is simply unfathomable that this group would move ahead with the designation of U.S. firms over the objections of the U.S. representatives. This means that the Treasury Department, Federal Reserve, and SEC all concurred in the decision to designate AIG, Prudential, and MetLife. In the case of MetLife and Prudential, this also means that these decisions were reached *before* the FSOC had conducted its supposedly fair, objective, and evidence-based designation process. Three members of the FSOC – the Federal Reserve, Treasury Department, and the SEC – had already made their decision months before. Perhaps this unusual process explains in part why a federal court has seen fit to overturn the MetLife designation as arbitrary and capricious.

Further, the U.S. insurance industry and its regulatory system are underrepresented at the FSB, with no involvement or consultation by the functional state regulators of the actual U.S. insurance entities of those designated G-SIIs. When the FSOC designations of Prudential and MetLife were made, they were done over the objections of the one voting member of the Council with insurance expertise, Roy Woodall as well as the

state regulator on the council, John Huff. As stated earlier, the court has since overturned the MetLife designation.

Mr. Woodall has stated in congressional testimony that he has a "concern that international regulatory organizations may be attempting to exert what I consider to be inappropriate influence on the development of U.S. regulatory policy."[3] NAMIC believes the evidence clearly demonstrates that he is right to be concerned.

Conclusion

In conclusion, the FSB actions on insurance capital requirements and its influence on the FSOC SIFI process have not been positive, and have in fact inhibited, and are likely to continue to inhibit, growth and competitiveness for the U.S. insurance industry. NAMIC believes it is important to ensure that federal agencies representing the U.S. on the FSB and at the IAIS are advancing policy positions that represent the interests of U.S. insurance consumers, insurance markets, insurance regulators, and the U.S. economy in general. To that end, the U.S. should insist on an open and transparent policy development process, and the U.S. representatives who engage with international bodies should share a common agenda and a common message. That message should include a strong defense of the U.S. insurance market and existing regulatory structure. It should also promote the interests of U.S. insurers and their policyholders.

Congress has a critically important role to play as these international discussions continue. Through oversight and awareness, along with the possible enactment of legislation to facilitate a needed course correction, lawmakers can help protect the robustly competitive insurance market in this country. NAMIC applauds the Committee for holding this important hearing.

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[3]Roy Woodall, Testimony before the U.S. Senate Banking Committee, April 2015, Page 3. http://www.banking.senate.gov/public/index.cfm/hearings?ID=29608126-AE85-4568-87B2-14E1A61D9774

Written Testimony of Mr. Carter McDowell

On behalf of the Securities Industry and Financial Markets Association

before the U.S. House of Representatives

Committee on Financial Services

Subcommittee on Monetary Policy and Trade

Hearing entitled "The Financial Stability Board's Implications for U.S. Growth and Competitiveness"

September 27, 2016

Chairman Huizenga, Ranking Member Moore, and distinguished members of the Subcommittee, thank you for providing me the opportunity to testify today on behalf of SIFMA[1] and to share our perspective on the effects of international standard-setting at the Financial Stability Board ("FSB"), the Basel Committee on Banking Supervision (the "Basel Committee"), and other international financial bodies on the United States and our economic growth opportunities.

I begin with an observation that echoes what many on this Committee have identified: U.S. financial markets are unparalleled in their size, depth, dynamism, diversification, and resiliency. As the representative of hundreds of banks, broker dealers, and asset managers, SIFMA could not agree more. Capital markets play a more significant role in fueling the U.S. economy than they do elsewhere. In the United States, non-financial corporations obtain approximately 80 percent of their aggregate debt financing from bonds, and 20 percent from bank loans; in other major economies, those proportions are nearly reversed.[2]

These attributes and qualities are not a given. Our industry has worked with regulators since the financial crisis to make top-to-bottom reforms, implement the requirements of the Dodd-Frank Act, and establish other robust risk management practices to rebuild trust in our financial institutions and markets. U.S. financial institutions have worked to make the system safer by raising significant amounts of

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[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $20 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit http://www.sifma.org.

[2] *See* SIFMA Research: U.S. Capital Markets Deck, at p. 8 (Oct. 2015), available at http://www.sifma.org/research/item.aspx?id=8589956851.

capital and liquidity, establishing living wills that support their orderly resolution, and changing market practices.

The strength of U.S. financial markets is also the result of a regulatory system that, historically, has been transparent and collaborative, involved robust public participation, and considered the particular circumstances of U.S. markets.

Of course, U.S. financial firms operate globally, and likewise, the U.S. capital markets are benefited by many non-U.S. domiciled firms that operate and provide valuable market capacity in the U.S. SIFMA represents both. In this context, global policymakers have found it increasingly necessary to establish harmonized regulatory standards for financial institutions *internationally*, with the goals of leveling the playing field among financial institutions based in different jurisdictions, minimizing the opportunities for cross-border arbitrage, and creating more consistent rules of the road for financial institutions and their customers and counterparties. SIFMA supports and shares these goals.

The result of this dynamic, however, is that major changes affecting the framework of United States prudential and market regulation increasingly originate at an international regulatory body. The process typically begins with the adoption of an international standard at the FSB, the Basel Committee, or, somewhat less frequently, the International Organization of Securities Commissions ("IOSCO") or the International Accounting Standards Board ("IASB"). Only *after* final adoption of the international standard do U.S. regulators typically initiate a notice-and-comment rulemaking subject to the Administrative Procedure Act ("APA") to translate the international standard into U.S. law.

While SIFMA and its members support harmonized and consistent international standards, we also believe that there are certain characteristics of U.S. markets that are unique or sufficiently different from markets in other jurisdictions that they should be subject to significant adjustments and calibration or even different standards. In this context, we have become very concerned that the more U.S.

regulators base their rules on standards adopted internationally, without adequately taking into account the unique characteristics of U.S. markets, the more U.S. financial institutions become subject to rules that in significant ways do not make sense for the U.S. financial markets or broader economy. To be clear, my remarks today are less about our substantive concerns with the particular rulemaking *outcomes* in the United States of standards adopted internationally, which we have raised in other testimony and comment letters. Rather, my focus today is more on the *process* for setting international standards and their knock on effects on the U.S. rule making process, which we believe can be improved. Indeed, insufficient international process has sometimes resulted in the eventual adoption of U.S. rules plagued by substantive issues that could have been avoided had they been subject to better process from the beginning. Regardless of one's opinion of the end product, however, the current international standard setting process lacks the equivalent transparency, accountability, and public participation that the APA requires for rulemakings promulgated in the United States.

The important roles that international standard setting bodies can and do play in coordinating global regulatory efforts and promoting financial stability underscore the need for better process. I will devote the remainder of my remarks to summarizing the most significant issues with the international standard-setting process, and then identifying ways in which we believe Congress should intervene to address these issues.

Lack of Procedural Safeguards at International Bodies

The FSB, Basel Committee, and other international bodies are not subject to statutory procedural protections such as those embodied in the APA, the Freedom of Information Act, or the Government in the Sunshine Act. As a result, the international bodies have adopted their own procedures, which are opaque compared to the requirements of U.S. administrative law, and should be reformed:

- ***Lack of public records.*** The international bodies do not meet or hold hearings publicly and do not provide the public with any written record of their deliberations.

- ***Lack of public positions by members.*** The international bodies do not disclose the positions that their individual members take on any matter. Of particular importance to the United States, there is no way for the American public to know the positions that U.S. regulators took on critical regulatory matters in the international forum.

- ***Lack of requirement for meaningful consideration of public comments.*** The international bodies have made some progress in enhancing outreach efforts by adopting procedures providing that they will generally solicit public comment on their proposals.[3] In addition, international bodies sometimes hold workshops and roundtables to provide financial market participants an opportunity to share views and industry expertise. While industry groups like SIFMA appreciate the opportunity to engage and provide input, it remains the case that there is no requirement that these international bodies actually *consider* those comments and views, or otherwise address them. In addition, the U.S. regulators and supervisors generally do not seek public comment domestically before agreeing to an international standard.

- ***Little explanation of basis for rules.*** The explanatory text that accompanies international standards is generally less robust in quantity and quality compared to the commentary that typically accompanies U.S. rules. Indeed, it is often not entirely clear why the international bodies choose to

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[3] *See* FSB Procedural Guidelines at p. 9 (Feb. 1, 2013), available at http://www.fsb.org/wp-content/uploads/FSB-Procedural-Guidelines-31.1.13.pdf ("The Plenary may decide to conduct a public consultation"); Basel Committee on Banking Supervision Charter, at p. 7 (Jan. 2013), available at https://www.bis.org/bcbs/charter.htm ("In principle, the BCBS seeks input from all relevant stakeholders on policy proposals.").

propose a new standard or to make significant changes to a proposal in adopting a final standard. Absent more robust explanation, it is difficult for the public to understand the concerns underlying the international bodies' standards and to provide meaningful comments on them.

- ***Reliance on non-public data.*** The international bodies *collect* considerable amounts of data from financial institutions, including through Quantitative Impact Studies (QIS), but generally do not disclose or discuss the results of these data exercises on which their decisions rely until *after* adopting a standard. As a result, the public generally does not have the opportunity to comment on whether the international bodies have drawn appropriate conclusions from their data, or whether their data shows significant variances in different jurisdictions and different business models.

- ***No cost-benefit analysis.*** The international bodies are not required to conduct *any* cost-benefit analysis, and even if they do conduct a cost-benefit analysis, they typically do not publish or discuss the results.

International Standard-Setting Can Impact the Public Comment Process in the United States

A meaningful public comment process is not only a legal requirement in the United States under section 533 of the APA, but also makes for better and more transparent rulemaking. As the U.S. Court of Appeals for the D.C. Circuit has stated:

> The general policy of section 553 [of the APA] is to provide for public notice and comment procedures before the issuance of a rule. This public participation assures that the agency will have before it the facts and information relevant to a particular administrative problem, as well as suggestions for alternative solutions. Public rulemaking procedures increase the likelihood of administrative responsiveness to the needs and concerns of those affected. And the procedure for public

> participation tends to promote acquiescence in the result even when objections remain as to substance.[4]

Yet, we fear that international standard-setting can result in U.S. regulators failing to engage adequately in their responsibilities to have relevant facts and suggestions before them when considering new rules. While the U.S. regulators still go through an APA notice-and-comment process in the United States, by the time they release a proposed rule domestically, we also fear they sometimes do so having already made up their minds in the international context when they committed themselves to the international standard, making any subsequent change to that standard much more difficult than might otherwise have been the case. Even the most well-reasoned and data-driven U.S. public comments may be no match for the weight given to a pre-existing international commitment. Stated differently, as one commenter has noted, "[a]fter international agreement, the domestic rulemaking that follows is the train that follows the engine: Although it may look like any other form of administrative action, its outcome is preordained by what has already happened abroad."[5]

As a result, when implementing an internationally adopted standard domestically, U.S. regulators have often been extremely reluctant to deviate in material ways from the international standard, especially in recent years – with one notable exception: they sometimes adopt a U.S. rule that is more stringent than, but conceptually consistent with, the international standard.[6] In effect, regulations often arrive in the United States appearing to be "pre-baked" before the public

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[4] Guardian Fed. Sav. & Loan Ass'n v. Fed. Sav. & Loan Ins. Corp., 589 F.2d 658, 662 (D.C. Cir. 1978).

[5] David Zaring, Best Practices, 81 N.Y.U. Law Review 294, 305 (2006).

[6] Very occasionally, the U.S. regulators will make changes to an international standard that are necessary to comply with other requirements of U.S. law. For instance, the Basel Committee's standardized approach to credit risk assigns risk weights to corporate exposures based on their external credit ratings. Under section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act, U.S. regulations may not reference external credit ratings. As a result, the U.S. capital rules assign a flat 100 percent risk weight to all corporate exposures.

comment period begins. As a result, we believe the APA process has become far less robust as a practical matter than it should be.

This problem is especially acute when the international bodies add new requirements or concepts for the first time not in a proposed standard, but in the final standard after ostensibly considering public comments. That is, sometimes an international body proposes a standard, receives comments on it, and then makes fundamental changes in the final standard without giving the public the opportunity to comment on those changes.[7] Then, when a U.S. regulation is proposed that includes these fundamental changes that were never subject to public comment, the U.S. regulators appear to be just as "dug in" and reluctant to make changes to these aspects of the rule, which never received any public scrutiny, as they are on other aspects of rule that had received such scrutiny. As a result, when international bodies fail to re-propose for comment materially changed concepts that they develop after their initial proposal, and the U.S. regulators treat such new concepts in proposed implementing rules as virtually set in stone, then the public is effectively shut out of the comment process altogether. We believe that result is a fundamental denial of due process that leads to less effective and less legitimate rules.

International Bodies Are Not Subject to Legislative Oversight or Accountability

The international financial regulatory bodies are not formed or governed by any treaty, and therefore have never been authorized by or subject to oversight by members' legislatures. And in the cases where an international body is technically

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[7] As an example, the Basel Committee adopted a final standard for the Net Stable Funding Ratio that included a number of significant features that the Basel Committee did not include in its proposed standard. SIFMA discussed this issue on pages 11 to 14 of our August 5, 2016 comment letter with other trade associations on the U.S. Net Stable Funding Ratio Proposed Rule, available at http://www.sifma.org/issues/item.aspx?id=8589961839.

subject to "oversight," it is effectively the international body itself that assumes the oversight role.

For instance, the Basel Committee is "overseen" by the Governors and Heads of Supervision. This body is comprised of monetary and supervisory authorities from the same member jurisdictions that comprise the Basel Committee. In many cases, the same government agencies that are represented on the Basel Committee are represented on the Governors and Heads of Supervision. Almost no information is publicly available regarding the process, composition, or decisions of the Governors and Heads of Supervision. It is not clear that this body provides any true challenge to the decisions of the Basel Committee.

International Standards Often Do Not Permit Adequate Tailoring For Unique Circumstances

Many international standards reflect the assumption that what works in one jurisdiction will always work in others. In many significant instances, this is not the case. For countries with limited capital markets activity, which describes many of the FSB and Basel Committee members, the standards that apply to financial institutions reflect a bank-centric approach. While they have made good progress of late, the FSB and the Basel Committee historically have not appeared to coordinate adequately with IOSCO and market regulators when setting capital and liquidity standards that have significant consequences for broker-dealers, asset managers, swap dealers, and future commission merchants affiliated with banking organizations, as well as the markets they serve. The Basel Committee's Net Stable Funding Ratio and Fundamental Review of the Trading Book are just two examples of standards that will significantly affect capital markets.

In the United States, where capital markets are more important sources of funding in the economy, a bank-centric approach can result in ill-fitting and artificially constraining regulations that impede growth. Even within the sphere of banking, the United States is unique. Here, banking institutions are legally separated from

securities and insurance affiliates, but many countries that are members of the international bodies have a universal bank model under which a single entity can engage in all types of financial activities. In addition, housing finance and consumer finance play much more significant roles in the U.S. economy than they do in most other countries.

SIFMA believes that many of the regulations adopted in the past several years that have had the most distortive effects are those that do not take into account effects on capital markets or the unique aspects of the U.S. markets.

Yet, International Standards Do Not Necessarily Result in Uniformity or Cooperation

International standards do not always result in their stated goal of harmonization, for several reasons:

- U.S. regulators often make their domestic rules more stringent than (or "super-equivalent" to) international standards. As one significant example, the U.S. has implemented an "enhanced" supplementary leverage ratio that is calibrated well above the minimum Basel leverage ratio.[8]

- Non-U.S. regulators sometimes make their domestic rules *less* stringent than international standards.

- International standards sometimes provide special treatment to certain member jurisdictions. For instance, the FSB delayed the effectiveness of its Total Loss-Absorbing Capacity standard for firms headquartered in emerging market economies.[9]

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[8] *See* 79 Fed. Reg. 24,528 (May 1, 2014).

[9] *See* FSB, Total Loss-Absorbing Capacity Term Sheet, at p. 21 (Nov. 9, 2015), available at http://www.fsb.org/2015/11/total-loss-absorbing-capacity-tlac-principles-and-term-sheet/.

In addition, international standards do not always improve coordination among regulators from different countries. For instance, the Federal Reserve has proposed an internal Total Loss Absorbing Capacity requirement for the U.S. subsidiaries of foreign banks that is super-equivalent to the international standard. In the event of the failure of a foreign bank, the proposal would effectively allow the U.S. regulators to "ring fence" assets in the United States rather than cooperate with the bank's home regulator to resolve the bank in an orderly manner. This proposal could inspire regulators around the world to retaliate against the foreign subsidiaries of U.S. banks by imposing similar requirements on them.[10]

International Standards Continue to Change

Just as the paint has begun to dry on the Basel III capital and liquidity framework in the United States, the Basel Committee has embarked on developing a slew of new standards, known collectively to the public as "Basel IV," to make capital requirements less risk-sensitive and increase capital requirements for trading activities.

Basel IV represents a move toward further standardization and away from the ways that banks manage risk internally. In developing Basel IV, the Basel Committee is providing itself even greater power to make judgments about risk and thereby dictate the activities in which banks around the world should engage. In addition, the part of Basel IV known as the Fundamental Review of the Trading Book would impose extremely high capital requirements on trading and securitization activities that play a much bigger role in funding the U.S. economy than they do elsewhere. SIFMA believes the Fundamental Review of the Trading Book is a prime example of

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[10] SIFMA discussed these issues in our February 19, 2016 letter to the Federal Reserve on the U.S. TLAC Proposed Rule, available at http://www.sifma.org/issues/item.aspx?id=8589958980.

(continued...)

an international standard that does not take into account the prominence of capital markets in debt financing in the United States.[11]

The U.S. regulators have not presented the numerous and highly consequential standards that comprise Basel IV for debate in the United States, even as they negotiate the standards internationally. Again, this could undermine the safeguards that Congress established when it passed the APA and disempower the stakeholders that are impacted by any subsequent domestic rulemaking.

Direction From Congress is Needed

In light of the increasing internationalization of financial regulation and the many serious issues that I have outlined with the process, SIFMA believes it is time for a critical examination of how U.S. regulators engage with international bodies that impact domestic policy. We hope that Congress uses this opportunity to mandate improvements in the international standard-setting process in two ways.

First, Congress should require the U.S. regulators to improve the process they use when participating in international rulemakings. SIFMA strongly supports section 10 of H.R. 3189, the Fed Oversight Reform and Modernization Act (FORM Act), which would require the U.S. banking regulators, U.S. Treasury, and the Securities and Exchange Commission to notify the public before participating in a process of setting international financial standards, and to seek public comment on the subject matter, scope, and goals of such a process. Adopting section 10 of the FORM Act, in its current form, would be an important first step that Congress could supplement with other reforms. The U.S. regulators should also be required to publish their positions and votes on international standards. In addition, Congress could make clear in legislation that the U.S. regulators should not follow international standards when doing so would be inappropriate in light of the structure,

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[11] SIFMA discussed these issues in our November 12, 2015 letter to the U.S. banking regulators and U.S. Treasury on the Basel Committee's Fundamental Review of the Trading Book, available at http://www.sifma.org/issues/item.aspx?id=8589957660.

conditions, or scale of U.S. markets. Finally, Congress should require the U.S. regulators, when proposing a regulation to implement an international standard, to identify and be especially receptive to comments and suggested changes to any significant provision that had not been subjected to public comment during the international standard-setting process.

Second, Congress should require, through legislation, reforms in the standard-setting processes of the international bodies themselves. These reforms could include, for example, requiring the international bodies to:

- hold public meetings and hearings, and publish records that include member votes;
- include robust discussion of significant public comments when publishing final standards, explaining why comments were rejected, accepted or modified;
- disclose the data on which their standards are based, subjects to appropriate safeguards to protect firm-level data;
- conduct publicly disclosed cost-benefit analyses; and
- ensure that material changes to a proposed standard will be re-proposed for public comment before the standard is finalized.

To be clear, Congress does not have authority to impose requirements *directly* on international regulatory bodies. However, Congress can impose conditions on the participation by U.S. regulators in those bodies. Participation of the United States in international standard-setting is so important to the legitimacy and influence of those bodies that they would likely adopt any reasonable conditions that Congress imposed.

There is precedent for this approach. In the International Lending Supervision Act of 1983, Congress directed that the FDIC be represented equally with the Federal Reserve and the OCC at the predecessor body to the Basel Committee.[12] Shortly thereafter, the FDIC was admitted as a member. More fundamentally, in 1983 Congress directed the U.S. banking regulators to "encourage" regulators of other major banking countries to strengthen the capital of internationally active banks.[13] This mandate from Congress resulted in the international adoption of the Basel I accord in 1988, and provided U.S. regulators with the ability to raise capital standards domestically without putting U.S. banks at a competitive disadvantage to their foreign peers.[14] In sum, Congress has taken action to influence international regulatory bodies in the past, and can and should do so now.

Conclusion

SIFMA recognizes that international standard-setting bodies have necessary and appropriate roles to play in the coordination of global regulatory efforts. However, these bodies, and the U.S. regulators' participation in them, should be subject to much more rigorous scrutiny, transparency and procedural requirements than they are currently. Procedural reforms that enhance public participation in the rulemaking process would improve the quality and "fit" of international and domestic regulation, ultimately to the benefit of U.S. financial markets and the businesses, and consumers who rely on those markets.

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12 Pub. L. 98-181 § 912, 97 Stat. 1284 (Nov. 30, 1983) (codified at 12 U.S.C. § 3911).

13 Pub. L. 98-181 § 908, 97 Stat. 1281 (codified at 12 U.S.C. § 3907(b)(3)(C)).

14 *See* Charles Goodhart, The Basel Committee on Banking Supervision: A History of the Early Years, 1974–1997, Cambridge University Press, at p. 5 (2011).

AFR Americans for Financial Reform

The Financial Stability Board's Implications for U.S. Growth and Competitiveness: Testimony before the U.S. House of Representatives Financial Services Committee Subcommittee on Monetary Policy and Trade

Marcus Stanley
Policy Director
Americans for Financial Reform
Tuesday, September 27, 2016

Chairman Huizenga, Ranking Member Moore, and members of the subcommittee, thank you for the opportunity to testify before you here today. My name is Marcus Stanley and I am the Policy Director of Americans for Financial Reform.

In considering the topic of today's hearing – the implications of the Financial Stability Board for U.S. growth and competitiveness – I believe the starting point should be the actual powers and responsibilities of the Financial Stability Board (FSB). The FSB is a not-for-profit association with no statutory powers whatsoever under U.S. law, or indeed the law of other member countries. Its output consists of reports and recommendations, not of laws or regulations.

The FSB does publish broad conceptual standards in the area of financial regulation, but its recommendations can only be legally realized through the actions of legislative or administrative bodies in member states. In the U.S., such actions would require either laws to be made through constitutional processes, or regulations passed through notice and comment rulemaking.

So the immediate response to the question of the implications of the FSB for the U.S. economy seems clear: there are no direct implications, as FSB recommendations and standards have no legal force in the U.S. or anywhere else. This is in sharp contrast to some other international discussions such as those resulting in trade agreements. The negotiation process for these agreements provides far less transparency than the FSB process, and they go into effect as U.S. law once they are ratified. It is notable, and ironic, that many who do not question the effects of trade agreements on the U.S. economy or U.S. sovereignty are expressing so much concern about the impacts of the FSB.

At the same time, the standards set by the FSB do have some weight as indicating the consensus of the international regulatory community. While the FSB is a purely advisory body, its membership contains key leaders of central banks and financial regulators across

the G-20 countries. FSB reports therefore indicate a broad conceptual consensus of key regulators on the financial regulation and systemic risk. Elements of this conceptual consensus have come under strong attack from industry interests in the United States.

These attacks are sometimes made even when there is no strong difference in views on FSB policy recommendations. Such recommendations tend to be rather mild generally. For example, the latest comment letter from the Investment Company Institute to the FSB states[1]:

> "By and large, we have few objections to the proposed policy recommendations. They generally envision that IOSCO and authorities in each jurisdiction will review existing disclosure and reporting requirements, the availability of risk management tools, and potential enhancements to data collection and regulatory monitoring. The recommendations further envision that, on the basis of their findings, IOSCO and the authorities will make enhancements to existing regulation and guidance where appropriate. This approach…contemplates taking into account existing regulation and relevant circumstances in each jurisdiction."

The letter then proceeds to take issue at length not with the FSB's policy recommendations, but with the FSB's empirically supported claims that open-ended funds could create some level of systemic risk due to possible mismatches between short-term liabilities and illiquid underlying assets. The concern seems to be less with the FSB's actual recommendations than with the very fact that they see the possibility of systemic risk in the asset management sector.

These conceptual disagreements with the FSB have been most vocal in the case of regulation of non-banks, or what is sometimes called shadow banking, especially investment fund regulation and the regulation of large insurance companies. Before turning to these topics specifically, however, it is useful to consider the general role of the FSB as a forum for international discussion and coordination of financial regulation.

Given the globalized nature of financial markets, the need for such an international forum is obvious. Especially in the context of trade agreements, we regularly see industry calling for improvements in regulatory coordination under the rubric of "regulatory coherence". From a different perspective, public interest groups such as Americans for Financial Reform and other civil society groups globally have fought for high standards of financial

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[1] Investment Company Institute, "Comment to Financial Stability Board On Consultative Document; Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management", September 21, 2016.

regulation across all of the various global financial centers. If an international forum like the FSB did not exist, we would probably all be urging regulators to invent it.

But coordination should not mean a "one size fits all" type of regulation. National circumstances and cultures differ, as do voter preferences concerning, for example, the extent of the national safety net. Americans for Financial Reform and other civil society organizations have consistently fought for "super-equivalence" of U.S. regulations when the consensus of international regulators fell short of the level of oversight needed to ensure the safety of the U.S. financial system and the protection of consumers. An advantage of an organization such as the FSB, as opposed to, for example, trade agreements that require a "minimum standard of treatment" enforced by private dispute settlement, is that individual nations have the freedom to diverge from FSB recommendations.

The FSB Perspective on Shadow Banking and Insurance Regulation

Much of the criticism of the FSB has come from financial industry attacks on the FSB perspective regarding shadow banking regulation, particularly the regulation of investment funds, and also the role of the FSB in coordinating with the International Association of Insurance Supervisors (IAIS) concerning global capital standards for insurance companies.

We support the efforts of the FSB to examine these sectors and to highlight potential risks. The experience of the financial crisis demonstrates the importance of regulating non-banks such as investment funds and insurance companies. The 2008 financial crisis showed that, particularly in a financial system that lacks firewalls between banking and capital markets activities, unforeseen stresses in capital markets can pose grave threats to both the banking system and the larger economy. At the heart of the financial crisis was a comprehensive failure of capital market liquidity. As major players in the capital markets, asset managers and insurance companies can contribute to such failures of liquidity through disorderly forced selling of assets ("fire sales") and/or an inability to execute on commitments to investors.

This concern is not simply theoretical. We know that insurance companies played a significant role in the 2008 financial crisis, both directly and indirectly. American International Group (AIG), the world's largest insurance group at the time, was at the epicenter of the crisis, and of course collapsed and required the largest government bailout in U.S. history. Monoline financial guaranty (bond) insurance companies and mortgage insurance companies also played a major

role in the crisis and in some cases also collapsed.[2] While these links between the financial crisis and the insurance industry were well publicized, it is less well known that life insurance companies offering large amounts of variable annuities also took heavy losses and came under enormous financial pressure due to market-linked liabilities and the failure of their hedging strategies in stressed markets.[3] In some cases these pressures, and their intersection with regulatory capital requirements, led to fire sales that increased losses in distressed markets.[4] Major life insurance companies also participated in TARP and various Federal Reserve emergency lending programs such as the commercial paper program.

The response of both U.S. and international regulators has been to seek mechanisms for better consolidated supervision of insurance companies. In Europe, which has an insurance regulatory system very different from that of the United States, the response has centered around the Solvency II initiative. In the U.S., the Federal Reserve is acting to introduce a layer of consolidated capital oversight of state-regulated insurance companies, which balances the need for a comprehensive consolidated view of insurer risks with the role of state supervision.

In the case of asset managers, although they did not play as central a role in the 2008 crisis, we can look both to recent events and to previous historical experience. The 1987 stock market crash was related to portfolio insurance implemented using program trading by asset managers. The crash triggered emergency Federal Reserve liquidity support and threatened the solvency of a major clearinghouse. It is a clear example of a systemic financial event related to operational failures by asset managers in planning for and executing mutual fund redemptions. The Long Term Capital Management failure in 1998 involved the failure of a major hedge fund that became overleveraged using derivatives strategies. As LTCM's failure threatened its prime brokers which were major banks, informal government intervention to negotiate an orderly wind down was necessary.

Asset managers also played a significant role in the 2008 financial crisis, although they were not its central players. The most important link to the fund management industry involved the role of money market funds. The exit of money market funds from commercial paper markets during

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[2] Schich, Sebastian, "Insurance Companies and the Financial Crisis", OECD Journal, Financial Market Trends, Volume 2009, Issue 2, Organization for European Cooperation and Development, October, 2009.
[3] McKinsey Consulting, "Responding to the Variable Annuity Crisis", McKinsey Working Papers on Risk, April, 2009; Du David Fengchen and Cynthia Martin, "Variable Annuities – Recent Trends and the Use of Captives", Federal Reserve Bank of Boston, October 7, 2014.
[4] Acharya, Vidal and Matthew Richardson, "Is The Insurance Industry Systemically Risky?", Conference Paper for Brookings Institution Conference On Insurance Regulation, October 14, 2014; Merrill, Craig B. and Nadauld, Taylor and Stulz, René M. and Sherlund, Shane M., "Were There Fire Sales in the RMBS Market?" Charles A. Dice Center Working Paper No. 2014-09; Fisher College of Business Working Paper No. 2014-03-09, May, 2014.

2007 helped trigger extraordinary intervention by the Federal Reserve, and the run on money market funds in late 2008 triggered a large-scale Federal government bailout. Beyond the clear role of money market funds, other asset managers were significantly involved in other ways. For example, hedge funds originated subprime CDOs that helped fuel the crisis, and the failure of two credit hedge funds helped trigger the collapse of Bear Stearns.[5] In other countries, investment funds also played a notable role in the crisis, as can be seen for example in the liquidity crisis in the commercial real estate sector in the UK, which was driven to a significant degree by forced selling and redemption issues among UK property funds.[6]

Yet seeking a smoking gun in terms of the ability of asset managers or insurance companies to singlehandedly "cause" a financial crisis misses the point. Simply because these entities play such a vital role in deploying a vast stock of assets, their decisions and behavior are central to the financial system and can impact the real economy. A key mechanism here is large-scale fire sales of assets, which impact market liquidity and can create spillover effects on banks and the broader economy. A recent study provides powerful evidence that disorderly forced selling of bonds by mutual funds and insurance companies during the 2008 financial crisis created direct economic harm to real economy companies, reducing investment and profitability over a period of years.[7]

We must also look beyond the experience of the past to current developments in financial markets. The large increase in assets held by bond funds since the financial crisis may produce vulnerability to forced selling in the case of rapid redemption demands that are not properly planned for by asset managers. Such forced sales could impact the stability and liquidity of financial markets more broadly, not just investors in the specific fund. A recent modeling exercise by economists from the New York Federal Reserve finds that the potential secondary price impact of bond sales by mutual funds has increased almost six-fold since the financial crisis.[8] The existence of this mechanism is also supported by other recent research.[9]

Highlighting and investigating these potential threats to financial market stability is exactly what we should be asking our regulators to do. Discussion, analysis, research, and coordination on an international level can only help in that effort. The proper regulatory response is an involved

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[5] Eisinger, Jesse and Jake Bernstein, "The Magnetar Trade: How One Hedge Fund Helped Keep the Housing Bubble Going", Pro Publica, April 9, 2010.
[6] Price Waterhouse Cooper UK, "Unlisted Funds -- Lessons From the Crisis, Report for the Association of Real Estate Funds", January, 2012.
[7] Aslan, Hadiye, and Praveen Kumar, "Spreading the Fire: Investment and Product Market Effects of Bond Fire Sales", American Finance Association Conference Paper, January 5, 2015.
[8] Cetorelli, Nicola, Fernando Duarte and Thomas Eisenbach, "Are Asset Managers Vulnerable to Fire Sales", Liberty Street Economics Blog, New York Federal Reserve, February 18, 2016.
[9] Goldstein, Itay, Hao Jiang and David T. Ng, "Investor Flows and Fragility in Corporate Bond Funds", Wharton Finance Working Paper, May, 2016.

question and regulations should be tailored to the specific markets being regulated. However, since the FSB does not directly regulate these markets, FSB involvement does not remove control of these issues from the U.S. political or regulatory system. The issues of specific regulation can be addressed by U.S. regulators in a transparent manner, through the notice and comment process.

This is exactly what is happening today. The Securities and Exchange Commission has responded to concerns about asset management by issuing several proposed rules that address issues ranging from fund disclosures to planning for investor redemptions. The Federal Reserve has issued proposals related to oversight of insurance companies within their jurisdiction. Both industry and the public can respond to these proposals, and are doing so. The international dialogue facilitated through the FSB is a helpful supplement to this process, and where appropriate a means of coordinating rules across international borders.

Thank you for the opportunity to testify before you today. I would be happy to take questions.

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STATEMENT

OF

PAUL SCHOTT STEVENS
PRESIDENT & CEO
INVESTMENT COMPANY INSTITUTE

BEFORE THE

US HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON
MONETARY POLICY AND TRADE

ON

THE FINANCIAL STABILITY BOARD'S IMPLICATIONS FOR US GROWTH AND COMPETITIVENESS

SEPTEMBER 23, 2016

EXECUTIVE SUMMARY

- ICI supports appropriate regulation to ensure the resiliency and vibrancy of the global financial system. We likewise believe it is appropriate for regulators to examine asset management to identify potential risks. Any such review, however, must be thorough, balanced, fact-based, and led by those with relevant expertise—*i.e.*, capital markets regulators.

- From the outset, the Financial Stability Board ("FSB"), whose membership consists largely of central bankers and finance ministers, has been predisposed to view virtually all financial activity conducted outside of banks as "shadow banking" and inadequately regulated because it is not subject to bank standards and supervision. As it relates to regulated funds and their managers, this orientation is deeply troubling in light of the FSB's ability to influence regulatory policy in its participating jurisdictions. US mutual funds and other regulated funds differ fundamentally from banks, and are among the most transparent and comprehensively regulated parts of the financial system.

- Over the last three years, the FSB has focused considerable attention on the asset management sector.

    - The FSB has proposed methodologies for identifying individual investment funds and asset managers for possible designation as global systemically important financial institutions ("G-SIFIs"). Broadly speaking, these methodologies have been advanced without due regard for empirical evidence, historical experience, industry structure and practice, existing regulation, and other factors that might bear on the existence or severity of the risks posited by the FSB.

    - The FSB is engaged in a review to identify "structural vulnerabilities" in asset management activities raising concerns for global financial stability and to develop policy recommendations to address such risks. Regrettably, the justifications underlying the FSB's recommendations reflect the same sort of conjectures and assumptions that are apparent in the FSB's G-SIFI work on asset management.

- There are fundamental problems that pervade the FSB's work on asset management.

    - First, the FSB's proposed G-SIFI methodologies and its review of asset management activities are firmly rooted in concerns with "distress" and "disorderly failure" derived from the experience of banks and banking regulators. Only the occasional nod is given to fundamental distinctions between banking and asset management.

    - Second, the FSB affords an inadequate role to subject matter experts. Of particular concern to ICI, capital markets experts are leading neither of the FSB efforts highlighted above.

- Third, the FSB discounts empirical data and analysis that does not comport with the theories on which its work in asset management are based. Those theories include the potential for "fire sales" of investment fund assets, the transmission of risk from one or more investment funds to other market participants, and spillover effects to the global financial system. ICI believes the FSB has vastly overstated the potential for such effects. And, in the 76-year history of the modern US fund industry, there is no empirical basis for the FSB's concerns.

  In this regard, it is troubling that individual members of the FSB—including the Bank for International Settlements (which describes itself as "a bank for central banks") and the International Monetary Fund—are perpetuating the same conjectures about investment funds through other means. Our testimony offers several examples.

- Fourth, there is reason to question whether the FSB's work in asset management is simply results-oriented. There is an extensive public comment record that contradicts the FSB's conclusions to date in fundamental respects, yet it appears to have had little impact on the FSB's thinking to date.

- Fifth, as set forth in detail below, we have strong reservations about the transparency and fairness of the process that the FSB has followed in its work on asset management and the process it envisions for evaluating investment funds and asset managers under its proposed G-SIFI methodologies.

- In many of the five areas enumerated above, we see similar deficiencies in the Financial Stability Oversight Council's ("FSOC") SIFI designations and its review of asset management.

- We are troubled by the fact that a US Federal Reserve Board Governor leads the FSB committee overseeing the work on proposed G-SIFI methodologies for investment funds and asset managers. This arrangement raises the prospect that the process set in motion by the FSB ultimately could be used to exert multilateral influence on the FSOC to expand the reach of the Federal Reserve Board itself to regulated US funds and their managers and, by extension, US capital markets.

- SIFI or G-SIFI designation of regulated funds or their managers would have severe consequences. The requirements prescribed by the Dodd-Frank Act for SIFIs, such as capital and liquidity requirements, would—if applied to a regulated fund—result in higher costs and lower investment returns for individuals saving for retirement, education, and other life goals. Designation also could have far-reaching implications for how a fund's portfolio is managed, depending on how the Federal Reserve exercises its supervisory charge under the Dodd-Frank Act to "prevent or mitigate" the risks presented by large, interconnected financial institutions. As I have explained in previous Congressional testimony, regulated funds and their managers could be subject to a highly conflicted form of regulation, pitting the interests of banks and the banking system against those of millions of investors.

- To address several of our concerns with the FSB, ICI recommends that Congress:

    - Continue to monitor closely US agencies' participation in the FSB's policy work and seek to ensure that their FSB participation does not conflict with the best interests of US investors and US capital markets.

    - Encourage US officials who participate in the FSB to support the delegation to the International Organization of Securities Commissions (that is, capital markets experts) of further work on asset management activities at the global level.

    - Use its influence to encourage the reconstitution of the FSB, with equal roles for capital markets, banking, and insurance, to advance the dual objectives of mitigating risk to the financial system, while promoting vibrant markets and economic growth.

- With regard to the FSOC, Congress should enact legislation, such as H.R. 1550, the FSOC Improvement Act, to codify in statute important improvements to the SIFI designation process that will advance the Dodd-Frank Act's dual goals of reducing systemic risk while reserving SIFI designation as a tool to be used only in truly exceptional cases.

I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute ("ICI") and I am pleased to appear before the Subcommittee today to discuss the role of the Financial Stability Board ("FSB") and its impact on financial regulation and regulated funds. Thank you, Chairman Huizenga, Ranking Member Moore, and members of the Subcommittee for inviting me to testify.

ICI is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide.[1] ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their investors, directors, and managers. ICI's US fund members today manage total assets of $18.4 trillion and serve more than 90 million US investors.

For more than 75 years, the Investment Company Act and the Investment Advisers Act have governed the regulation of funds and their managers. As administered by the Securities and Exchange Commission ("SEC"), those statutes have supported the growth of the modern fund industry, which today helps American investors meet their most important financial goals, such as saving for college, purchasing a home or providing for a secure retirement.

ICI members, as both issuers of securities and investors in capital markets worldwide, understand the importance of sound, tailored regulation in maintaining a strong and resilient financial system. For this reason, ICI and its members seek to engage actively with policymakers and regulators and to provide meaningful input on financial policy matters that may have significant implications for funds and their investors. As financial policy continues to take on a greater global dimension, so too have ICI's efforts to monitor the work of, and engage with, policymakers and regulators outside the United States.[2]

In the years since the global financial crisis, the FSB has asserted an expanding role on the world stage. The FSB claims a broad mandate—nothing less than the entire global financial system—but it is dominated by central bankers and finance ministers. This membership is predisposed to viewing financial activity conducted outside of banks as "shadow banking" and to considering such activity to be

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[1] In this testimony, the term "regulated funds" includes "regulated US funds" (or "US mutual funds," where appropriate), which are comprehensively regulated under the Investment Company Act of 1940 ("Investment Company Act"). This testimony generally addresses regulated stock and bond funds and not money market funds, given the significant regulatory reforms that have been adopted for money market funds.

[2] The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.9 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

inadequately regulated because it is not subject to bank standards and supervision. Not surprisingly, we strongly disagree with this portrayal and are deeply troubled by the FSB's ability to perpetuate this view through its influence on financial policy in its participating jurisdictions.

Our particular concerns about the FSB arise in the context of its work on asset management and financial stability. In January 2014, the FSB issued the first of two consultations on the design of methodologies for identifying and potentially designating global systemically important financial institutions—or G-SIFIs—within the asset management sector. The proposals advanced by the FSB (one for investment funds, the other for asset managers) took little or no account of empirical evidence, historical experience, industry structure and practice, existing regulation, and other factors that might bear on the existence or severity of the risks posited by the methodologies.[3] We thus were, and remain, concerned not only about the substance of the FSB's work but also by the processes by which this work is conducted.[4]

We likewise are concerned by the FSB's current review of potential "structural vulnerabilities" in asset management activities.[5] As discussed more fully below, we have few objections to the substance of the FSB's proposed policy recommendations. We strenuously object, however, to the way in which the FSB attempts to justify the need for those recommendations. Again we see the FSB resorting to conjecture over empirical evidence and actual experience.

Several of ICI's concerns with the FSB parallel those we have with the Financial Stability Oversight Council ("FSOC") here in the United States. For this reason, my testimony will highlight ICI's concerns with, and suggest some improvements relating to, both the FSB and the FSOC.

In Section II below, we discuss the composition and structure of the FSB, its "macroprudential" focus, and its pejorative view of capital markets and other nonbank activity as "shadow banking." In Section III, we discuss the FSB's actions to date with respect to the asset management sector. Section IV

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[3] ICI has provided extensive data and analysis to demonstrate that regulated funds and their managers do not pose risks to financial stability. *See* Letters from Paul Schott Stevens, President & CEO, ICI to the Financial Stability Board, dated April 7, 2014 and May 29, 2015, available at https://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf and https://www.ici.org/pdf/15_ici_fsb_comment.pdf, respectively. These letters also make the case that SIFI or G-SIFI designation is not necessary or appropriate for regulated non-US funds (*i.e.*, funds organized or formed outside the United States and substantively regulated to make them eligible for sale to retail investors).

[4] We have expressed similar concerns to the heads of the US agencies that are members of the FSB. *See* Letter from Paul Schott Stevens, President & CEO, ICI to the Honorable Jacob J. Lew, Secretary, Department of the Treasury, The Honorable Mary Jo White, Chair, SEC, and The Honorable Janet Yellen, Chair, Federal Reserve Board of Governors, dated May 28, 2015 ("Lew/White/Yellen Letter"), available at https://www.ici.org/pdf/15_ici_fsb_lew_yellen_white.pdf.

[5] Financial Stability Board, Consultative Document, *Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (22 June 2016) ("FSB Activities Consultation"), available at http://www.fsb.org/wp-content/uploads/FSB-Asset-Management-Consultative-Document.pdf. The FSB consultation has four areas of focus: (1) liquidity mismatch between fund investments and redemption terms and conditions for fund units; (2) leverage within investment funds; (3) operational risks and challenges in transferring investment mandates in a stressed condition; and (4) securities lending activities of asset managers and funds.

highlights the five reasons why the FSB's work on asset management has been deficient, and explains that some of these reasons apply equally to the FSOC's SIFI designation process and its own asset management review. In Section V, we briefly discuss the implications of the FSB's work for US regulated funds, their investors, and the capital markets. Finally, in Section VI, we provide our recommendations, including those regarding the involvement of US officials in FSB policymaking.

II. THE FSB: BACKGROUND INFORMATION FOR THE SUBCOMMITTEE

To provide important context for our concerns with the FSB and its work, below is brief background information about: (1) the FSB's composition, structure, and "macroprudential" focus; and (2) its pejorative views of the capital markets and nonbank activity more generally.

A. FSB Composition, Structure and "Macroprudential" Focus

Established by the Group of 20 in 2009 as the successor to the Financial Stability Forum, the FSB by its charter has two broad objectives. These are: (1) to coordinate at the international level the work of national financial authorities and international standard-setting bodies in order to develop and promote the implementation of effective regulatory, supervisory, and other financial sector policies; and (2) in collaboration with the international financial institutions, to address vulnerabilities affecting financial systems in the interest of global financial stability.[6] Although the FSB's decisions are not legally binding on its members, the FSB nevertheless is able to forge global recommendations regarding those activities perceived to pose systemic risk and to require international attention.

By any measure, the FSB is a bank-centric organization. Among the FSB's members, central bank officials, finance ministers, and representatives of banking-related bodies (e.g., the Bank for International Settlements ("BIS"), International Monetary Fund ("IMF"), and the Basel Committee on Banking Supervision) far outnumber capital markets regulators. And central bankers and finance ministers hold key leadership positions, chairing the FSB, its Steering Committee, its four standing committees,[7] and its six regional consultative groups.[8] Of particular relevance to today's hearing, the FSB's membership includes three US regulators: the Board of Governors of the Federal Reserve System

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[6] *See* Charter of the Financial Stability Board (as amended and restated June 2012) ("FSB Charter"), available at http://www.financialstabilityboard.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf, at Section I, Article 1.

[7] The standing committees are: (1) Standing Committee on Assessment of Vulnerabilities; (2) Standing Committee on Supervisory and Regulatory Cooperation; (3) Standing Committee on Standards Implementation; and (4) Standing Committee on Budget and Resources.

[8] There are six regional consultative groups, one each for the Americas, Asia, Commonwealth of Independent States, Europe, Middle East and North Africa, and Sub-Saharan Africa. They are designed to expand upon and formalize the FSB's outreach activities beyond the membership of the G20 and to reflect the global nature of the financial system.

("Federal Reserve Board"), the SEC, and the Treasury Department.[9] And a Federal Reserve Board Governor chairs the FSB's Standing Committee on Supervisory and Regulatory Cooperation—the committee overseeing the FSB's current review of asset management activities.

While the FSB has its own legal identity and governance structure, the BIS hosts the FSB's Secretariat, which operates out of the BIS's head office in Basel, Switzerland. The BIS's mission is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas, and to act as a bank for central banks.[10] The BIS's website touts the fact that through this arrangement with BIS, the FSB receives "synergies of co-location; flexibility and openness in the exchange of information; and support from BIS expertise in the field of economics, banking and regulation."[11]

The FSB's charter further solidifies the organization's banking orientation. The charter specifies that as part of its mandate, the FSB will "assess vulnerabilities affecting the global financial system and identify and review on a timely and ongoing basis *within a macroprudential perspective*, the regulatory, supervisory and related actions needed to address them, and their outcomes."[12] Thus, incorporated into the FSB's organizational documents is a directive to approach its work on vulnerabilities to the global financial system "within a macroprudential perspective"—*i.e.*, from the perspective of central bankers.

B. Views of Capital Markets and Other Nonbank Activity

From the perspective of central bankers, non-bank financial entities arouse skepticism based on the fact that they are not regulated in the same way as banks. Central bankers routinely refer to financial entities and activities outside of the banking system as "shadow banks" and "shadow banking"—an epithet regularly and deliberately used to suggest that entities like mutual funds present unacceptable risks because they are not regulated like banks.

In 2011, the FSB commenced its efforts to address "shadow banking" by instituting five workstreams to strengthen oversight and regulation of non-bank credit intermediation.[13] In a comment letter to the FSB at the commencement of this work, ICI agreed that it was appropriate for the FSB "to consider whether additional or different regulatory measures for non-bank financial entities may be important to

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[9] Under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Treasury Secretary and the chairs of the Federal Reserve Board and SEC are members of FSOC; the Treasury Secretary also serves as FSOC's chair.

[10] *See* http://www.bis.org/about/index.htm.

[11] *See* http://www.bis.org/about/basel_process.htm.

[12] FSB Charter, *supra* note 6, Section I, Article 2(1)(a) (emphasis added).

[13] *See, e.g.*, FSB Published Recommendations to Strengthen Oversight and Regulation of Shadow Banking (press release dated 27 Oct. 2011), available at http://www.financialstabilityboard.org/2011/10/financial-stability-board-publishes-recommendations-to-strengthen-oversight-and-regulation-of-shadow-banking/.

strengthening the global financial system."[14] But—in addition to pointing out that the FSB uses inherently inaccurate and misleading terminology—our letter made a number of broader points that continue to be relevant, including:

- It is imperative for the FSB to acknowledge and respect the differences that exist between banking and securities and their respective regulatory frameworks.
- Banks and capital markets have existed alongside one another in the United States for centuries, with parallel bodies of regulation and oversight.
- The US financial system and our economy at large have thrived on the benefits that both banks and capital markets provide.
- Bank-like regulation is not appropriate, necessary or workable for funds registered under the Investment Company Act of 1940.

According to the FSB's annual report issued this August, "transforming shadow banking into resilient market-based finance" continues to be one of the core areas of the FSB's regulatory reform program.[15] As applied to regulated funds and their managers, this characterization suggests a level of disregard both for the way in which such funds and their managers long have operated and been regulated, *and* for the contributions they already make today as sources of long-term capital to finance economic growth. In Sections III and IV below, we discuss in detail how this orientation has affected the FSB's work on asset management.

III. THE FSB's WORK TO DATE ON ASSET MANAGEMENT

A. Proposed Assessment Methodologies to Identify G-SIFIs in the Asset Management Sector

During the global financial crisis, governments stepped in using public funds to prevent the distress or disorderly failure of certain large financial institutions from having cascading effects throughout the financial system. In an effort to avoid the systemic and moral hazard risks associated with such bailouts in the future, a key priority on the FSB's financial stability agenda has been "Ending 'Too Big to Fail'

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[14] Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Secretariat of the Financial Stability Board, dated June 1, 2011 (responding to an FSB background note entitled "Shadow Banking: Scoping the Issues"), available at http://www.ici.org/pdf/25258.pdf, at 4. We expressed support for "the efforts of the FSB and the regulatory bodies it represents to study ways to monitor non-bank financial intermediaries, such as by improving and expanding data collection from these entities, as necessary, to help regulators identify and manage systemic risk." *Id.*

[15] FSB, Implementation and Effects of the G20 Financial Regulatory Reforms, 2nd Annual Report (31 August 2016) ("FSB Report on Reform Implementation"), available at http://www.fsb.org/wp-content/uploads/Report-on-implementation-and-effects-of-reforms.pdf.

(TBTF)."[16] Starting with banks and then turning to insurance companies, the FSB's approach has been to develop assessment methodologies for identifying financial entities "whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity across jurisdictions."[17]

Having already identified 30 banks and 9 insurance companies as G-SIFIs, the FSB intends to adopt assessment methodologies to identify non-bank, non-insurer ("NBNI") G-SIFIs.[18] The FSB's initial consultation in January 2014 proposed a methodology for identifying global systemically important investment funds.[19] On the basis of their size alone, the methodology singled out 14 highly regulated US funds as the *only* funds that automatically would be subject to further review for possible G-SIFI designation. This was a curious and very troubling result, especially given that these funds belong to the part of the financial system that proved most stable during the global financial crisis.

After receiving extensive public comments, including from ICI, the FSB issued a second consultation in March 2015 that included a revised methodology for investment funds and a new proposed methodology for asset managers.[20] The second consultation discounted key aspects of the public comment record on the initial consultation. And the methodologies it proposed again placed undue emphasis on size, thus continuing to single out large, highly regulated US funds (and mostly US asset managers) as candidates for potential G-SIFI designation.

This is particularly troublesome as the consequences of designating regulated US funds or their managers would be highly adverse to investors and the capital markets. Application of the bank-oriented "remedies" prescribed by the Dodd-Frank Act would increase costs and reduce returns for

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[16] *Id. See also Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF), Report of the Financial Stability Board to the G-20* (2 September 2013), available at http://www.financialstabilityboard.org/wp-content/uploads/r_130902.pdf.

[17] *See, e.g., Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (8 January 2014), available at http://www.financialstabilityboard.org/publications/r_140108.pdf, at 2.

[18] *See, e.g.,* Consultative Document, *Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (22 June 2016) at 2, available at http://www.fsb.org/wp-content/uploads/FSB-Asset-Management-Consultative-Document.pdf.

[19] The consultation also included proposed methodologies for market intermediaries (securities broker-dealers) and finance companies.

[20] Consultative Document (2nd), *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (4 March 2015) ("FSB Second Consultation"), available at http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf.

fund investors, distort the fund marketplace, introduce a conflicted model of regulation, and compromise the important role that funds play as a source of financing in the economy.[21]

B. Review of "Structural Vulnerabilities" from Asset Management Activities

In responding to each of the FSB's consultations on NBNI G-SIFI methodologies, ICI pointed out a series of fundamental problems with FSB's approach to asset management. We strongly urged the FSB to pursue an activity-based approach as a better way to address any identified risks to global financial stability posed by the asset management sector, given the agency nature of the business and the high degree of substitutability of investment funds and asset managers.

ICI therefore welcomed the FSB's July 2015 announcement that it had set aside the NBNI G-SIFI project while conducting a review of asset management activities. Eleven months later, in June 2016, the FSB requested public comment on proposed policy recommendations to address potential financial stability risks in four areas: liquidity and redemptions in investment funds offering daily redeemability ("open-end funds"); leverage within investment funds; operational risk and the transfer of investment mandates; and securities lending. The consultation discusses the posited "structural vulnerability" in each area, describes in broad terms the way in which existing regulation and practices already address the vulnerability, and proposes policy recommendations to address any "residual risk" in that area.

As explained in our letter responding to the consultation, we generally have few objections to the substance of the FSB's proposed policy recommendations.[22] They generally envision that the International Organization of Securities Commissions ("IOSCO")[23] and authorities in each jurisdiction will review existing regulation and make enhancements where appropriate. This approach properly directs these responsibilities to the regulators with deep experience in asset management and the capital markets.

But ICI strenuously objects to the justifications offered by the FSB in this consultation, particularly with regard to "liquidity mismatch" in open-end funds. In conclusory terms, the FSB describes the potential mismatch between the liquidity of individual fund portfolio holdings and daily redeemability of fund shares as a "key structural vulnerability" raising concerns for global financial stability. In

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[21] *See, e.g.*, Statement of Paul Schott Stevens, President & CEO, ICI before the Committee on Banking, Housing, and Urban Affairs, US Senate, on FSOC Accountability: Nonbank Designations (March 25, 2015) ("Stevens Testimony"), available at https://www.ici.org/pdf/15_senate_fsoc.pdf.

[22] *See* Letter to the FSB from Paul Schott Stevens, President & CEO, ICI, dated Sept. 21, 2016 ("ICI Letter on FSB Activities Consultation").

[23] The International Organization of Securities Commissions (IOSCO) is the international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector. IOSCO develops, implements and promotes adherence to internationally recognized standards for securities regulation. For more information, *see* https://www.iosco.org/about/?subsection=about_iosco.

support of its contention, however, the FSB resorts to conjecture and assumptions about the potential for destabilizing impacts from fund redemptions, while discounting empirical evidence and the actual experience of open-end funds and their investors. This is a recurring problem in the FSB's work, and one that we discuss more fully below.

IV. FUNDAMENTAL PROBLEMS PERVADE THE FSB'S WORK—AND THAT OF THE FSOC—RELATING TO ASSET MANAGEMENT

ICI supports appropriate regulation to ensure the resiliency and vibrancy of the global financial system. As a related matter, we believe that regulators can—and should—examine different sectors of the financial system, including asset management, to identify potential risks to financial stability. But reviews of this nature must be thorough, balanced, and fact-based—and, to those ends, led by policymakers with requisite expertise. For asset management, this means capital markets regulators. Clearly, these regulators are best positioned to determine whether regulated funds and their managers do or do not pose potential risks to financial stability.

The FSB's work relating to asset management falls far short of these basic standards. We highlight five specific areas of concern below. In many of those areas, unfortunately, we see similar deficiencies in the FSOC's SIFI designations and its review of asset management.

A. Misconception of the Business of Asset Management

The FSB's propensity to view the world through a banking lens is readily apparent in its work on asset management and financial stability. Although giving the occasional nod to fundamental distinctions between banking and asset management, the FSB's work on asset management is firmly rooted in concerns with "distress" and "disorderly failure" derived from the experience of banks and banking regulators.

In its G-SIFI work, for example, the FSB states frankly that the proposed methodologies for investment funds and asset managers "aim to measure the impact that an NBNI financial entity's failure can have on the global financial system and the wider economy, rather than the *probability* that a failure could occur."[24] We continue to question how the FSB can simply assume its way past such a fundamental

[24] FSB Second Consultation, *supra* note 20, at 10 (emphasis in the original). With regard to the SIFI designation process in the United States, the question of whether FSOC is required (by statute or its own interpretive guidance) to assess the likelihood that a company will experience material financial distress is currently being litigated. *See, e.g., MetLife, Inc. v. Financial Stability Oversight Council*, C.A. No. 15-0045 (D.D.C. Mar. 30, 2016). In *MetLife*, the court rescinded FSOC's designation of MetLife, Inc. (identified by the FSB, in consultation with the International Association of Insurance Supervisors and national authorities, as a global systemically important insurer in July 2013) as a SIFI under US law. The court found that FSOC violated its own analytical framework for assessing nonbank financial companies for possible SIFI designation by (1) failing to assess MetLife's vulnerability to material financial distress, and (2) assuming that MetLife's material financial distress would inflict significant damage on the US economy. The court also found that FSOC failed to consider the costs of designation to MetLife, in violation of recent US Supreme Court precedent. FSOC is appealing the court's decision..

question—that is, whether an investment fund or asset manager might actually experience such distress or disorderly failure.

This same propensity remains present in the FSB's asset management activities consultation, where the FSB bases its operational risk concerns on the notion of distress befalling a large asset manager. For example, the FSB states "operational difficulties could potentially become a financial stability concern if they were to materialise during stressed market conditions, particularly if they affect an asset manager (or managers) of sufficient scale or complexity." The FSB contends that such difficulties could lead to redemptions in the manager's funds and that "[r]edemptions at a large manager[s] or manager[s] that plays a significant role in certain markets can potentially affect the market prices of investment assets . . . particularly during a period of market stress." And the FSB focuses its policy recommendations to address "residual risks" associated with transferring investment mandates or client accounts solely on asset managers that are "large, complex, and/or provide critical services."

As ICI repeatedly has advised, regulated funds and their managers should not be viewed through a banking lens. They do not "fail" like banks do. They are highly substitutable. Regulated funds generally use little to no leverage. Fund managers act as agents, not principals. They invest on behalf of their clients, leaving the risks—and rewards—to the end investors, who knowingly accept this tradeoff. And regulated funds and their managers routinely exit the business in an orderly way, with no systemic impact, even during periods of severe market stress.

B. Inadequate Deference to Capital Markets Experts

As discussed in Section II above, the FSB's membership largely consists of central bankers, finance ministers, and representatives of banking-related bodies. As a result, capital markets experts are not leading the FSB's work on asset management.

To its credit, the FSB has seen fit to involve IOSCO in its work on the G-SIFI assessment methodologies for investment funds and asset managers. It is our understanding, however, that rather than establishing an equal partnership with IOSCO or deferring to IOSCO members' expertise in this area, the bank-dominated FSB has remained firmly in charge of the project. And it was not until after the IOSCO Board publicly recommended that a full review of asset management activities take precedence over consideration of how to designate funds or asset managers as G-SIFIs[25] that the FSB changed the course of its work. While we are pleased that the FSB set aside its work on G-SIFI methodologies to conduct an activities-based review, we note that the review likewise is under the FSB's control.

Why is this a problem? The central bankers who dominate the FSB are experts in banking, and they come to their FSB duties with that expertise and experience in mind—in particular, the "safety and

[25] *See* IOSCO: Meeting the Challenges of a New Financial World (media release dated 17 June 2015), available at https://www.iosco.org/news/pdf/IOSCONEWS384.pdf.

soundness" goals of bank regulation, the inherent riskiness of the highly-leveraged bank model and its propensity for "runs," the significant problems that banks experienced during the crisis, the unprecedented level of government intervention needed to safeguard the banking system, and the various regulatory tools that have been employed to strengthen individual banks and the overall banking sector. It is not surprising, therefore, that this banking expertise colors the FSB's views of investment funds and asset managers, leading them to believe that the largest funds and managers may pose unaddressed and unacceptable risks to other market participants and the financial system as a whole.

Domestically, we have had similar concerns. FSOC's review of asset management began most inauspiciously with a highly flawed 2013 report on asset management written by the FSOC's research arm, the Office of Financial Research ("OFR"). Among the range of sharp criticisms the report drew was that it reflected deep misunderstandings of the asset management industry.[26]

As with the FSB, the composition of the FSOC is weighted toward bank regulators. This would appear to give bank regulators the upper hand in designation decisions and other matters—even if they are not the experts with respect to the subject matter under consideration. It is unclear, for example, why FSOC felt compelled to offer recommendations relating to issues of mutual fund liquidity during an open SEC rulemaking on that very topic.[27] We have seen this concern play out in the insurance industry, where the FSOC has designated firms as SIFIs despite the objections and misgivings of the presidentially appointed independent member of the FSOC with insurance expertise.

C. Reliance on Conjecture and Theory Rather than Empirical Data and Actual Experience

The FSB discounts empirical data and analysis that does not comport with the theories on which its work in asset management are based. Those theories include the potential for "fire sales" of investment fund assets, the transmission of risk from one or more investment funds to other market participants, and spillover effects to the global financial system.

We believe the FSB has vastly overstated the potential for such effects. And, in the 76-year history of the modern US fund industry, there is no empirical basis for the FSB's concerns. ICI's submissions to the FSB have offered extensive data and analysis showing that regulated stock and bond funds—particularly US mutual funds—and their investors simply do not behave in the manner that the FSB envisions. Yet all this data and analysis does not appear to have prompted the FSB to re-examine its hypotheses, or seek to understand (and, in their models, account for) *why* the experience of regulated funds has been so consistent, across even the most severe periods of market stress.

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[26] Stevens Testimony, *supra* note 21, at 13.

[27] *See* FSOC, Update on Review of Asset Management Products and Activities (April 18, 2016), available at https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf.

The FSB also has relied on the conjectures of other banking-oriented regulators or their representatives—including the FSOC—as support for its positions. For example, in its second G-SIFI consultation, issued in March 2015, the FSB appeared to endorse certain statements set forth in the FSOC's December 2014 notice seeking comment on asset management products and activities. The FSB repeated, without empirical or historical support, the FSOC's conjectures about possible financial stability effects from a "first mover advantage" for investors in investment funds that offer redeemable interests, particularly funds investing in less liquid asset classes. This bank-regulatory "echo chamber," in which the FSB cites the mere speculations of the FSOC as evidence or authority, is a matter of deep concern.

Also troubling is the fact that individual members of the FSB are perpetuating these conjectures through other means. We offer several examples.

- A representative from the Reserve Bank of Australia sits on the FSB's Steering Committee. Last year, staff at the Bank issued a bulletin entitled *Recent Developments in Asset Management*.[28] The bulletin's discussion of asset management and systemic risk relies heavily on the FSB's two G-SIFI consultations and the widely-discredited 2013 report by the Office of Financial Research. The bulletin states baldly—without citation to any source, much less empirical or historical evidence—that "[o]pen-ended funds that offer daily redemptions are susceptible to bank-like runs." The bulletin concludes by stating that the asset management industry "poses potential risks to financial stability."[29]

- The BIS—which funds the FSB's work and houses the FSB Secretariat within its offices—has included similar conjectures about the risks posed by the asset management industry in each of last two annual reports. The BIS annual report for 2015 states, for example, that "asset managers' business models . . . incentivize short-sighted behaviour that can be destabilising in the face of adverse shocks" and that "[t]he decisions taken by a single large asset manager can potentially trigger fund flows with significant system-wide repercussions."[30] In a chapter devoted to "the challenges the financial sector is facing," the BIS annual report for 2016 points to the growth in assets under management, the "increasing presence" of open-end mutual funds in corporate bond markets, and concerns about market liquidity.[31] The BIS then suggests that

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[28] *See* Fiona Price and Carl Schwartz, Reserve Bank of Australia, *Recent Developments in Asset Management*, Bulletin, June Quarter 2015, at 72. The bulletin's reference to open-ended funds appears to be targeted to stock and bond funds. *Id.* at 71-72 and Graph 4. The bulletin is available at http://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-8.pdf.

[29] *Id.*

[30] *See* Bank for International Settlements, *85th Annual Report, 1 April 2014–31 March 2015* (Basel, 28 June 2015) at 118, 119. The report is available at http://www.bis.org/publ/arpdf/ar2015e.htm.

[31] *See* Bank for International Settlements, *86th Annual Report, 1 April 2015—31 March 2016* (Basel, 26 June 2016) at 103, 120-21. The report, which is available at https://www.bis.org/publ/arpdf/ar2016e.htm?m=5%7C24, claims that in the United States, open-end mutual funds "now hold some 22% of corporate debt according to financial accounts data—up

"it is investors, not market-makers, who need to internalise the risk that liquidity will evaporate when everybody heads for the exits."[32] This is a stark example of banking experts projecting the bank experience onto regulated funds. Anyone familiar with the basic workings of the capital markets can confirm that "everybody" can't "head for the exits" at the same time—because trades require both a seller *and* a buyer.

- In April 2015, the IMF Global Financial Stability Report included a chapter on "The Asset Management Industry and Financial Stability."[33] On its face, the chapter appears to present a robust analysis based on empirical data sufficient to support the IMF's declaration that "even simple investment funds such as mutual funds can pose financial stability risks."[34] Closer examination, however, reveals that the chapter contains numerous data errors, misinterpretations, and misleading charts.[35] By and large, these issues arise because the IMF lacks expertise in, and institutional knowledge of, regulated funds.[36]

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from about 8% in 2005." In fact, according to revised Federal Reserve Board data, US mutual funds have only a 15 percent share of the corporate bond market, essentially unchanged since 2012. ICI applauds the Federal Reserve Board for improving the quality of these data. The revised data show that FSB concerns about mutual funds (at least those that invest in corporate bonds)—which the BIS perpetuates—relied upon the faulty predicate that US mutual funds' share of the corporate bond market is large and growing rapidly. Thus, it is incumbent on these and other policy bodies to step back and reexamine their conjectures concerning bond funds and systemic risk.

[32] *Id.*

[33] IMF, *The Asset Management Industry and Financial Stability*, Chapter 3, Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks (April 2015) ("Asset Management Chapter"), available at http://www.imf.org/external/pubs/ft/gfsr/2015/01/pdf/c3.pdf.

[34] *See Plain Vanilla Investment Funds Can Pose Risks*, IMF Survey Magazine: Policy (April 8, 2015) (describing the IMF's conclusions in the Asset Management Chapter), available at http://www.imf.org/external/pubs/ft/survey/so/2015/POL040815B.htm.

[35] ICI economists have written a series of blog posts explaining various problems in the IMF's analysis of the asset management industry. *See The IMF Is Entitled to Its Opinion, but Not to Its Own Facts*, ICI Viewpoints (April 10, 2015); *The IMF Quietly Changes Its Data, but Not Its Views*, ICI Viewpoints (April 21, 2015); *The IMF on Asset Management: The Perils of Inexperience*, ICI Viewpoints (May 28, 2015); *The IMF on Asset Management: Which Herd to Follow?* ICI Viewpoints (June 1, 2015); *The IMF on Asset Management: Sorting the Retail and Institutional Investor "Herds,"* ICI Viewpoints (June 4, 2015). All of the blog posts in this series can be accessed at https://www.ici.org/viewpoints/view_15_imf_gfsr.

[36] Nevertheless, the FSB continues to cite to this report. *See* FSB Activities Consultation, *supra* note 5, at 10 n.29 (cited as support for the FSB's contention that "[t]here may also be cases in which open-ended funds could create incentives for investors to redeem ahead of others (*i.e.*, create a 'first-mover advantage')."

D. Indications That Desired Results May Drive the FSB's Work Product

ICI has taken advantage of every available opportunity to participate in the public consultation process regarding the FSB's work on asset management.[37] Frankly, it is frustrating to see how precious little impact the extensive public comment record appears to have had on the FSB's thinking to date.

Despite extensive public commentary on the initial G-SIFI consultation that size alone does little to indicate the potential for systemic risk, the FSB's second G-SIFI consultation continued to place undue emphasis on the size of a fund, thus singling out many large regulated US funds for potential designation. It also added criteria to sweep large asset managers into the designation net, possibly based entirely on the amount of assets under management. The approach, too, would result in identification of large US asset managers for potential designation.

This is not the only example of the FSB ignoring public commentary on a significant aspect of its proposed G-SIFI methodologies. Virtually all commenters agreed with the FSB's reasoned decision in the initial consultation not to focus on individual asset managers because of the agency nature of their business. In other words, the FSB recognized that fund investors and other clients of an asset manager, rather than the manager itself, are the bearers of investment risk. Nevertheless, in the second consultation, the FSB chose to ignore public comments *and* its own counsel by adding a separate assessment methodology for asset managers.

What could account for this sharp reversal of views? It is possible that the FSB could have been influenced by the views of commenters whose identities, like their comments, have not been made publicly available.[38] An alternative, and equally unsettling, explanation is that the FSB could have been attempting to reverse-engineer the proposed methodologies to achieve a specific outcome.

Similarly, in the United States, the way in which the FSOC has approached the question of nonbank SIFI designation suggests a results-oriented exercise as opposed to an objective analysis. In none of its nonbank designations thus far has the FSOC chosen to explain the basis for its decision with any particularity. The FSOC also has theorized about risks instead of conducting the kind of thorough, balanced, empirical analysis that should underlie its decisions. And by avoiding any meaningful discussion of the particular aspects or activities of the company that are thought to pose systemic risks, the FSOC not only forecloses the prospect of any reasoned justification for its decisions, but also frustrates Congressional intent.[39]

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[37] We also have participated in numerous meetings with FSB officials and staff.

[38] *See* FSB Second Consultation, *supra* note 20, at 3 (stating that all comments will be published "unless a commenter specifically requests confidential treatment.").

[39] Roy Woodall, the independent member of FSOC having insurance expertise, made a similar observation in dissenting from FSOC's decision to designate MetLife Inc. as a SIFI. *See* Views of the Council's Independent Member Having Insurance Expertise at 2 ("It is important to identify particular activities in order to encourage appropriate and further action that could lessen any company-specific threat to U.S. financial stability. Paraphrasing what one insurance thought

E. Insufficient Transparency and Accountability in Consultation and Designation Processes

In the course of our ongoing engagement with the FSB on asset management issues, ICI has highlighted significant concerns with how the FSB conducts its work. In so doing, we have contrasted the FSB's flawed processes with the requirements to which US regulators must adhere in developing new regulations. Under the Administrative Procedure Act, US regulators must examine relevant data and articulate a satisfactory basis for their actions, including a rational connection between the facts found and regulatory choices made. Conclusory statements and unsupported conjectures are not sufficient, nor may regulators ignore contradictory evidence in the record before them. Regulators may not impose substantial new burdens on regulated entities to guard against illusory or wholly improbable risks.

We have urged the FSB to consider adopting similar requirements to guide its work. We also have suggested that the FSB consider more robust rules designed to bring greater transparency to the input that shapes its initiatives and related deliberations, some of which now escapes public scrutiny.[40]

Similarly, ICI is concerned by the process that the FSB has proposed for evaluating investment funds and asset managers for possible G-SIFI designation.[41] Among the serious shortcomings of that process are the following:

- Investment funds or asset managers being considered for G-SIFI designation may have little or no information as to the basis upon which specific decisions are being or will be made.
- There is no required notice that an investment fund is being evaluated (*i.e.,* for funds that do not meet the specified threshold but are considered by national authorities to be "potentially globally systemic") or that a fund will *not* be designated (for funds that do meet the threshold).
- There is no assurance that an investment fund or asset manager will be permitted to provide information that they believe is relevant to a designation determination (or that any such information would be considered by the FSB and the relevant national authority).
- There is no requirement to consider the relative costs and benefits of a potential designation.
- There is no formal (or informal) mechanism for an investment fund or asset manager to challenge a G-SIFI determination.

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leader once told me: 'We should not tolerate any insurance company posing a threat to our financial system – pinpoint what makes them systemically risky and let's fix them.'") (citation omitted). Mr. Woodall's dissent is available at https://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.

[40] *See* ICI Letter on FSB Activities Consultation, *supra* note 22.

[41] *See* FSB Second Consultation, *supra* note 20, at 12-15.

We have recommended various reforms to the proposed process that, in our view, would help address concerns that the FSB has a predetermined outcome in mind—*i.e.*, naming the largest investment funds and asset managers as G-SIFIs. The most significant of those reforms are:

- First, the FSB should provide an entity under review with sufficiently detailed information about the potential risks of concern to the FSB.
- Second, the process should include greater reliance on an entity's primary regulator, including consideration of whether potential risks posed by the entity are better addressed through regulation targeted to the relevant activity, rather than through G-SIFI designation.
- Third, the entity should have the opportunity to propose changes to its business, structure or operations to address the risks identified by the FSB, and should receive a response from the FSB to these proposed changes.

The FSOC SIFI designation process likewise would benefit from these types of common-sense improvements. ICI and many other stakeholders, including Financial Services Committee Chairman Jeb Hensarling, have expressed concerns with this process.[42] In a December 2014 letter to the FSOC, for example, ICI highlighted the following areas for potential reform: greater engagement with companies under evaluation; greater involvement by a company's primary financial regulator; allowing a company to propose a "de-risking" plan as an alternative to SIFI designation; greater transparency, which would give other companies and the broader public more insight into the FSOC's concerns about systemic risk and the business activities or practices giving rise to such risks; and periodic comprehensive review of designated companies.[43]

In February 2015, in response to those calls for change, the FSOC voted to approve "supplemental procedures" to revise its SIFI designation process. The new procedures call for earlier engagement with companies under review, more transparency to the public on the designation process and reasons for designating companies, and a more robust process for annual reviews. While a helpful first step, these new procedures do not go far enough and can be changed at any time without prior notice. ICI believes

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[42] *See, e.g.*, Letter from Rep. Carolyn B. Maloney (D-NY), Ranking Member, Subcommittee on Capital Markets and Government Sponsored Enterprises to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, dated July 29, 2014; Statement of Chairman Jeb Hensarling before Committee on Financial Services, Hearing on "The Annual Report of the Financial Stability Oversight Council" (June 24, 2014) (stating that, with the exception of the national security agencies dealing in classified information, the "FSOC may very well be the nation's least transparent federal entity"); Letter from Jeb Hensarling (R-TX), Chair, Committee on Financial Services, et. al. to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, et al., dated May 14, 2014 (raising concerns about the SIFI and G-SIFI designation process); Letter from Sen. Mark Warner (D-VA) to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, dated May 9, 2014 (noting that SIFI designation analysis "should follow a rigorous and transparent process, using reliable data, so that regulators and the marketplace can be armed with the best information possible").

[43] *See* Letter from Paul Schott Stevens, President & CEO, ICI to Patrick Pinschmidt, Executive Director, FSOC, dated Dec. 17, 2014.

the changes should be codified in statute to provide greater certainty and predictability to the SIFI designation process.

In this regard, the Subcommittee should be aware of a related issue. In issuing the above-noted supplemental procedures, the FSOC indicated that it would publish "further details explaining how the Stage 1 thresholds are calculated."[44] The so-called Stage 1 thresholds are the six quantitative metrics that the FSOC and its staff use to identify those companies that will be subject to comprehensive review for possible SIFI designation.[45] The FSOC and its staff maintain that these metrics "are designed to be uniform, transparent, and readily calculable by the Council, nonbank financial companies, market participants, and other members of the public."[46] Even with the further details the FSOC staff issued in early June, however, the metrics fall well short of this standard. With respect to the metric focused on derivatives liabilities, for example, the new guidance provides *no* additional details—despite specific industry requests for clarification[47]—and merely restates information from the FSOC's 2012 release adopting these metrics. At a minimum, if the FSOC and its staff are not willing to provide the information needed to make the Stage 1 thresholds "transparent and readily calculable," they should refrain from mischaracterizing this part of the SIFI designation process.

V. THERE IS A CLEAR PROSPECT OF HARMFUL CONSEQUENCES FOR REGULATED US FUNDS, THEIR INVESTORS AND THE CAPITAL MARKETS

ICI is greatly concerned about the deficiencies discussed in Section III above because of the potential for the FSB's work to have serious negative consequences for regulated US funds, fund investors, and the capital markets. In this section, we highlight how the FSB's work is able to affect US entities and reiterate what the consequences of designation would be for US funds or their managers.

A. Effect of the FSB's Work on US Entities

As mentioned earlier, three US government agencies represented on the FSOC—the Federal Reserve Board, the Treasury Department, and the SEC—also are members of the FSB. The lack of transparency and accountability around the FSB's NBNI G-SIFI consultation process makes it impossible to know precisely what role these agencies have played in this project and what their views

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[44] FSOC, Supplemental Procedures Relating to Nonbank Financial Company Determinations (Feb. 4, 2015), available at http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf, at 5.

[45] We note, however, that FSOC reserves the right to evaluate a company even if it does not meet the Stage 1 metrics.

[46] FSOC Staff Guidance, Methodologies Related to Stage 1 Thresholds (June 8, 2015), available at http://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf, at 1.

[47] *See, e.g.*, Letter from Gus Sauter, Managing Director and Chief Investment Officer, and John Hollyer, Principal and Head of Risk Management and Strategy Analysis, Vanguard, dated Dec. 19, 2011 (recommending that, in calculating net derivative liability under its "Stage 1" analysis, FSOC take into account not just cash collateral but also collateral consisting of cash-equivalents, such as Treasuries and other U.S. government agency securities).

are on it.[48] Efforts by members of Congress to gain greater insight into these matters have been largely unavailing.[49]

It also is troubling that, as mentioned above, a Federal Reserve Board Governor leads the FSB committee overseeing the work on proposed G-SIFI assessment methodologies for investment funds and asset managers. This arrangement raises the prospect that the process set in motion by the FSB ultimately could be used to exert multilateral influence on the FSOC to expand the reach of the Federal Reserve itself to regulated US funds and their managers and, by extension, US capital markets.

The FSOC maintains that the FSB's decisions do not determine those of the FSOC.[50] Federal Reserve Board Chair Yellen echoed this view in her June 2015 response to ICI's letter. Chair Yellen indicated that "any recommendations by the FSB with respect to the asset management industry would not be binding on the United States. That responsibility remains with the appropriate domestic regulatory authorities and the Financial Stability Oversight Council."[51] But these assertions provide little comfort insofar as the FSB's decisions may front-run the FSOC process. While the FSB's recommendations may not be "binding," they seem certain to have some import for the FSOC. One need only consider the experience of the insurance industry. Surely it is more than just a coincidence that the FSOC has designated for enhanced prudential regulation and Federal Reserve Board supervision *all* of the US-based insurance firms the FSB named as global systemically important insurers.

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[48] Chair Yellen's response to the Lew/White/Yellen Letter (*supra* note 4) shed no additional light. Chair Yellen stated that "as the FSB is made up of participants from many jurisdictions, the particular statements and documents produced by the FSB do not necessarily reflect my views or those of the Federal Reserve." Letter from Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, to Paul Schott Stevens, President and Chief Executive Officer, Investment Company Institute, dated June 11, 2015 ("Yellen Response").

[49] *See, e.g.*, Hearing Transcript, *The Annual Testimony of the Secretary of the Treasury on the State of the International Financial System*, Committee on Financial Services, House of Representatives (May 8, 2014) (exchange between The Honorable Jacob Lew, Secretary, Department of the Treasury, and Chairman Jeb Hensarling (R-TX) *et al.* regarding the FSOC's interaction with the FSB and the FSB's designation of three U.S. insurance companies as G-SIFIs).

[50] *See, e.g.*, FSOC Nonbank Designations – FAQs (FAQ #11), available at http://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx. FAQ #11 states:

"11. If international entities such as the Financial Stability Board (FSB) identify a U.S. firm as systemically important, does that mean that the FSOC will do the same?

No. While the FSB and the FSOC are both focused on strengthening financial stability, their processes are distinct. Decisions reached in the FSB do not determine decisions made by the FSOC. In fact, the FSOC is under no obligation to even consider a firm identified by the FSB for designation.

The FSB's identification of a firm as a global systemically important financial institution does not have legal effect in the United States or any other country. In the United States, the FSOC is the only entity that can designate nonbank financial companies for enhanced prudential standards and Federal Reserve supervision. FSOC designations can be made only pursuant to a super-majority vote of its 10 voting members based solely on the standards and processes set forth in U.S. federal law, after a robust analysis that reflects extensive interaction with the company."

[51] Yellen Response, *supra* note 48.

Indeed, the FSB's proposed process for identifying NBNI G-SIFIs expressly calls for involvement by "national authorities" in each member jurisdiction. Thus, if the FSB were to adopt the process outlined in its second consultation, regulators in the United States would be called upon to analyze US funds and asset managers under the applicable assessment methodology and to develop a preliminary list of NBNI G-SIFIs. In addition, under the proposal, national authorities would be permitted to add to their preliminary lists "other NBNI financial entities that are below the materiality thresholds but which they determine should still be added for more detailed assessment."[52] Subsequently, US regulators, together with the FSB, would determine the final list.

Moreover, participation as a member of the FSB carries with it the expectation that member jurisdictions will implement any agreed upon standards and policy measures.[53] Consistent with this expectation, FSB Chairman Mark Carney has stated that "*full, consistent and prompt implementation*" of the standards developed under the FSB "remains *essential* in order to maintain an open and resilient global financial system."[54] Notwithstanding this stern injunction, we believe that the deeply flawed way in which the FSB has developed its proposed asset management methodologies means that they simply cannot serve as any predicate for regulatory action in the United States.[55]

B. What is At Stake? The Consequences of Designation

As ICI has cautioned previously, SIFI or G-SIFI designation of regulated funds or their managers would have severe consequences. In both cases (*i.e.*, SIFI and G-SIFI), US law already has established the measures that would apply to any fund or manager designated as systemically important. As prescribed by the Dodd-Frank Act, these measures include capital and liquidity requirements and prudential supervision by the Federal Reserve.[56] These measures are designed to moderate bank-like risks and are ill-suited to regulated funds and their managers.

Based on these requirements, designated funds would face higher costs resulting in lower investment returns for individuals saving for retirement, education, and other life goals. The resulting competitive imbalances would distort the fund marketplace, potentially reducing investor choice. Designation also

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[52] Second FSB Consultation, *supra* note 20, at 14.

[53] *See, e.g.*, Letter from Mark Carney, Chairman, FSB to G20 Finance Ministers and Central Bank Governors, dated 9 April 2015 (emphasis added).

[54] *Id. See also* FSB Report on Reform Implementation, *supra* note 15, at 2 ("G20 Leaders' continued support is needed to address identified gaps and inconsistencies in . . . core reform areas, and to overcome legal and operational obstacles to implementation by . . . ensuring that legal, data and capacity constraints do not hamper implementation efforts.")

[55] Lew/White/Yellen Letter, *supra* note 4, at 3-4.

[56] In May 2014, ICI's Chairman testified in greater detail about the consequences of SIFI or G-SIFI designation of regulated funds or their managers. *See* Statement of F. William McNabb III, Chairman and Chief Executive Officer, The Vanguard Group, Inc., on behalf of the Investment Company Institute, before the Committee on Financial Services, US House of Representatives, on Examining the Dangers of the FSOC's Designation Process and Its Impact on the US Financial System (May 20, 2014).

could have far-reaching implications for how a fund's portfolio is managed, depending on how the Federal Reserve exercises its supervisory charge under the Dodd-Frank Act to "prevent or mitigate" the risks presented by large, interconnected financial institutions. As I have explained in previous Congressional testimony, regulated funds and their managers could be subject to a highly conflicted form of regulation, pitting the interests of banks and the banking system against those of millions of investors.[57]

VI. RECOMMENDATIONS

ICI is pleased to offer its recommendations for addressing several of the concerns we discuss above.

- On an ongoing basis, Congress should continue to monitor closely US agencies' participation in the FSB's policy work, particularly as it relates to asset management. As part of its oversight of these agencies, Congress should seek to ensure that their FSB participation does not conflict with the best interests of US investors and US capital markets.

- In the near term, Congress should encourage US officials who participate in the FSB to support the delegation to IOSCO of further work on asset management activities at the global level. This would mean having the FSB delegate to IOSCO responsibility for final consideration of the policy recommendations set forth in the current consultation (as appropriate after IOSCO gives due consideration to public comments) and monitoring progress as the recommendations are implemented.

- Congress should use its influence to encourage the reconstitution of the FSB. This reformed FSB should give all major sectors of the global financial system—capital markets, banking, and insurance—an equal role. In addition, in pursuit of global financial health, the organization's mission should be to advance the dual objectives of mitigating risk to the financial system, while promoting vibrant markets and economic growth.

- With regard to the FSOC, Congress should enact legislation, such as H.R. 1550, the FSOC Improvement Act, to codify in statute important improvements to the SIFI designation process. In particular, ICI strongly believes that Congress must reform the FSOC's designation process in ways that will advance the Dodd-Frank Act's dual goals of reducing systemic risk while reserving SIFI designation as a tool to be used only in truly exceptional cases. We suggest focusing such reforms on three critical areas:

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[57] Stevens Testimony, *supra* note 21, at 15-18 (discussing in greater detail the highly adverse consequences of inappropriate designations to investors and the capital markets). *See also* Paul Schott Stevens, *Designation's Vast Reach into Investor Portfolios,* ICI Viewpoints (March 24, 2015), available at https://www.ici.org/viewpoints/view_15_designation.

- First, the FSOC should provide notice sufficient to inform a company as to the financial stability risks that the FSOC believes the company presents.

- Second, the primary financial regulator of a company under evaluation should have a meaningful opportunity, prior to designation, to address any risks the FSOC identifies as systemic. The primary regulator generally will have greater expertise and regulatory flexibility than the FSOC to address such risks.

- Third, a company under evaluation should have an opportunity, prior to designation, to propose changes to its structure or business practices that would address the risks the FSOC has identified. This "de-risking" option, which would require the FSOC's consent, could prove to be a more direct and effective way to achieve the FSOC's goal of risk mitigation.

ICI is pleased that the House Financial Services Committee approved H.R. 1550 with a strong bipartisan vote.[58] If adopted, these measures would give the FSOC additional tools and *more* flexibility to ameliorate systemic risks. We emphasize that, if the FSOC determines that neither action by the primary regulator nor the company's de-risking proposal is sufficient, the FSOC retains the authority to move forward with a SIFI designation. Neither of those two options, moreover, interferes with the FSOC's emergency authority to designate.

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I appreciate the opportunity to share these views with the Committee. ICI looks forward to continued engagement with Congress on these important matters.

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[58] Similar provisions have been included in the Senate as part of S. 1484, the Financial Regulatory Improvement Act, and these policies have garnered bipartisan support. *See, e.g.*, Remarks by Senator Mike Crapo (R-ID) at *Oversight of the Financial Stability Oversight Council Designation Process*, Hearing before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (July 22, 2015) ("If at that point when the decision apparently has been made and the risks have been identified, the activities have been identified, shouldn't the company at that point have an opportunity to evaluate its business model and structure and determine whether to adjust it?"); Remarks by Senator Robert Menendez (D-NJ) at *FSOC Accountability: Nonbank Designations*, Hearing before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (March 25, 2015) ("what is the use of engaging with a company if it is not to both come to a conclusion as to whether it is systemically risky, what activities are systemically risky, and if it wished to avoid the designation because of the consequences that flow from that, give it the opportunity to do so? To me, that is not theoretical. It just makes common sense.").

DIRK KEMPTHORNE
President & Chief Executive Officer

Statement for the Record
Governor Dirk Kempthorne, President & CEO
American Council of Life Insurers

Subcommittee on Monetary Policy & Trade
House Committee on Financial Services
U.S. House of Representatives

Hearing titled "The Financial Stability Board's Implications for U.S. Growth and Competitiveness."

September 27, 2016

On behalf of the American Council of Life Insurers (ACLI), I am pleased to submit this statement for the hearing record expressing the views of the life insurance industry regarding the Financial Stability Board's (FSB) implications for U.S. growth and competitiveness.

The American Council of Life Insurers is a Washington, D.C.-based trade association with approximately 280 member companies operating in the United States and abroad. ACLI advocates in state, federal, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing 95 percent of industry assets, 92 percent of life insurance premiums, and 97 percent of annuity considerations in the United States.

ACLI has significant concerns about certain actions of the FSB and the impact of FSB decisions on the competitiveness of the U.S. life insurance industry. The FSB has already designated three U.S. insurers as Global Systemically Important Insurers (G-SIIs), designations which could shift the competitive landscape and increase regulatory complexity. FSB designations and regulatory directives should not predetermine decisions by U.S. prudential regulators and could imperil the fundamental contributions of the life insurance industry to retirement security.

The life insurance industry is uniquely suited to provide retirement solutions. Life insurers provide risk protection, insurance, and annuities products that help families save for retirement. Annuities are the sole means available in the marketplace today by which retirees can receive guaranteed income for life. Now more than ever, life insurance companies are essential to helping families build and achieve

retirement security. By strengthening retirement security, life insurers are improving the lives of retirees.

Life insurers are also important contributors to economic growth as long-term investors. Life insurers are leading purchasers of corporate bonds, which fund business expansion, job growth, and infrastructure. Because life insurers make guarantees that often last many decades, they must invest in assets that have a long-term horizon. This kind of asset-liability duration matching is not only a fundamental principle of prudential regulation of insurers, but also positions life insurers to be a powerful source of long-term capital and economic growth. The bonds that life insurers purchase today have an average maturity of more than 18 years.

A major concern of the life insurance industry is that FSB designations of GSIIs seem to have prejudged the Financial Stability Oversight Council's (FSOC) designations and may place designated companies at a competitive disadvantage. In the case of two GSII designations of U.S. insurers by the FSB, the GSII designation preceded the FSOC designation. In the case of the third U.S. insurer, the designation occurred at roughly the same time. The timing of these designations raises serious concerns about the independence of the two processes, concerns that have been voiced by FSOC Independent Member with insurance expertise, Roy Woodall. In his dissents to both the Prudential and MetLife designations, Mr. Woodall noted that the FSB's designations were taken in consultation with members of FSOC, and that these discussions appear to have predisposed FSOC's independent designation process.

The potential negative consequences of designation are significant. The insurance industry is highly competitive, and the additional regulation imposed upon a designated company could place that company at a significant competitive disadvantage relative to its non-designated competitors. Capital standards are the most obvious example. If capital requirements on designated insurers are materially different from those imposed by the state insurance regulators, designated insurers may find it difficult to compete against non-designated competitors, resulting in a loss of business or an altered product mix. Less competition or less product availability is not in keeping with a healthy market that best serves insurance consumers.

Even before any additional regulation is implemented, the prospect of such regulation has an immediate impact as it forces designated companies to manage their operations by taking into account looming, but unspecified regulatory requirements. Finally, ACLI is troubled that FSB and FSOC have taken markedly different approaches in their treatment of different categories of nonbank financial companies. While FSB and FSOC have designated insurers for heightened supervision and regulation, they are pursuing an "activities-based" approach for asset managers rather than the imposition of heightened regulation on individual companies merely because of size.

ACLI believes that both FSB, in partnership with the International Association of Insurance Supervisors (IAIS), and FSOC should pursue an "activities-based" approach to insurers. The authority to recommend primary regulator action on activities brings real focus to the specific activities that may involve potential systemic risk and avoids the competitive harm that an individual company may face following designation. In certain markets, designated companies can be placed at a competitive disadvantage to non-designated companies because of different regulatory requirements. The

authority to recommend primary regulator action on activities avoids the "too-big-to-fail" stigma that some have associated with the designation of individual companies.

Conclusion

ACLI appreciates the work of the committee to conduct oversight over the U.S. representatives to the FSB, IAIS, and FSOC. Current approaches undertaken by these institutions do not always facilitate the goal of reducing systemic risk and could undermine a level playing field in the marketplace. The FSB, IAIS, and FSOC must do more to ensure a fair process. Thank you for convening this important hearing and for your consideration of the views of ACLI and its member companies.

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STATEMENT

PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA

FOR THE HOUSE FINANCIAL SERVICESS COMMITTEE HEARING ON

THE FINANCIAL STABILITY BOARD'S IMPLICATIONS FOR U.S. GROWTH AND COMPETITIVENESS

September 23, 2016

The Property Casualty Insurers Association of America (PCI) represents roughly 1000 insurers and reinsurers that write more than $200 billion in coverage throughout the U.S. and the world. We appreciate this opportunity to comment on the current status and issues relating to the Financial Stability Board, created as one of the global responses to the financial crisis.

In our statement below, PCI first addresses general areas for possible improvement including enhancing the role of state insurance regulators and increasing transparency. Next, we discuss specific work streams such as governance, global systemic risk designation and resolution. And finally we suggest that policymakers urge the FSB to focus more on stopping the growing international trend of self-defeating protectionism in the guise of prudential regulation.

General Issues

Include State Insurance Regulators

The charter of the FSB is exceptionally broad, encompassing insurance regulation as well as banking and securities regulation. And, many of its work streams, including macro-prudential risk, resolution, conduct of business and governance apply to insurers and reinsurers. FSB members commit to developing guidance that local authorizes are encouraged to implement in supervisory regulatory frameworks. Yet, the U.S. delegation does not include the primary insurance regulators, the states, which have traditionally and effectively regulated insurance in the U.S. This primacy of state regulation was recently reiterated by Congress in Dodd-Frank.

Without formal inclusion of state regulators, errors can be made about how best to apply general principles to the very different realities of insurance and insurance regulation when compared to the banking and securities sectors. For example, the state resolution system for insurers recognizes that there is a long time horizon for resolution for insurers, often years if not decades, when compared to banks which may need to be resolved in hours.

Including insurance regulators from the U.S. more generally in the FSB will also help prevent the inappropriate migration of banking regulatory concepts onto insurers. This will avoid a "one size-fits-all" regulatory approach that will not work for insurance and may actually harm both consumers and well managed companies.

More Transparency and Consideration of Costs and Benefits

The OECD in its Policy Framework for Effective and Efficient Financial Regulation recommended a transparent approach to regulation and selection by regulators of the policy option that is the least

burdensome and yet still effective. We think that a closer adherence to that policy framework would improve the work of the FSB.

The vast majority of meetings of the FSB are conducted behind closed doors. PCI appreciates the formal consultations provided to stakeholders and rare invitations to attend meetings. PCI also appreciates that confidentiality is appropriate when discussing the specifics of particular companies. However, the FSB is unnecessarily secretive with regard to its deliberations on public policy matters of general applicability. The lack of transparency reduces the ability of stakeholders to better understand the underlying issues and problems sought to be addressed. It also inhibits the ability of regulators to fully understand industry practices to be able to tailor any regulatory proposal to effectively address real world gaps. Further, any international guidelines are more likely to be implemented in local jurisdictions when stakeholders have been involved throughout the process of their development.

PCI also endorses the notion of the FSB incorporating an element of cost/benefit analysis in its work. Regulations can sometimes have consequences such as unnecessarily increasing consumer costs and reducing competition and consumer choice. On the other hand, everyone benefits when abusive practices are prevented and consumers pay the least they need to, with the greatest degree of choice.

Current Issues

Governance

The FSB is in the midst of reviewing its governance recommendations. PCI is pleased to have drafted comments on behalf of the global insurance industry, which are attached. We also much appreciate the invitation to appear before the FSB on September 30 to provide further information.

FSB governance guidelines should remain high level and respect differences in jurisdictional laws and should be applied proportionally, based on the nature, scale and complexity of the entity at issue. Overall, the OECD/IAIS governance materials focused specifically on the insurance sector currently accomplish that goal. Because of this activity specifically geared to the insurance sector, there would be little value in the FSB's governance work becoming more prescriptive, at least with respect to insurance.

Resolution

The U.S. has a comprehensive, time-tested system of resolution for insurers. Our system works because of several factors including comprehensive and consistent laws, a strong role for the courts, and in particular the consumer protection and safety net provided by the state guaranty funds. The FSB should recognize our system as at least one way to comply with its general principles.

The FSB's work on resolution should also recognize the unique nature of the insurance business model including the long term nature of many insurance liabilities, the lack of runs on insurance companies and the very long-term nature of most insurance resolutions in the U.S. Accordingly, PCI recommends a principles based, high level and flexible approach that reflects sectoral differences and local jurisdictional systems. Vague references in FSB documents to the insurance industry providing "critical functions" as a justification for global insurance resolution standards are also problematic and unwarranted, particularly if applied beyond the confines of designated systemically important financial institutions.

Global Systemic Risk Designation Process

PCI has previously submitted testimony regarding our concerns about the back-room process of designating Global Systemically Important Insurers (G-SIIs). That process should seek to manage systemic risk by focusing on risky *activities*. While most international institutions have recognized that traditional insurance activities are not systemically risky, the FSB seems driven to designate a group of the largest insurers as G-SIIs, even if the systemic importance of those institutions was far less than undesignated banks or securities firms. Recent publications promote a methodology focused on activities as a more effective way of managing systemic risk. The shift will take time, and we suggest in the interim that FSB G-SII designations should be based on a credible demonstration of exposure to systemic risk, not based on size and global footprint. In addition, potential G-SIIs should be provided with appropriate due process and a clear path towards adequately de-risking to avoid a designation or consider working towards a future off ramp.

An Additional Area for FSB Focus

Making the Case for Open Markets and Removing Barriers to Trade in Insurance and Reinsurance

Open, competitive and well-regulated insurance markets provide significant value to the public welfare, including financial security, identification of risk and a focus on risk mitigation. Instead of more market opening, however, barriers to trade in insurance and reinsurance are increasingly being erected around the world. These include discriminatory limits on foreign reinsurance, unfair advantages for state-owned enterprises and data localization mandates. As markets become less competitive and more domestically focused, they become more vulnerable to systemic shocks. While generally appearing in less developed large and small markets, we even see discrimination against U.S. companies in developed markets such as the EU. The FSB should take up this challenge, particularly as many of these barriers are being erected in the name of prudential regulation.

Conclusion

Several fundamental reforms such as enhancing the role of insurance regulators and increasing transparency and cost/benefit analysis will greatly improve the work of the FSB. The FSB is considering important reforms in corporate governance, resolution, and designation of global systemically important insurers, where PCI believes more work needs to be done in appropriately tailoring the approach of global standard setting and implementation. Beyond our comments on current work streams, PCI encourages the FSB to more strongly advocate for open and well-regulated markets and thereby help combat the alarming negative trend of protectionism being imposed in the guise of prudential regulation.