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Before the House Financial Services Committee
Hearing on the Financial Stability Oversight Council
May 20, 2014

Chairman Hensarling, Ranking Member Waters, I am pleased to appear before you today to discuss the key role of the Financial Stability Oversight Council in reducing risks to the financial system.

In 2008, the United States plunged into a severe financial crisis that shuttered American businesses, and cost millions of households their jobs, their homes and their livelihoods. The crisis was rooted in unconstrained excesses and prolonged complacency in major financial capitals around the globe. The crisis demanded a strong regulatory response as well as fundamental changes in financial institution management and oversight.

The Dodd-Frank Act created the authority to regulate Wall Street firms that pose a threat to financial stability, without regard to their corporate form, and to bring shadow banking into the daylight; to wind down major firms in the event of a crisis, without feeding a panic or putting taxpayers on the hook; to attack regulatory arbitrage, restrict risky activities, regulate short-term funding markets, and beef up banking supervision; to require central clearing and exchange trading of standardized derivatives, and capital, margin and transparency throughout the market; to improve investor protections; and to establish a new Consumer Financial Protection Bureau (CFPB) to look out for the interests of American households.

The Act established a Financial Stability Oversight Council with authority to designate systemically important firms and financial market utilities for heightened prudential oversight by the Federal Reserve; to recommend that member agencies put in place higher prudential standards when warranted; and to look out for risks across the financial system. The Council is aided in its task by its own staff, the staff of member agencies, and the independent Office of Financial Research, which has its own duty to standardize and collect data and to examine risks across the financial system.

One of the major problems in the lead up to the financial crisis was that there was not a single, uniform system of supervision and capital rules for major financial institutions. The federal financial regulatory system that existed prior to the Dodd-Frank Act developed in the context of the banking system of the 1930s. Major financial firms were regulated according to their formal labels – as banks, thrifts, investment banks, insurance companies, and the like—rather than according to what they actually did. An entity that called itself a "bank" faced tougher regulation, more stringent capital requirements, and more robust supervision than one that called itself an "investment bank." Risk migrated to the less well-regulated parts of the system, and leverage grew to dangerous levels.

The designation of systemically important financial institutions (SIFIs) is a cornerstone of the Dodd-Frank Act. A key goal of reform was to create a system of supervision that ensured that if an institution posed a risk to the financial system, it would be regulated, supervised, and have capital requirements that reflected its risk, regardless of its corporate form. To do this, the Dodd-Frank Act established a process through which the largest and most interconnected financial firms could be designated as systemically important financial institutions and then supervised regulated by the Federal Reserve. The Council has developed detailed rules, interpretive guidance, and a hearing process, which goes beyond the procedural requirements of the Act, and including extensive engagement with the affected firms, to implement the designation process outlined in Dodd-Frank. The existing rules provide for a sound deliberative process; protection of confidential and proprietary information; and meaningful and timely participation by affected firms. The Council has begun designating firms under this authority.

Critics of designation contend that it fosters "too big to fail," but the opposite is the case. Regulating systemically important firms reduces the risk that failure of such a firm could destabilize the financial system and harm the real economy. It provides for robust supervision and capital requirements in advance, to reduce the risks of failure, and it provides for a mechanism to wind down such a firm in the event of crisis, without exposing taxpayers or the real economy to the risks of their failure.

Other critics argue that the FSOC should be more beholden to the regulatory agencies that are its members, but again, the opposite is true: Congress wisely provided for its voting members, all of whom are confirmed by the Senate, to participate based on their individual assessments of risks in the financial system, not based on the position of their individual agencies, however comprised. Members must also individually attest to their assessments in the FSOC's annual reports. The FSOC, moreover, has the duty to call on member agencies to raise their prudential standards when appropriate, and member agencies must respond publicly and report to Congress if they fail to act. If anything, the FSOC's powers should be strengthened, so that fragmentation in the financial regulatory system does not expose the United States to enormous risk, as it did in the past.

Some critics contend that certain types of firms in certain industries or over certain sizes should be categorically walled off from heightened prudential supervision, but such steps will expose the United States to the very risks we faced in the lead up to the last devastating crisis. The failure of firms of diverse types and diverse sizes at many points in even very recent memory—from Lehman and AIG to Long Term Capital Management—suggest that blindspots in the system should at the very least not be intentionally chosen in advance by the Congress. The way to deal with the diversity of sizes and types of institutions that might be subject to supervision by the Federal Reserve is to develop regulation, oversight and capital requirements that are graduated and tailored to the types of risks that such firms might pose to the financial system. FSOC and member agencies also have other regulatory tools available with respect to risks in the system for firms not designated as SIFIs, including increased data collection and transparency, collateral and margin rules for transactions, operational and client safeguards, risk management standards, capital requirements, or other measures.

Lastly, some critics complain that the FSOC's work is too tied to global reforms by bodies such as the Financial Stability Board (FSB). But global coordination is essential to making the financial system safe for the United States, as well as the global economy. The United States has led the way on global reforms, including robust capital rules, regulation of derivatives, and effective resolution authorities. These global efforts, including designations by the FSB, are not binding on the United States. Rather, the FSOC, and U.S. regulators, make independent regulatory judgments about domestic implementation based on U.S. law. The FSB itself has become more transparent over time, adopting notice and comment procedures, for example, but it could do more to put in the place the kind of protections that the FSOC has established domestically.[1]

Significant progress has been made in making the financial system safer, fairer and better focused on serving households, businesses and the real economy. The new CFPB has been built and is helping to make the marketplace level and fair. New rules governing derivatives transactions have largely been proposed. Resolution authority and improvements to supervision are being put in place. The Financial Stability Oversight Council has begun designating non-bank firms for heightened supervision and at the end of last year regulators finalized the Volcker Rule. These are important achievements. Now is not the time to weaken the system, but to stay strong on the path of reform.

[1] *See* Michael S. Barr, Who's In Charge of Global Finance, Georgetown Journal of International Law (forthcoming 2014).