Statement before the House Committee on Financial Services
On "Examining the Dangers of the FSOC's Designation Process and its Impact on the U.S. Financial System"

Testimony on the Designation of Systemically Important Financial Institutions by the Financial Stability Oversight Council and the Financial Stability Board

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

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Chairman Hensarling, Ranking Member Waters, and members of the committee:

Thank you for the opportunity to testify this morning on the designation of systemically important financial institutions (SIFIs) by the Financial Stability Oversight Council (FSOC). I believe this issue deserves serious attention by Congress. I am Peter Wallison, Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute. The views expressed in this testimony are my own and not necessarily those of the American Enterprise Institute.

Financial services is one of the most important and successful industries in the United States. It includes banks, of course, as well as insurers, asset managers, securities broker-dealers, finance companies, private equity firms, and hedge funds, among others. The services of these companies enable main-street Americans to buy and sell assets, and to save for the future to purchase a home, send children to college or retire comfortably. As important, financial services channel these savings into financing for business, which in turn creates jobs and—through growth in productivity—improves the standard of living for all of us.

Although some observers of the financial markets favor more regulation than others, it is not in dispute that financial regulation can have a significant effect on the performance of financial institutions, and thus on economic growth. For this reason, Congress should have a major role in formulating the policies that underlie the regulatory decisions that affect the US financial industry. However, in the case of banking regulation, Congress has generally not intervened in the development of the bank capital regulations. Basel I, II and III were developed by bank regulators , approved by an international agreement among bank regulators, and subsequently applied to the US banking industry. Later in this testimony, I discuss reasons why congressional abstention from this process was not a good idea.

The Dodd-Frank Act, the FSOC, and growth in the scope of regulation

In 2010, in the wake of the financial crisis, Congress adopted the Dodd-Frank Act, which created a special body known as the Financial Stability Oversight Council (FSOC). The FSOC is composed of the heads of all the federal financial regulators—the Federal Reserve, FDIC, SEC, CFPB, etc.—and a person who is appointed by the President and confirmed by the Senate as an expert in insurance, an industry that is not regulated by the federal government. The secretary of the Treasury is the chairman of the FSOC and runs the meetings. The secretary also has an effective veto over the FSOC's most important decisions, since his affirmative vote is necessary for approval. Because the act specifies that the members are the *heads* of the regulatory agencies—not the agencies themselves—virtually all the members are appointees of the administration in power. They are not required to represent their agencies' views and they don't; they seem generally to follow the directions of the Treasury secretary. This in itself is highly unusual for a regulatory agency. In creating other regulatory agencies, particularly those that engage in financial regulation, Congress has generally set up bipartisan commissions, in order to ensure that different views are brought to bear on contentious regulatory matters where

significant parts of the economy could be harmed. The FSOC is almost unique in the sense that it is made up principally of appointees of the administration in power, and is headed by the secretary of the Treasury, a political appointee. This means that important and controversial decisions of the FSOC can be made on the basis of political or ideological factors rather than fully debated as regulatory or supervisory matters. There is strong evidence that most of the members of the FSOC know little about the decisions they are asked to make, and simply follow the directions of the secretary of the Treasury as the senior administration official at the table.

Dodd-Frank enjoins the FSOC to "identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large interconnected bank holding companies or nonbank financial companies." (Sec 112). The act designates all banks or bank holding companies with more than $50 billion in assets as systemically important financial institutions (SIFIs) and subjects them to special stringent regulation by the Federal Reserve Board (Fed), but it leaves to the FSOC the task of designating nonbank financial institutions as SIFIs. To implement this idea, Section 113 authorizes the FSOC to designate a nonbank financial firm as a SIFI if "the Council determines that material financial distress at the US nonbank financial company…could pose a threat to the financial stability of the United States." Firms so designated are then turned over to the Fed for prudential regulation which Section 115 requires to be more "stringent" than the regulation to which firms of the same type are ordinarily subject. Section 115 and other provisions of the act suggest that this regulation be bank-like—that is, it should involve regulation of their capital and supervision of their risk-taking activities.

The conventional narrative about the financial crisis has created major new opportunities for regulators.

Bank-like regulation of nonbank firms is a sharp change in substantive US regulatory policies from those that prevailed in the past. The 2008 financial crisis was a disaster for the American people, but it was a huge gift for financial regulators in the US and abroad. After all major financial downturns, those who support government involvement in the economy claim that it wouldn't have occurred if financial regulators had more power. Congress usually gives in to this argument, despite the evidence. The collapse of the S&Ls in the late 1980s brought forth the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) and the FDIC improvement Act of 1991 (FDICIA). The Enron scandal produced the Sarbanes-Oxley Act. All these new laws promised to prevent the recurrence of the prior events such as banking or financial crises. As we can see from the 2008 financial crisis, they did not perform as advertised. Despite statements to the contrary by people who should know better, there has been no deregulation of the financial system in the last 30 years, while many other areas of the economy—securities trading, communications, trucking and air travel—have been deregulated with huge benefits for the American people. The plain fact about financial regulation is that existing regulation creates repeating crises, which in turn bring forth additional regulation, culminating in the recent financial crisis.

The 2008 financial crisis had many elements of earlier crises, except in two respects: it was much larger than any previous crisis and it involved the whole financial system and not just depository institutions. The narrative that grew out of the crisis was, once again, that it could

have been prevented if the regulators had more power.[1] But there was a difference; before the crisis, the only theory for federal prudential regulation of financial institutions supported the regulation of banks; since banks were backed by the government, prudential regulation—requiring capital and controlling risk-taking—was necessary to prevent moral hazard and to protect the taxpayers. But after the crisis, which involved many large financial institutions in addition to banks, the conventional Washington narrative became something far more expansive. In that narrative, the failure of any large financial institution could be a danger to the entire financial system. This spawned a wholly new and expansive theory for regulation—that the risk-taking and capital position of *any* financial institution should be subject to prudential bank-like regulation if there is even a minimal case that its failure could cause a financial crisis. That's why the Dodd-Frank Act adopted the idea that any firm should be subject to this regime if its "financial distress" could cause "instability in the US financial system." However, since it is impossible to know in advance whether a particular institution's "distress" would cause "instability in the US financial system" (whatever *that* is), the FSOC's authority is in effect a blank check to consign to Fed regulation any large financial firm that the government wants to regulate.

I need not tell many members of this committee that the narrative that brought about this major shift in regulatory policy was false. The financial crisis was not caused by insufficient regulation of the financial system; it was caused by government housing policies that built an enormous bubble between 1997 and 2007 and suffused the financial system with subprime and other low quality mortgages. These defaulted in unprecedented numbers in 2007 and 2008 when the bubble deflated, severely weakening banks and other large financial institutions. Banks in particular were hard hit because the government-mandated capital requirements had encouraged them to hold mortgage backed securities that lost substantial value when the mortgage defaults began. When Lehman Brothers was allowed to fail in September 2008, a huge investor panic ensued that we know as the financial crisis.

The practical effect of the huge shift in regulatory policy, based on this misreading of the cause of the crisis, was a large increase in the potential reach of bank-like prudential regulation and a large corresponding increase in regulatory power. Now, *all* large financial institutions in the US—not just banks—can be made subject to bank-like prudential regulation unlike anything they have faced before. Given the unprecedented character of this power, it seems reasonable that Congress should have a say, at the very least, about how this change in the scope of regulation is implemented, especially because substantial increases the extent and cost of regulation can have a substantial effect on economic growth and the well-being of all Americans.

Much of the rest of my testimony will discuss why congressional intervention is necessary as a matter of broad policy, but I'd like to mention one fact at this point that I think will be particularly salient with Congress. Recently, the FSOC has taken steps that indicate it is likely to designate large asset managers as SIFIs. When this became known, Barney Frank, the chief House sponsor of the Dodd-Frank Act and the authority of the FSOC, said that he had

[1] See, e.g., the majority Report of the Financial Crisis Inquiry Commission, from which I dissented. http://www.aei.org/files/2011/01/26/Wallisondissent.pdf

never intended that asset managers should be considered SIFIs.[2] Nevertheless, the breadth of the language in the congressional authority given to the FSOC does not prevent the FSOC from going this far. If Congress didn't intend this, it should step in to make its intentions clearer to the FSOC.

The scope of the FSOC's authority

The first thing to be said about the language of Section 113 is that it is an extraordinary grant of authority, and essentially permits the FSOC to determine the scope of its own jurisdiction. This can be done by reaching out to designate any financial institution operating in the US that the FSOC believes could cause instability in the US financial system. There is no outer boundary, such as size or type of company, in this grant of authority. Although the courts often frown on this when it is called to their attention, it is unlikely that this particular grant of authority will ever be tested; regulated firms, fearing retaliation, are very reluctant to challenge the legal authority of their regulators. Indeed, after Prudential Financial was designated as a SIFI, the firm initially suggested that it would challenge the FSOC's decision, but after going through a pro forma administrative appeal process decided not to engage.

The Dodd-Frank language that authorizes the FSOC to designate SIFIs is seriously flawed. Key terms the FSOC must apply in order to take jurisdiction over any particular firm—"financial distress" and "market instability"—have no clear meaning, and because both involve predictions about the future, they amount to an enormous grant of discretionary power. Where judicial intervention is unlikely, as in this case, wide discretionary power can result in arbitrary, capricious and politically-based administrative decisions. An agency can rectify this problem by developing and applying standards that limit its own discretion, providing a roadmap for compliance by affected companies, and allowing the basis of its decisions to later be judged by Congress and the public. However, the FSOC has not developed any such standards. Quite the opposite. In its recent decision to designate the insurance firm Prudential Financial as a SIFI, the FSOC studiously avoided any standards that might limit its discretion in the future. As a result, other insurers can have no idea what they should do or not do to avoid a SIFI designation, and there is no way for Congress or anyone else to determine whether the FSOC is acting objectively and carefully with its extraordinary statutory mandate. For example, in summarizing its Prudential decision, the FSOC stated:

> Prudential is a *significant* participant in financial markets and the U.S. economy and is *significantly* interconnected to insurance companies and other financial firms through its products and capital markets activities. Because of Prudential's interconnectedness, size, certain characteristics of its liabilities and products,…material financial distress at Prudential could lead to an impairment of financial intermediation or of market functioning that would be sufficiently severe to inflict *significant* damage on the broader economy.[3] [emphasis supplied]

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[2] Joe Morris, "Fidelity not a 'systemic risk' in Barney Frank's book," *Financial Times*, December 8, 2013.

[3] Financial Stability Oversight Council, "Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc.," September 19, 2013, p2

Although this was a summary paragraph, it was never followed by any numerical or otherwise intelligible analysis of Prudential's effect on the market if it should encounter financial distress. In its 12 page statement, The FSOC used the term "significant" 47 times. The most useful numerical data in the whole statement were the page numbers. Thus, the first concern that Congress should have about the FSOC is that it is failing to circumscribe its discretionary authority in any way that will give financial institutions a way to change their activities in order to avoid a SIFI designation, or a way for Congress to determine whether the FSOC is carrying out its extraordinary mandate as Congress had intended. Or, indeed, whether the agency is acting arbitrarily in designating firms without a rational basis for doing so. If the agency is unable to meet these basic tests, its authority should be taken away.

Dodd-Frank suggests many factors that the FSOC should consider in addition to size—such factors as interconnectedness, leverage, and maturity mismatch—but the FSOC has refused to provide any indication of how these criteria will be weighted. For example, all financial firms are interconnected with others in some way, but what degree of interconnection will be considered a reason to designate a firm as a SIFI? The failure to specify how it will define and weigh these issues preserves maximum discretion for the FSOC but provides no useful information to firms that wish to avoid designation. The FSOC's designations of AIG and GE Capital, which preceded the designation of Prudential, were similarly opaque.

But there is another point that makes the FSOC's power particularly troubling. As noted earlier, the pattern established in bank regulation—and implicitly accepted by Congress—is that agreements among international regulators can become the rule in the US without the express approval of Congress. This pattern was established with the capital accords of the Basel Committee on Bank Supervision in the 1980s. We are all familiar with the substance of these capital rules, in which bank regulators from the developed countries got together and decreed that while 8 percent risk-based capital was the suitable capital charge for the risk of a corporate loan, only 4% was necessary for a mortgage and 1.6% for high quality mortgage-backed securities. These internationally-agreed rules were made applicable to all US banks by the US bank regulators. Congress never voted on any of this, although Congress clearly acquiesced in these rules. There was no debate on whether these rules were good policy.

It turned out that the Basel capital rules were terrible policy. They encouraged banks worldwide to buy mortgage-backed securities that were rated triple-A, because the capital charge was so small. And when the mortgage-backed securities market collapsed in 2007 and 2008, the resulting losses led directly to a financial crisis because most banks had followed the incentives created by the Basel capital rules. In other words, international regulatory accords, which can be very popular with *regulators* because they eliminate regulatory competition (usually called "opportunities for regulatory arbitrage" by the regulators) can be very bad policy, and can become law in the US without any kind of serious debate in Congress. This experience should give Congress pause before it acquiesces in a similar process again.

This is especially true in SIFI designations, where the FSOC has wide discretionary authority from Congress to identify specific institutions for special and stringent treatment. It would be unprecedented and not within the likely contemplation of Congress if this judgment were to be made through an international agreement among regulators, without the thorough case-by-case decision-making that Congress seems to have expected the FSOC to provide when

it makes SIFI designations. Yet that seems to be exactly what is happening now through the work of an international body of central banks, financial regulators and government officials called the Financial Stability Board (FSB).

The authority of the Financial Stability Board

In November 2008, shortly after the financial crisis, the leaders of the G-20 countries met in Washington, DC. There, they authorized the FSB to effect "a fundamental reform of the financial system, to correct the fault lines that led to the global financial crisis and to rebuild the financial system as a safer, more resilient source of finance that better serves the real economy."[4] Both the Treasury and the Fed are members of the FSB, along with representatives of all the major developed countries and many other international government organizations.

The fact that the FSB was directed by the G-20 leaders to bring about a fundamental reform of the international financial system is important. To the regulators and finance ministers that are part of the FSB process, the G-20 leaders are their political masters. From their point of view, the FSB is carrying out the policies of their leaders. President Obama was of course part of the G-20 leader group that directed the FSB to take steps that would make the financial system safer, so the Treasury is simply implementing this direction, like any other decision of the president. The political direction from the top undoubtedly makes it easier for the FSB to achieve consensus on specific steps. It also means that the FSB is not going to stop of its own accord until it gets a counter direction or meets an obstacle of some kind.

Thus far, the FSB has designated 39 banks and 9 insurance firms (including the US insurers AIG, Prudential and MetLife) as global SIFIs. In making these designations, the FSB did not announce publicly either the standards that it used, if any, or the way the standards were applied to the banks or insurance firms that were designated as SIFIs. In the case of the insurance firms, the International Association of Insurance Supervisors (IAIS) had developed (at the request of the FSB) a methodology that purported to assign weights to various activities. For example, mere size was accorded a 5% weight, while interconnectedness was accorded 40% and non-insurance or bank-like activities were accorded 45%. Whether one agrees with these weightings or not, it sounds like there could have been a legitimate designation process using these standards. But it was not to be. It seems instead that the FSB made its designations without saying how it applied the IAIS methodology to any particular insurer. This is a pattern that, as outlined above, has been repeated at the FSOC. It is typically adopted by regulators when they do not want to limit their discretion in the future. It is also the hallmark of a "we know-it-when-we-see-it" approach to designation that can't be what Congress had in mind for the FSOC.

One important question about how the FSB made its designations is the role of the Treasury and the Fed in the FSB's decision process. At the very least, both agencies had to acquiesce in that decision; it is highly unlikely that the FSB would have designated three US insurers as global SIFIs if the Treasury and the Fed had objected. A legitimate basis for such an objection would have been that the process of designation in the US was not complete, so the Treasury and the Fed could not vote in favor of the FSB's designation. If they did not raise an

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[4] Financial Stability Board, "Overview of Progress in Implementation of ther G20 Recommendations for Strengthening Financial Stability" *Report of the Financial Stability Board to G20 Leaders*, September 5, 2013, p3.

objection—in other words if they acquiesced—they had already prejudged the designation of Prudential before the decision was made by the FSOC. This should be unacceptable to Congress or any fair- minded person. In a hearing on May 8, 2014, Congressman Garrett tried but was unsuccessful in getting an answer from Treasury Secretary Lew that explained whether the Treasury had concurred or acquiesced in the FSB's Prudential designation. That is something that Congress must determine in order to decide whether the FSOC is carrying out a fair and honest inquiry when it designates financial firms as SIFIs.

Relationship between the FSB and the FSOC

It is likely that the FSB, which has no enforcement mechanism of its own, expects to follow the pattern of the Basel Committee on Banking Supervision when it makes its designations. In that case, an agreement among all the central banks and financial regulators that are participating in the decision will designate certain financial institutions to be SIFIs, and any special regulation associated with designation will be carried out by their home country regulators. If this process is followed, the FSOC will simply implement the FSB's decisions in the United States. Congress will hold hearings, but there will be no legislation, no debate and no vote. As noted above, it was a mistake for Congress not to raise questions about the Basel capital accords, and it would be another and more serious mistake for Congress to acquiesce in SIFI designations because they were made pursuant to an international agreement of regulators.

It is important for Congress to keep in mind that regulators are interested in broadening the breadth of their authority, and when they can reach an international agreement on regulations they enhance their authority because the regulated industries have fewer opportunities to avoid regulation by moving operations elsewhere. As noted earlier, regulators call this freedom of regulated firms to move elsewhere "regulatory arbitrage," but one advantage of regulatory competition (i.e., different rules in different places) is that it keeps regulation from stifling innovation and change. This is the lesson of the Basel capital accords, which drove many banks to invest in mortgage-backed securities and thus weakened them all at the same time when mortgages declined in value in 2007 and 2008, bringing on the financial crisis.

It may be that the Treasury and Fed, because of the G-20's direction, expect to follow the rulings of the FSB through the FSOC. There are several indications that this is what is happening. Thus far, it appears that the FSOC is simply implementing the earlier FSB policy and designation decisions. For example, the FSB has recommended that if money market mutual funds do not adopt a floating net asset value, they should be subject to capital requirements like banks.[5] The FSOC then pressured the Securities and Exchange Commission to adopt similar rules for money market funds. The FSB has indicated that all asset managers with assets of more than $100 billion may be subject to prudential regulation.[6] Then, the Office of Financial Research, another Treasury agency created by Dodd-Frank, produced two reports at the request of the FSOC to support the idea that large asset managers should be designated as SIFIs. The FSB has designated three US insurance firms as SIFIs—AIG, Prudential, and MetLife—and the

[5] Financial Stability Board, "Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability," September 5, 2013, 24.
[6] Financial Stability Board, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies," consultative document, January 8, 2014, www.financialstabilityboard.org/publications/r_140108.pdf.

FSOC has already designated AIG and Prudential as SIFIs and is currently investigating MetLife for a possible SIFI designation. These parallel decisions again suggest that unless Congress asserts its interests, the SIFI designation process will devolve into the implementation of policies and decisions of the FSB.

The likelihood that the FSB, the FSOC and the Fed will coordinate their activities is high. In a sense, it could not be otherwise; the Treasury and the Fed are members of the FSB, probably the most important members; if they participate in discussions that lead to an agreement, as they do, they have to implement that agreement in the US. Given the importance of the US market and US financial institutions, it is difficult to imagine that the FSB would make any SIFI designations without the concurrence of the Treasury and the Fed, and it is difficult to imagine that the FSB could designate a US financial firm as a SIFI while the FSOC does not. This would put the US firm in a position of operating at home and abroad under rules that are different from—and probably less stringent—than those imposed by the FSB. Similarly, if the FSOC were to designate a US firm as a SIFI while the FSB does not, the US firm would be at a competitive disadvantage in competing outside the US. Accordingly, it is reasonable to assume that the FSOC and the FSB are eventually going to come to identical conclusions for which firms are SIFIs and which are not.

This raises questions about the objectivity of the investigative and analytical work that the FSOC is supposed to do before declaring US firms to be SIFIs under the Dodd-Frank Act—a concern that is fully validated by the kind of analysis the FSOC did in the Prudential case. There, the FSOC produced what can only be called a perfunctory decision. All the bank regulators, who know nothing about insurance regulation, voted for designating Prudential as a SIFI, but Roy Woodall, the sole voting member of the FSOC who has insurance expertise and is the Independent Person appointed to the FSOC because of his insurance knowledge, had this to say in his dissent:

> In making its Final Determination, the Council has adopted the analysis contained in the Basis [the FSOC's statement of its reasoning and analysis]. Key aspects of said analysis are not supported by the record or actual experience; and, therefore, are not persuasive. The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems. As presented, therefore, the analysis makes it impossible for me to concur because the grounds for the Final Determination are simply not reasonable or defensible, and provide no basis for me to concur. [7]

Woodall played it straight, but the decision on Prudential seems to have been baked in the cake before it was made by the FSOC. The fact that the FSB, the preceding July, had already determined that Prudential was a SIFI—with the concurrence or at least the acquiescence of the Treasury and the Fed—made it inevitable that the FSOC would come to the same conclusion. It seems highly likely that the FSOC will make the same decision about MetLife, which has also

[7] Roy Woodall, "Views of the Council's Independent Member having Insurance Expertise," p1, http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf

been designated as a SIFI by the FSB. Clearly, if the Basel Committee's procedures are followed in the FSB and acquiesced in by Congress, many large nonbank financial institutions in the US may become subject to prudential bank-like regulation for reasons other than the objective analysis that Dodd-Frank expected the FSOC to apply.

The FSB, the FSOC and Shadow Banking

The most problematic element of the SIFI designation process is the transparent effort of bank regulators to get control of what they call "shadow banking." Since the financial crisis in 2008, central bankers and bank regulators world-wide have repeatedly called for controls on "shadow banking." Federal Reserve officials, including former Chairman Ben Bernanke, have been among the most outspoken on this matter. At the 2011 Cannes summit, and again at its Los Cabos summit in 2012, the G-20 leaders called on the FSB strengthen the oversight and regulation of "shadow banking." It would be interesting to know what the G-20 leaders thought they were approving when they endorsed a regulatory program for something as technical as shadow banking, especially since in 2011 it had not been defined by anyone at that point, including the FSB.

The FSB finally defined shadow banking in 2012. Shadow banking, it said, is "credit intermediation involving entities and activities (fully or partially) outside the regular banking system."[8] Taken literally, this language is absurdly broad, since it covers all financial intermediation that is not subject to bank-like regulation, but in subsequent statements the FSB has not stepped back from the breadth this definition.

It would be easy to define shadow banking narrowly and get at least some buy-in from the financial community. The defining characteristic of banks is that they perform something called maturity transformation—that is, they turn their short-term deposits into long term assets by making loans. It's a risky business, and in the modern world is somewhat protected by deposit insurance, which reduces the tendency of depositors to withdraw their funds (often called a run) when they believe the bank's financial condition is weak.

During the financial crisis there were a number of institutions—Lehman Brothers and Bear Stearns being two—that failed or came close to failing because they attempted to use short term repo financing to carry long term assets like mortgages. If we ignore the pejorative connotation associated with the term "shadow", the non-banks that did what banks traditionally do could logically be called "shadow banks."

But although this might be a reasonable inference from what happened in the financial crisis, it is not the inference that the FSB chose to draw when it came to defining shadow banking. Thus, in 2012, it noted that

> "[E]xperience from the crisis demonstrates the capacity for some non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability (longer-term credit extension based on short-term funding and leverage). Such risk creation may take place at an entity level but it can also form part of *a complex chain of*

[8] FSB, "Strengthening Oversight and Regulation of Shadow Banking," Consultative Document, November 18, 2012, p1

> *transactions, in which leverage* and maturity transformation occur in stages, and in ways that create multiple forms of feedback into the regulated banking system." [9][emphasis added]

As the FSB sees it, then, many entities in the shadow banking world work together to produce the maturity transformation that is the risky element of traditional banking. Former Fed chair Ben Bernanke—a strong and persistent backer of regulating shadow banks—provided an example of what the FSB is getting at in a 2012 speech:

> As an illustration of shadow banking at work, consider how an automobile loan can be made and funded outside of the banking system. The loan could be originated by a finance company that pools it with other loans in a securitization vehicle. An investment bank might sell tranches of the securitization to investors. The lower-risk tranches could be purchased by an asset-backed commercial paper (ABCP) conduit that, in turn, funds itself by issuing commercial paper that is purchased by money market funds.[10]

The problem with this, Bernanke went on, is that "Although the shadow banking system taken as a whole performs traditional banking functions, including credit intermediation and maturity transformation, unlike banks, it cannot rely on the protections afforded by deposit insurance and access to the Federal Reserve's discount window to help insure its stability."

Thus, to the extent that Bernanke reflects the underlying ideas circulating in the FSB—a good bet given the importance of the Fed in the world's financial system—the effort to control shadow banking is based on the idea that while it can create risky maturity transformation it does not have the necessary access to either the deposit insurance or the Fed's discount window that protect shadow banks against runs.

For this reason, apparently, the FSB is considering how to designate shadow banks—as defined above—as "systemically important financial institutions," or SIFIs. Thus, in September 2013, the FSB announced that it is "reviewing how to extend the SIFI Framework to global systemically important nonbank noninsurance (NBNI) financial institutions." This category of firms, said the FSB, "includes securities broker dealers, finance companies, asset managers and investment funds, including hedge funds."[11]

This is troubling for two reasons. First, the persistent calls by bank regulators to get control of "shadow banking"—even before it had been defined—calls into question whether bank regulators are doing this because they honestly believe that shadow banking is a danger to the financial system, or because shadow banking is a serious competitive threat to the traditional regulated banking system. It is interesting to note that as early as 2009 the Group of 30—another organization of bank regulators and financial experts—called for the regulation of large nonbank systemically important financial institutions, including large pools of capital, well before the term "shadow banking" had become widespread.

The second reason is that if they are successful in controlling what the FSB has now defined as shadow banking—that is asset managers, securities firms, investment funds, finance companies

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[9] Ibid.

[10] Ben Bernanke, "Fostering Financial Stability," Speech at 2012 Federal Bank of Atlanta Financial Markets Conference, p2

[11] FSB, "Progress and Next Steps Towards Ending 'Too-Big-to-Fail,'" Report of the Financial Stability Board to the G-20, September 2, 2013, p17.

and hedge funds, among others—they may succeed in stifling the continued growth of the securities and capital markets in the United States, which have been far and away the main sources of financing for US business. Both the competitive problem for banks and the potential problems for continued economic growth in the US are illustrated in the following chart, which shows the growth of the capital markets in relation to banks over the last 50 years.

The FSB is serious enough about this idea to suggest in January of this year that asset managers with more than $100 billion under management could be designated as SIFIs. Since pension funds, bond funds, and mutual funds don't engage in maturity transformation on their own, this latest sally must come under the category of "*a complex chain of transactions, in which leverage* and maturity transformation occur in stages."

This could explain why the FSB is considering asset managers as SIFIs, although they do not engage in maturity transformation, and the funds they manage are completely different from the banks or investment banks that suffered losses in the financial crisis. When a bank or investment bank suffers a decline in the value of its assets—as occurred when mortgages and mortgage-backed securities were losing value in 2007 and 2008—it still has to repay the full amount of the debt obligations it incurred to acquire those assets. Its inability to do so can lead to bankruptcy. But if a collective investment fund suffers the same losses, these pass through immediately to the fund's investors. The fund does not fail and thus cannot adversely affect other firms. In other words, asset management cannot create systemic risks,[12] yet the FSB seems bent on including the largest firms in this industry among the SIFIs it will designate. And, as outlined above, the FSOC seems to be following this lead.

Members of the asset management industry have argued, correctly I believe, that if the Fed attempts to impose capital requirements on managed funds those funds would quickly lose their investors. But this does not mean that the Fed would have no interest in regulating them—if that would enable the Fed to control the nature and scope of their investment activities. As the supervisor of fund managers the Fed could prevent them from engaging in making investments that are part of a "complex chain of transactions" that results ultimately in maturity transformation. As noted earlier, Section 115 of the Dodd-Frank Act gives the Fed the authority to engage in prudential supervision of nonbank SIFIs, and that would mean controlling their risk-taking. In addition "risk management" is one of the specific areas that the Section 115 says the Fed can consider when it supervises a SIFI.

This point highlights an important fact about the FSOC's designation process: the Fed has not made clear what restrictions it would impose on the insurance companies that have already been designated as SIFIs, on the asset managers the FSOC is now considering for designation, or on the securities and capital market firms of various kinds that might be designated in the future. It will be impossible for Congress to determine the effect of these designations until the Fed has clarified what it actually intends to do when it has the power to impose what the Dodd-Frank Act calls stringent prudential regulation, and how it intends to interpret what is called the Collins amendment, which requires that SIFIs hold capital in some form. Accordingly, in addition to all the other reasons for the SIFI designation process to stop, there is the further reason that neither the FSOC nor Congress can assess what effect

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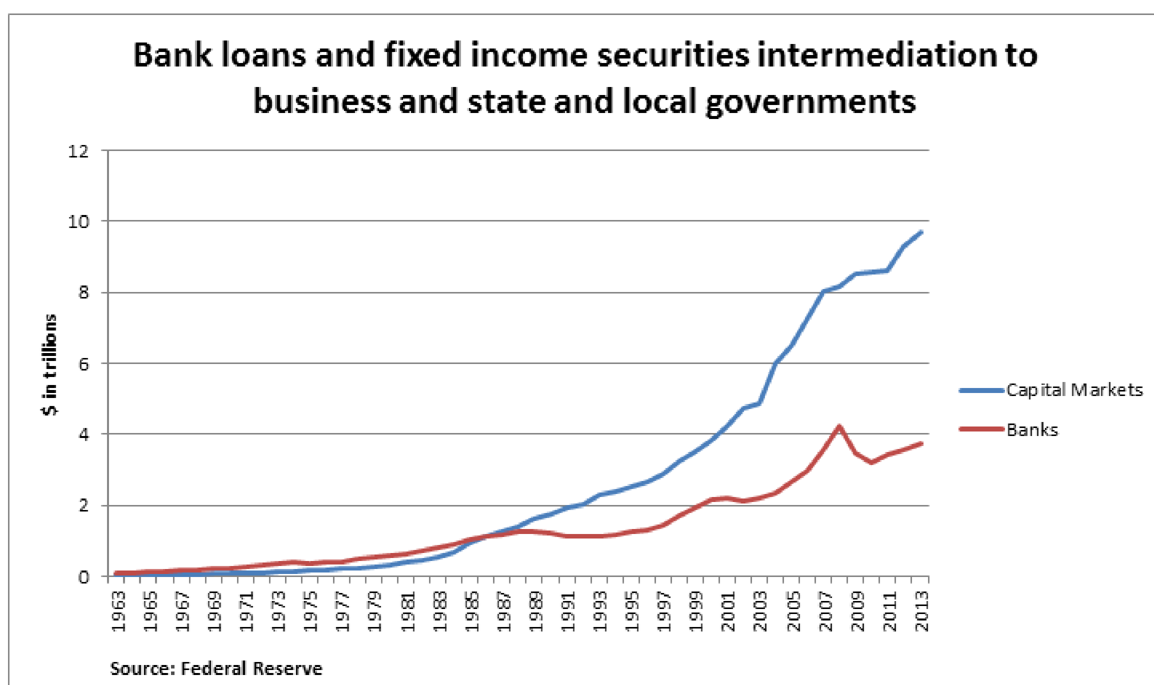
[12] See, Peter J. Wallison, "Unrisky Business: Asset Management Cannot Create Systemic Risk," *Financial Services Outlook,* January, 2014.

designations will have on the US economy until the Fed has made clear what restrictions it intends to impose.

Nevertheless, even without knowing exactly what the Fed intends to do, it is clear that an effort by the FSB and the FSOC to designate members of the securities and capital markets industry as SIFIs could have a highly adverse effect on economic growth and jobs in the US. Over the last 30 years, the success and growth of nonbank financial institutions (again, what the regulators call shadow banking) have reduced the importance of banks, and thus the importance and regulatory latitude of bank regulators. In the chart below, we can see that since the 1980s the securities industry—more generally the capital markets—have outcompeted the banks for financing corporations and states and municipalities.



One of the reasons for this is probably the tighter regulation of banks. The additional costs have made banks uncompetitive as financial sources for firms that can raise funds directly in the securities markets. Another and probably more important reason is that commission-based intermediation is inherently more efficient than principal intermediation by a bank. The communications revolution that occurred in the mid-1980s allowed corporations to disseminate directly to investors the financial information they were filing with the SEC. With that information, investors and analysts could make their own judgments about credit issues, buying bonds, notes and commercial paper from, and paying commissions to, securities intermediaries. The traditional intermediary advantage of banks—that they had information about companies that no one else had or could easily get—disappeared. Once the information was available elsewhere, the principal intermediation of banks was simply too expensive. This made it more difficult for regulators to restrict bank activities, since that only weakened banks further in the face of capital markets competition. If the main competition for banks can be brought under effective regulatory control, bank regulation can become even tighter.

The effects of regulation

The dollar effect of regulatory restrictions cannot be calculated. That is one of the reasons that economists do not try to estimate the cumulative effect of Dodd-Frank on economic growth. But the effect can be seen in the results of individual financial firms. In March, for example, JPMorgan Chase, the largest US banking organization, cut back its projections for the coming year, saying that its trading profits and return on equity would be down. It noted that it would also add 3000 new compliance employees, on top of the 7000 it added last year. But the total employees of the bank are expected to fall by 5000 in the coming year.[13]So what we are seeing is that compliance costs are being substituted for the personnel that are normally the sources of revenue and profit.

Often, these negative reports are blamed on slow business growth or lack of consumer spending, but this may be confusing cause and effect. If JPMorgan Chase were not substituting compliance officers for calling officers, the calling officers would be out in the market talking to businesses and offering them credit for expansion.

If what the FSB called the "SIFI Framework" is in fact extended to the rest of the financial system through decisions of the FSOC, the regulatory sclerosis that is affecting banks will be extended to the rest of the financial system and then to the economy as a whole. We can anticipate that credit will become more costly, simply because securities and capital markets entities will be doing a variation of what JPMorgan Chase is doing—hiring more compliance officials and substituting them for employees that are profitable for the firm. If credit is more expensive, some firms will be priced out of the market; the cost of borrowing will exceed the profit that could be earned from the additional productive resources put in place. If there is less borrowing, there will be less firm expansion and less equipment installed that will increase productivity. All of this will mean less economic growth.

Less tangible losses will also occur. If large capital markets firms are placed under bank-like supervision, they will take fewer risks. This is because it is the inclination of regulators and supervisors to reduce risk-taking for fear that it will cause losses for which they will be blamed. Less risk-taking will mean less innovation, fewer new efficiencies tried and, again, slower growth. Yes, there will be fewer failures of financial firms, but at the same time there will be fewer new start-ups because there will be less credit for start-ups, which are riskier than established firms.

Finally, we have the problem of too-big-to-fail (TBTF). This is a serious problem in the banking industry, where we have a few gigantic banks that are considered SIFIs as well as more than two dozen others that were designated as SIFIs by the Dodd-Frank Act because they have more than $50 billion in assets. A SIFI designation is a statement by the government that the firm will not be allowed to fail because its failure could cause instability in the US financial system. That's what it means when the FSOC says that a firm's "financial distress" will cause "instability in the US financial system."

If the government will not allow a firm to fail, creditors will see it as a safer investment than other firms that do not have this designation, and as a result its cost of credit will be lower because it will be seen as less likely to fail. We do not know how to solve the TBTF problem in

[13] Dan Fitzpatrick, "J.P. Morgan Dims Its Light on 2014," *Wall Street Journal*, February 26, 2014.

the banking industry, but with SIFI designations for nonbanks we are going to create the same problem in other industries.

The SIFI designations that have already occurred in the insurance industry could create TBTF in insurance, where it has never been a problem before. This would be particularly acute in the insurance market, where competition is often about which is the safest insurer from which to buy coverage against various risks. A company that is designated by the government as TBTF will be able to attract business because it is unlikely that it will ever fail—a key selling point. In addition, insurers that have been designated as SIFIs might also be able to attract lower cost funding for the same reason that is true of the TBTF banks.

Thus far, TBTF has not been a problem in the capital markets. It has always been assumed that capital markets firms could fail. Indeed, they are supposed to be risk-takers while banks are supposed to be more cautious and safer. However, if SIFI designations begin in the securities and capital markets business it could bifurcate the market with firms that are seen as protected by the government having better and lower cost access to credit than firms that don't. This could eventually cause the kind of consolidation of the market that has happened in banking.

Or, it could work the other way. Barney Frank was fond of saying that if SIFI designation would make firms TBTF, why were so many firms fighting it? The answer is that no firm knows what kind of regulatory costs they will face once they have been designated as a SIFI. The costs could far outstrip the benefits. But from a policy perspective that would not be good either. It would mean that these large SIFI firms would not be able to compete effectively with their more nimble and less regulated competitors. In that case, we would end up with a lot of firms in "financial distress" that the government has said will create "financial instability" if they fail. One thing is clear: it will never happen that the benefits of being TBTF are exactly matched by the detriments of regulatory costs. One or the other will be the outcome, and neither is acceptable as a matter of policy. One way or the other, we will have made a huge mistake if we allow the largest firms in the nonbank financial industry to be designated as SIFIs and thus regulated like banks.

Conclusion

Congress should be wary of the FSOC's extraordinary discretionary authority. This authority is the result of a misperception that the financial crisis was caused by insufficient regulation of the financial community. The Dodd-Frank Act was the result. The actual cause was the US government's housing policies. Nevertheless, if Dodd-Frank can't be repealed at this point, Congress should at least have an opportunity to consider the effects of SIFI designations before they are made. The potential adverse effects of these designations are too important to be left for consideration by regulators, who are eager to extend their control over the financial system.

Despite the apparent appetite of both the FSB and the FSOC for placing what the FSB calls a "SIFI Framework" over "shadow banking," –asset managers, mutual funds, securities firms and hedge funds, among others—there is no indication that these entities had any role in the financial crisis. Instead, these firms have been the key organizations that have financed

American business over the last 30 years, and subjecting them to bank-like prudential regulation could do serious damage to the US economy.

Your recent request, Mr. Chairman, that FSOC "cease and desist" any further designations until Congress has an opportunity to consider the consequences for the economy, should be recognized by the FSOC as reasonable—and obeyed. If it is not, Congress should consider repealing the authority of the FSOC to designate SIFIs and to release from Fed regulation and supervision the firms that have already been designated.