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The Financial Stability Oversight Council and the Financial Stability Board: Issues in International Regulation

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Chairman McHenry, Ranking Member Green, and members of the subcommittee:

Thank you for the opportunity to testify this afternoon on a number of issues in international financial regulation that I believe deserve serious attention by Congress. 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 firms, finance companies, private equity firms, and hedge funds. The services of these companies enable Americans to save for the future, buy and sell assets, and retire comfortably. As important, financial services firms provide the 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 major 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 decisions that affect the US financial industry. In the case of banking regulation, Congress has generally not intervened in the development of the bank capital regulations—Basel I, II and III—as these were developed, agreed internationally among bank regulators, and applied to the US banking industry. However, as discussed later in this testimony, there are reasons to believe that this abstention was not a good idea.

The Dodd-Frank Act, the FSOC, and the 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, which 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 and they don't; they seem generally to follow the directions of the Treasury secretary.

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). To implement this idea, Section 113 authorizes the FSOC to designate a nonbank financial firm as a systemically important financial institution (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 regulation which the act requires to be more "stringent" than the regulation to which they are ordinarily subject. Other elements of the act suggest that this regulation be prudential and bank-like—that is, it should involve their capital and their risk-taking activities.

This 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 and the FDIC improvement Act of 1991. The Enron scandal produced the Sarbanes-Oxley Act. All these new laws promised to prevent the recurrence of the prior events. As we can see from the 2008 financial crisis, none of them succeeded.

The 2008 financial crisis was no different from 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, regulation 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 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 control any large financial firm that the government wants to regulate.

The practical effect of this huge shift in regulatory policy was a large increase in the potential reach of bank-like prudential regulation and thus a large 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. It seems reasonable that Congress should have a say, at the very least, about how this unprecedented change in the scope and range of regulation is being implemented, especially because the degree of regulation can have a substantial effect on economic growth and the well-being of all Americans.

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[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

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 never intended that asset managers should be considered SIFIs.[2] Nevertheless, the breadth of the language in the congressional authority given to the FSOC would allow them to go 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. 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 it initially suggested that it would challenge the FSOC's decision, but after going through a pro forma administrative appeal process decided not to engage.

Thus, because the 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, wide discretionary power can result in arbitrary, capricious and politically-based administrative decisions. This can be rectified if an agency develops and applies standards that limit its own discretion, provides a roadmap for compliance by affected companies, and allows the basis of its decisions to later be judged by Congress and the public. However, the FSOC has not developed any standard. 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 restrict 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 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

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

functioning that would be sufficiently severe to inflict *significant* damage on the broader economy.[3] [emphasis supplied]

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. If the agency is unable to do this, its authority should be restricted.

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 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 never any debate on whether these rules were good policy.

It turned out that the 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 "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 harsher 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 might be exactly what is happening now through the work of an international body of financial regulators and government officials known as the Financial Stability Board (FSB).

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

The authority of the Financial Stability Board

In November 2008, shortly after the financial crisis, the leaders of the G20 countries met in Washington, DC. There, they authorized an international organization now known as the Financial Stability Board 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, such as the International Monetary Fund, the Basel Committee on Bank Supervision, the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS).

Thus far, the FSB has designated 39 banks and 9 insurance firms (including the US firms AIG, Prudential and MetLife) as global SIFIs. In making these designations, the FSB did not indicate either the standards that it used 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 IAIS had developed 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 a legitimate process of designation would be followed. But it was not to be. 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.

If the FSB follows the pattern of the Basel Committee on Banking Supervision, an agreement among all the central banks and financial regulators that are participating in the decision will declare certain additional financial institutions to be SIFIs, as they have already done with 39 banks and 9 insurance firms. The designations will be published for comment by the affected parties, altered as the FSB deems appropriate after the comment period, and eventually adopted; they then become binding on all the affected firms because their regulators have reached an accord with regulators elsewhere. In this process, Congress will hold hearings, but—if the Basel process is followed—there will be no legislation, no debate and no vote.

Since it has been supercharged by the G20, the FSB does not lack ambition. In addition to its designation of certain banks and insurance firms, it has suggested that large asset managers should be designated as SIFIs, recommended that MMFs hold capital if they do not adopt a floating NAV, and announced that it is planning to go much further to press bank-like regulation of nonbank financial firms. In a report on September 2, 2013, for example, it stated: "The FSB is reviewing how to extend the SIFI Framework to global systemically important non-bank non-insurance (NBNI) financial institutions. This category of firms includes securities broker-dealers, finance companies, asset managers and investment funds, including hedge funds."[5]

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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.
[5] 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.

To demonstrate how radical this idea is, consider the treatment of asset managers as SIFIs. This would be a major extension of government power. Collective investment funds 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 funds. In other words, asset management cannot create systemic risks,[6] yet the FSB seems bent on including the largest firms in this industry among the SIFIs it will designate. And, as outlined below, the FSOC seems to be following this lead.

I have covered the FSB in detail for a reason. Since the Treasury and the Fed are both members of the FSB, there is a substantial likelihood that they will sign on to its decisions, and if the FSB's recommendations follow the pattern that has been pursued thus far by the Basel Committee on Bank Supervision and US bank regulators, the FSB's SIFI designations will be adopted in the US by the FSOC without any specific authorizing legislation by Congress. To be sure, the FSOC has this authority already, but it is one thing for the FSOC to make its decisions based on an independent and objective analysis contemplated under the Dodd-Frank Act, but quite another for the FSOC to designate particular US firms as SIFIs by agreement or compliance with a decision by an international organization.

It does not appear that the FSOC has been authorized by the Dodd-Frank Act to do this. Section 175 of the act authorizes the president to "coordinate through all available international policy channels, *similar policies as those found in United States law* relating to limiting the scope, nature, size, scale, concentration, and interconnectedness of financial companies, in order to protect financial stability and the global economy." [emphasis supplied] The language focuses on *policies*, not on the designation of specific institutions as SIFIs. The FSOC is authorized in the same section to consult with international organizations, and the Fed is authorized to *consult* with these organizations to "encourage comprehensive and robust prudential supervision and regulation for all highly leveraged and interconnected financial companies." This language does not amount to an authorization for the FSOC or the Fed to *agree or comply* with an international body like the FSB on which specific financial institutions should be designated as SIFIs; it is phrased as a direction to the Fed to press international bodies to do what the Fed is doing on supervision and regulation.

Thus, the Dodd-Frank Act authorizes the FSOC to designate, and the Fed to regulate, banks and nonbank financial institutions that are deemed to be a threat to the stability of the US financial system, but the act does not authorize the FSOC, the Fed or the Treasury Department to enter into international agreements that designate specific US firms as SIFIs. Yet the evidence thus far suggests that the FSOC is in fact coordinating its activities with the FSB. For example, as noted above, the FSB has recommended that if money market mutual funds do not adopt a floating net asset value (NAV), they should be subject to capital requirements like banks.[7] FSOC

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[6] See, Peter J. Wallison, "Unrisky Business: Asset Management Cannot Create Systemic Risk," *Financial Services Outlook,* January, 2014.
[7] Financial Stability Board, "Overview of Progress in the implementation of the G20 Recommendations for Strengthening Financial Stability" September 5, 2013, p24

then pressured the SEC to adopt similar rules for MMFs. The FSB has indicated that all asset managers with assets of more than $100 billion may be subject to prudential regulation,[8] and the Office of Financial Research (OFR), another agency created by Dodd-Frank, has produced two reports at the request of the FSOC to the effect 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 FSOC has already designated AIG and Prudential as SIFIs and is currently investigating MetLife for a possible SIFI designation.

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; if they participate in its discussions they have to agree with its decisions. 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. Moreover, 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 abroad under rules that are different from those imposed by the FSB, and may mean that it would not be able to operate abroad at all. 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 the independent person appointed to 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. [9]

Roy 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, in in the preceding July, had

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[8] FSB, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Importyant Financial Institutions: Proposed High Level Framework and Specific Methodologies," *Consultative Document,* January 8, 2014.

[9] 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

already determined that Prudential was a SIFI—with the concurrence 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 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.

Are the interests of US firms being protected?

The next legitimate question, then, is whether the interests of US financial institutions are being protected by the Treasury's and the Fed's involvement in the FSB's deliberations. Ideally, one would hope this is true, but the fact is we'll never know. The deliberations of the FSB are secret. Neither the public nor the media are permitted to observe. After the meetings, there is occasionally a brief report on the deliberations, but not in enough detail to reveal who said what.

At this point it is important to point out that what's at stake in these meetings is not necessarily the interests of the private sector in each country, particularly the US. As noted earlier, the narrative that came out of the financial crisis—that private sector risk-taking and lack of adequate regulation caused the crisis—has given rise to the idea that every large financial firm, not just large banks, could be potentially dangerous. If so, regulators believe they need the power to control all risk-taking by large financial firms, which means placing all large financial institutions—not just banks—under prudential, bank-like regulation.

Although we cannot know what goes on in the FSB and FSOC meetings, we can understand the incentives. What is important to the regulators is to come to some agreement that will allow them to extend their authority over more of the financial system—essentially what they call "shadow banking." In effect, they are trading with other people's money. The US regulators are not likely to hold out for better treatment for US financial firms if that prevents an international agreement that will help them extend their regulatory control over shadow banking in the US.

One way to prevent this secret negotiation for power, of course, is for Congress to insist that it, or at least the media, have an opportunity to observe the proceedings of the FSB and the FSOC. The US has laws like the Government in the Sunshine Act and the Federal Advisory Committee Act to prevent government agencies from engaging in private deal-making at the expense of the public's interests. These laws can be easily circumvented, and are, and in some cases are more harmful than beneficial, but the FSB and the FSOC have such enormous discretionary power, and can cover so much of the world's economy, that they are exactly the kinds of government institutions that should be open to objective scrutiny. The FSOC, in particular, is so secretive that non-chair members of regulatory bodies are not permitted to attend. This insures that no views other than the current administration's, are likely to be seriously considered at meetings. (For some reason, an exception is made for the Fed; at least one governor, in addition to the chair, is permitted to attend.)

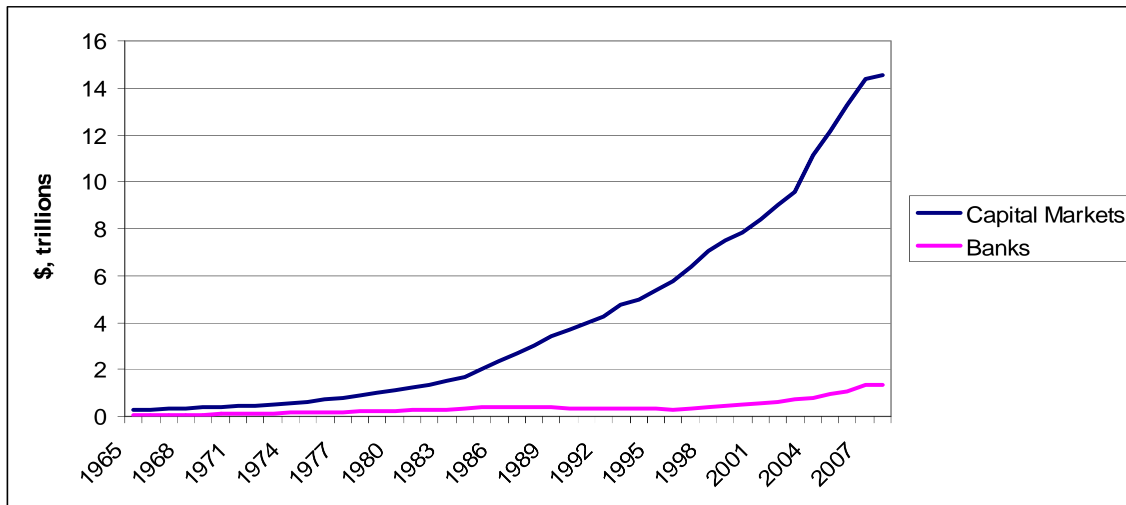
There is also another point that should be mentioned here—that the success and growth of nonbank financial institutions (again, what the regulators call shadow banking) over the last

30 years has 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.

This is because commission-based intermediation is inherently more efficient than principal intermediation. 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.

Chart 1 compares the cumulative level of financing for business corporations and state and local governments from 1965 until 2007. As can be seen, securities intermediation through the capital markets—generally, what the regulators call the shadow banking system—has substantially out-competed the banks. It is easy to imagine what would happen to business and state and local credit if the shadow banking system were brought under the control of bank regulators.

Chart 1. Bank loans and fixed income securities intermediation to business and state and local governments, in trillions of dollars



Source: Federal Reserve Flow of Funds Level data

Examples of international and US rules that will have major effects on the US growth

The Dodd-Frank Act itself, by imposing enormous regulatory costs on all parts of the financial system, is in my view one of the major causes of the slow US recovery from the recession that followed the financial crisis. Much attention has been focused on the Affordable Care Act, of course, but there is at least as strong a case that—in addition to compliance costs—Dodd-Frank has created so much uncertainty and so much fear of regulatory intervention among financial services firms that the normal level of risk-taking in the US financial industry has been blunted. In some cases, as discussed below, certain kinds of activity, formerly profitable and vital to the economy, have been impeded by specific provisions in Dodd-Frank and new regulations on banks.

Notable examples are the Liquidity Coverage Ratio adopted by the Basel Committee, and the Volcker Rule adopted in Dodd-Frank.

Liquidity Coverage Ratio

In January 2013, the Basel Committee on Banking Supervision unanimously endorsed a concept known as the Liquidity Coverage Ratio (LCR). At the time, Mervyn King, chairman of the Basel committee that developed the LCR, said "The Liquidity Coverage Ratio is a key component of the Basel II framework. The agreement reached today is a very significant achievement. For the first time in regulatory history, we have a truly global minimum standard for bank liquidity."[10] He is assuming, based on past precedent, that whatever the bank regulators agree will be the rule everywhere. Legislatures, like the US Congress, won't interfere.

The LCR requires a banking organization (that is, a bank holding company (BHC) and its subsidiaries) to maintain a minimum amount of liquid assets to withstand a 30 day liquidity stress event. The rule outlines the kinds of liquid assets that must be held in order to put the BHC in a position to withstand a 30 day liquidity crunch. The US rule appears to be somewhat stricter than the European rule, but all BHCs world-wide must comply. Because liquid assets like Treasury bills and reserves at the Fed have very low yields, this rule will be very costly to banks and BHCs. We get the idea; if banking organizations hold more liquid assets they won't be caught short if we have another event like the financial crisis. Leaving aside the question of whether such an event is likely in the near future—the last one appears to have been in 1907, one hundred years ago—what affect will it have on banks and other financial institutions, those designated as SIFIs, that will be regulated like banks?

From what we know about regulatory requirements that are globally applicable, we should be wary of the LCR. Recall that the exception to the bank capital requirements for mortgages and mortgage-backed securities turned out to be a disaster for the world's banking system, bringing on the financial crisis and the Dodd-Frank Act. The LCR is another of these universally applicable rules, like the capital requirements in Basel I, II and III. As Mervyn King noted proudly, the LCR requires all banking organizations to do the same thing, and although it is difficult to predict how this could backfire in the future, we have to recognize that it could. For one thing, maintaining this liquidity buffer eliminates some of the market discipline that comes from depositors refusing to make deposits, or withdrawing funds, if they don't like the bank's

[10] Bank for International Settlements, "Group of Governors and Heads of Supervision endorses revised liquidity standard for banks," January 6, 2013. http://www.bis.org/press/p130106.htm

risk-taking posture. Since banks will now have large liquidity pools, depositors will be less worried about their ability to pull out their deposits if the bank gets in trouble. Thus, while the LCR will certainly mean reduced bank profitability (LCR assets do not produce much yield), it might also enable them—by reducing market discipline—to take more risks in order to recover that profitability. That's the way uniform rules come back to bite the framers. As with all universally applicable rules, we will not be able to compare how banks that are not subject to the rule behave. We also have to consider that if all SIFIs are going to be regulated like banks, they will be subject to the same LCR requirements, and will also be less profitable, setting in motion not only competitive effects in every industry but the likelihood that they too will take more risks in order to recover their profitability—and will be allowed to do so because their LCR will reassure their short-term creditors.

Volcker Rule

On the subject of rules that may backfire, one can't ignore the Volcker Rule. The rule prohibits proprietary trading of securities by banking organizations (a BHC and its bank and nonbank subsidiaries). Proprietary trading involves buying and selling securities for one's own account and not for the account of customers. There has never been any indication that prop trading by banking organizations (or anyone else) had any role in the financial crisis. The rule was advertised as preventing banks from using insured deposits for risky trading activities, but that claim was false in two ways. First, the Volcker rule applies to the holding company and all nonbank subsidiaries, as well as subsidiary banks. BHCs and their nonbank subsidiaries have no access to insured deposits, so preventing them from prop trading was not the result of any effort to protect insured deposits. Second, prop trading, which was a profitable activity that allowed banking organizations to make use of their financial knowledge, helped them understand what was happening in the market on a daily basis, and allowed them to participate in a growing business, is less risky than lending, which is something banks are encouraged to do. When a bank makes a loan, it is putting funds in another entity's hands and rarely has effective control over whether those funds are used effectively. In prop trading, the bank holds a portfolio of debt securities which it can liquidate at any time if it thinks the securities will lose value in the future.

In addition, while the Volcker Rule prohibits prop trading, it permits banking organizations to engage in market making and hedging. Market-making is a vital market function. The debt markets are not nearly as liquid as the equity markets. There is frequently no exchange where an investor can buy or sell a debt security. If investors are not able to sell a security easily, they are taking a risk in buying it. The market maker reduces this risk by standing ready to buy a security when approached by an investor who wants to sell. Hedging, which reduces risks on investments, is also an essential activity for every financial and non-financial firm. Market making, however, is close to prop trading. A market maker must hold a portfolio of securities it is willing to buy or sell. But banking organizations that engage in it are in jeopardy of violating the Volcker Rule; it is frequently the intent of the trader that may determine whether a particular trade is a market-making trade or a prop trade. If it's the latter, the banking organization could be subjected to a fine; this could also be a career-ending event for the trader.

So banks will be much less likely to engage in market-making after the Volcker Rule, and that will raise the costs in the market for issuers, buyers and sellers of debt securities, because the market will be less liquid and thus riskier all around. Congress recognized this in Dodd-Frank, when it exempted Treasury securities from the prop trading restrictions.

Finally, the Rule also permits banks to engage in hedging transactions, which of course it should, since hedging reduces risk. But again, a hedging transaction, in which a bank buys or sells a security to offset the risk of some other transaction, can look a lot like a proprietary trade. The rule requires the banking organization to demonstrate that hedging trades actually hedged a specific risk. In some cases, this could be difficult because of the nature of the underlying transaction, so in order to avoid violating the Volcker Rule the bank will not engage in the underlying transaction. It is important to note that the underlying transaction may not be particularly risky in itself, but attempting to hedge it may involve the bank in what might appear to be a proprietary trade, creating what might be called regulatory risk. So, to avoid this risk, banking organizations may avoid the underlying transaction, thus reducing credit for consumers or businesses.

My AEI colleague, Paul Kupiec, has pointed out that the Fed has attempted to cut back on leveraged loans because of a belief that a bubble is developing in leveraged lending. He notes that this is a major change from the past, when regulators looked at a bank's entire business and decided whether as a whole it was being well-managed. The specific investments banks made were not questioned. Now, the regulators are substituting their judgment for bankers' judgments about specific kinds of loans. This will inevitably have an effect on bank lending and the availability of credit. Nonbank SIFIs that are eventually consigned to Fed regulation will no doubt be subject to the same intrusive treatment. Can we imagine a time when the government will be approving all lending, perhaps loan-by-loan, and how different will this be from the government dictated lending that occurs in China?[11]

Cumulative effect

The cumulative effect of these and other 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. Just this past week, 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,[12] 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.

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[11] Paul Kupiek, "When Governments Direct Bank Credit, the Economy Suffers" *Financial Services Outlook,* March, 2014.

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

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 JPMorgan Chase will be extended to the rest of the financial system and then to the economy as a whole. Congress created the Dodd-Frank Act and the FSOC; it can surely indicate that it will oppose this result.

Conclusion

Congress should be wary of the FSOC’s extraordinary discretionary authority. Whenever possible, the agency should be pressed to set out its standards in numerical terms, so firms and Congress will know what rules it is following and firms in danger of SIFI designations will understand what they should or should not do to avoid a SIFI designation. At the same time, Congress should rein in the tendency of the FSOC to simply implement the decisions of the FSB in the US. The FSOC’s decisions on SIFI designations should be made on the basis of clear standards and guidelines about when an institution’s distress can have such a substantial negative effect on the market that another financial crisis might result. It cannot be simply a matter of regulatory discretion. One first step would be to require both the FSB and the FSOC to open their meetings to observers, so that the information they have and true reasons for their decisions become clear.

If these efforts are not effective, Congress should consider repealing the authority of the FSOC to designate SIFIs. Despite the apparent appetite of both the FSB and the FSOC for placing what the FSB calls a “SIFI Framework” over asset managers, mutual funds, securities firms and hedge funds, 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 35 years, and subjecting them to bank-like prudential regulation will do serious damage to the US economy.