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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

<u>The FSB Perspective on Shadow Banking and Insurance Regulation</u>

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

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

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

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

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

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

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

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[2] Schich, Sebastian, "Insurance Companies and the Financial Crisis", OECD Journal, Financial Market Trends, Volume 2009, Issue 2, Organization for European Cooperation and Development, October, 2009.

[3] McKinsey Consulting, "Responding to the Variable Annuity Crisis", McKinsey Working Papers on Risk, April, 2009; Du David Fengchen and Cynthia Martin, "Variable Annuities – Recent Trends and the Use of Captives", Federal Reserve Bank of Boston, October 7, 2014.

[4] Acharya, Vidal and Matthew Richardson, "Is The Insurance Industry Systemically Risky?", Conference Paper for Brookings Institution Conference On Insurance Regulation, October 14, 2014; Merrill, Craig B. and Nadauld, Taylor and Stulz, René M. and Sherlund, Shane M., "Were There Fire Sales in the RMBS Market?" Charles A. Dice Center Working Paper No. 2014-09; Fisher College of Business Working Paper No. 2014-03-09, May, 2014.

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

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

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

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

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[5] Eisinger, Jesse and Jake Bernstein, "The Magnetar Trade: How One Hedge Fund Helped Keep the Housing Bubble Going", Pro Publica, April 9, 2010.

[6] Price Waterhouse Cooper UK, "Unlisted Funds -- Lessons From the Crisis, Report for the Association of Real Estate Funds", January, 2012.

[7] Aslan, Hadiye, and Praveen Kumar, "Spreading the Fire: Investment and Product Market Effects of Bond Fire Sales", American Finance Association Conference Paper, January 5, 2015.

[8] Cetorelli, Nicola, Fernando Duarte and Thomas Eisenbach, "Are Asset Managers Vulnerable to Fire Sales", Liberty Street Economics Blog, New York Federal Reserve, February 18, 2016.

[9] Goldstein, Itay, Hao Jiang and David T. Ng, "Investor Flows and Fragility in Corporate Bond Funds", Wharton Finance Working Paper, May, 2016.

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

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

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