Statement before the House Financial Services Committee
Subcommittee on Oversight and Investigations
On "The Arbitrary and Inconsistent Non-Bank SIFI Designation Process"

Is there a uniform standard for FSOC designation?

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Chairman Wagner, Ranking Member Green, and distinguished members of the subcommittee, thank you for convening today's hearing on the FSOC non-bank SIFI designation process, and for inviting me to testify. I am a resident scholar at the American Enterprise Institute, but this testimony represents my personal views. My research is focused on banking, regulation, financial stability and systemic risk. I have prior experience working on these issues at the Federal Reserve Board, the IMF and the FDIC, including as chairman of the Research Task Force of the Basel Committee on Banking Supervision. It is an honor for me to be able to testify before the committee today.

I want to begin my testimony with an analogy that explains the deficiencies in the FSOC designation process using an everyday commuting experience to which many can relate.

When you or I are driving west on K street in Washington DC, and we see a bright burst of light as we approach the 22nd street underpass,[1] we instinctively check our speedometers, recall the posted speed limit, and quickly try to assess whether it was our vehicle that triggered the photo ticketing camera.

Now instead imagine that you are the CEO of a large, very successful, nonbank financial firm. One day you experience a sudden spike in blood pressure when you receive an email from the FSOC informing you that your institution has been selected for a stage-three FSOC designation review.

Stage-three review, you ask? We had no idea the FSOC had already concluded a stage-two examination. Our institution is profitable, well-capitalized and growing. Our state regulators have given us a clean bill of health. No one on staff can imagine what our institution may have done to trigger the FSOC's ire.

Keeping with the speeding ticket analogy, now ask yourself: Is there a speed limit for the institution? How fast is the firm going? How fast does the FSOC think the firm is going? Where can the institution find out answers to these questions?

And then you discover---there are no definite answers to these questions.

The FSOC has the power to set individual speed limits for each and every nonbank financial institution under its designation jurisdiction. Frustration builds when you learn that the FSOC does not have to disclose your institution's speed limit—even if you pay your white-shoe law firm to make a formal request. Worse still, you learn that the FSOC is the only agency that has the authority to measure your firm's velocity, and since your firm is in a stage-three review, the FSOC's "scientists" are already measuring your institution's speed using an unknown process without any impartial witnesses present.

If this nightmare of jurisprudence reminds you of the twilight zone, the episode you are watching is entitled "The Dodd-Frank Act."

[1] https://www.youtube.com/watch?v=G2qiifHBO3o

A central tenet of the Dodd-Frank Act (DFA) is idea that some financial firms are too big or too important to fail, and that these so-called "systemically important financial institutions" (SIFIs) must be identified and subjected to supplemental government supervision. This tenet is rooted in the mistaken belief that the financial crisis was *caused* by the failure of large financial institutions.

In truth, the financial crisis was caused by a number of factors including poorly designed capital regulations that allowed excessive financial institution leverage and misguided government housing policies that encouraged consumers to overextend themselves purchasing real estate using poorly underwritten mortgages. Financial institutions ultimately failed because the firms took on excessive leverage to buy securities backed by the debt of overleveraged consumers. Underlying imbalances—excess consumer leverage and excess financial sector leverage—caused the financial crisis. The large financial firms that failed in fall of 2008 were a casualty—not the cause—of the financial crisis.

To be clear, the pre-crisis problem was not that financial regulators has insufficient powers to require minimum standards for safety and soundness of the firms that they regulate. Instead, the problem was that regulators exercised poor judgement and promulgated weak regulations. Even before the financial crisis, regulators themselves set the minimum regulatory capital standards that applied to the financial institutions under their charge. Regulators could have chosen to exercise their powers and adopt a more prudent standard, but they didn't. They had the power to set stricter standards without the DFA—they just did not exercise this power prudently.

Post DFA, regulators still set the minimum capital standards that apply to firms under their charge. In that regard, nothing has changed. DFA merely adds an additional requirement that designated institutions be subjected to enhanced capital and liquidity standards. However, the DFA does not specify the actual standards that apply to designated institutions. Instead, as it did before the crisis, the design of the enhanced capital and liquidity standards for designated firms is left to regulators—in this case the Federal Reserve Board.

In the case of bank holding companies, the DFA language itself identifies the SIFIs that are to be subjected to Dodd-Frank's "too-big-to-fail" regulatory regime. With regard to non-bank financial firms, the DFA delegates SIFI identification to the financial stability oversight council (FSOC) and delegates the Federal Reserve Board with the duty to develop and impose an appropriate too-big-to-fail regulatory regime for non-bank SIFIs.

The DFA Act identifies bank holding company SIFIs on the basis of consolidated balance sheet size alone. In the case of non-bank SIFIs, the DFA includes specific criteria to guide the FSOC in its duty to identify non-bank SIFIs. A non-bank financial firm must have a minimum share of its assets (85 percent) invested in financial activities or earn a minimum share of its revenues (85 percent) from financial services to be eligible for FSOC designation. Among non-bank firms that meet this threshold, the FSOC may designate a firm if: (1) its financial distress could pose a threat to the financial stability of the United States; or, (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the company could pose a threat to the financial stability of the United States.

Aside from specifying the criteria the FSOC may use to identify non-bank SIFIs, the DFA is silent regarding any specific thresholds regarding size, market concentration, leverage, credit ratings, the nature of activities, scope of activities or any other factors that should trigger a designation. The FSOC is left to devise the rules, processes and detailed guidelines that it will use to designate non-bank institutions as SIFIs.

When the FSOC designates an institution, it provides a public background brief that explains the FSOC's rational for designation.[2] Many, including appellant judges, have been critical of the level of detail that has been provided in these public justifications. To date, FSOC designations that have been made have argued that the institution's financial distress could pose a threat to the financial stability of the United States. However, in its designation justifications, the FSOC has provided few details—too few to convincingly support its designation conclusions.

For example, in its designations to date, the probability that the designated financial institution might face financial distress is never explicitly assessed or discussed. The FSOC begins its assessment assuming that the firm being designated experiences financial distress. This assumption would seemingly violate the FSOC's legal responsibility to assess an institution's potential for creating systemic risk taking into account the supervisory processes and regimes that are already in place. To date, all FSOC-designated firms are supervised by (numerous) state insurance regulators. To the best of my knowledge, none of the state insurance regulators with jurisdiction have raised concerns regarding the solvency status of the insurance subsidiaries of FSOC-designated institutions.

The FSOC's assumptions regarding the mechanics of designated firms' financial distress typically mirror those of a classic bank run even though designated companies are insurance companies without a preponderance of deposit-like liabilities. The institution's financial distress is then assumed to cause distress for other important financial market participants because the firms are alleged to be "highly interconnected." How the FSOC concludes that the firms' are highly interconnected is unknown as other financial firms' net exposures to the FSOC-designated firms are never explicitly calculated. Indeed, such conclusions are almost certainly speculative as the necessary exposures information cannot be calculated based on information the FSOC might acquire from the designated firm alone.[3]

In its recent report (GAO-15-51), the General Accountability office found (p. 39) that, "the FSOC did not develop a process or additional guidance for identifying detailed and specific analytical methods or prescriptive criteria for applying the analytical framework in evaluating companies." Until the Subcommittee on Oversight and Investigation released its recent report,

[2] https://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx

[3] The FSOC has the power to require any information it deems necessary to make its assessment from the institution that is a candidate for designation, and yet this information would not be adequate to determine counterparties' exposures to the candidate for designation. For example, counterparties to the designated firm could offset (or acquire) exposure in swap markets without the knowledge of the designated firm. To accurately determine the exposure of other financial firms to the designated firm would require that the FSOC receive detailed exposure reports from any firm exposed to the designated firm. To the best of my knowledge, this level of analysis is beyond the capabilities of the FSOC.

"The Arbitrary and Inconsistent FSOC Nonbank Designation Process," there was no way to know how this identified FSOC shortcoming impacted FSOC designation decisions. Unfortunately, the new information provided in the subcommittee's report shows that the FSOC designation decisions are the outcome of a completely *ad hoc* evaluation process.

The inconsistency in the FSOC's designation processes becomes strikingly apparent when one compares the FSOC's reasoning in public designation cases to the discussion that appears in documentation acquired by the subcommittee on the FSOC's so-called stage-two designation decisions.

In a stage-two assessment, firms are evaluated by the FSOC staff. The staff either recommends that the FSOC elevate the firm to a stage-stage three investigation, or the staff recommends that the FSOC end its investigation. Failure to elevate a firm to a stage-three evaluation is effectively a decision to decline to designate the firm. So the FSOC reasoning behind non-designation decisions reveals important information about the FSOC's evaluation process. Before the subcommittee released its report, the details surrounding stage-two assessments were completely confidential—to the public, to Congress, and to the firms that were reviewed for designation by the FSOC.

The comparison of stage-two FSOC documents with public FSOC designation documents reveals that, in many stage-two assessments where the FSOC evaluated a firm but declined to designate it, FSOC staff did make an assessment about the potential that the firm being evaluated might face financial distress. But even in these cases, the documents reveal that the FSOC did not follow its own guidance regarding this matter, and the FSOC staff did not use the same criterion to assess the probability of financial distress in every case.

According to its own guidelines, the FSOC is supposed to evaluate the potential for an institution to experience financial distress in the midst of overall stress in the financial services industry and a weak macroeconomic environment. Yet in a number of cases, the FSOC failed to designate a firm on the basis of the staff judgment regarding the potential that the institution's failure in isolation (without regard to the health of the financial services sector or the state of the macro economy) might pose a threat to US financial market stability.

Apparently some companies are evaluated by the FSOC based on a subjective judgement about the financial stability impact of the firm's failure in a normal market, whereas other institutions are judged according to the impact their failure may have when financial markets and the economy are in turmoil. The documents clearly show that the FSOC has not evaluated all firms it has examined under a common standard or using uniform assessment criteria.

Another nonstandard practice revealed in the subcommittee's examination of stage-two documents is the manner in which the FSOC staff evaluates the implications of collateral associated with sizable repurchase agreement and securities lending programs. In some instances, the collateral associated with repo and securities lending is characterized as a strength for the firm being evaluated, while for other firms with exposures of similar size and character, collateral was deemed to be a potential threat for financial market stability. Clearly the FSOC has not developed a standardized approach for evaluating the stability impact of these activities.

The findings reported in the subcommittee report are disturbing, but they are not shocking. One reason that the FSOC has had difficulty in establishing uniform methodologies and processes to identify SIFIs is that no such processes exists. There is no scientific way to identify the "systemic risk" that is created by an individual financial institution.[4] To date, all SIFI designations represent little more than the judgements of empowered regulators who back up their designations using hypothetical stories of the consequences of firm financial distress but without any solid evidence to support these claims.

In many ways, systemic risk has become the financial equivalent of a "boogie-man" who is hiding out of sight— under the bed or in the closet—in places that only regulators can see. Thank goodness the Dodd-Frank Act requires regulators to protect us from this specter.

[4] This issue is analyzed in detail in Kupiec, Paul and Levent Güntay (2016). "Testing for Systemic Risk Using Stock Returns," *Journal of Financial Services Research* (49), pp. 203-227.