TESTIMONY OF DAVID ZARING

Associate Professor of Legal Studies and Business Ethics, The Wharton School

to the

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Committee on Financial Services

Oversight and Investigations Subcommittee

Hearing on "The Arbitrary and Inconsistent Non-Bank SIFI Designation Process."

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I am an associate professor of legal studies and business ethics at the Wharton School. I study financial regulation and, have written an article on the administrative procedure of the Financial Stability Oversight Council (FSOC or "the council") with Daniel Schwarcz, professor of law at the University of Minnesota, that is forthcoming in the University of Chicago Law Review, and that may be found here.[1] FSOC has already transformed the way that banks and capital markets are regulated, and has become, through its nonbank designation program, influential for insurance and other financial companies as well.

I. Overview

In my testimony on the procedures followed by the Financial Stability Oversight Council (FSOC or "the council") today, I would like to focus on three points.

[1] Schwarcz, Daniel and Zaring, David T., *Regulation by Threat: Dodd-Frank and the Non-Bank Problem*, (November 7, 2016). University of Chicago Law Review, Vol. 84, 2017, Forthcoming; Minnesota Legal Studies Research Paper No. 16-42. Available at SSRN: https://ssrn.com/abstract=2865958

First, the report prepared by the Republican staff of the Committee on Financial Services subjects the council to a degree of after-the-fact review that is inconsistent with the flexibility Congress gave the council in the Dodd Frank Wall Street Reform Act.

In that statute, Congress charged the council with designating non-bank financial companies as systemically significant on the basis of, among other things, a ten-factor test. It did not specify how those factors should be weighed and emphasized that the council should apply "any other risk related factors that the council deems appropriate" to its designation decisions, in addition to those identified in the statute.

The Republican staff report identifies portions of the written memoranda of the council where it emphasized some safety and soundness factors more heavily than other factors. It also identifies cases where the council considered the riskiness of a financial institution as a general matter as indicative of the risk the institution would pose when the economy was stressed. There is nothing arbitrary about emphasizing some factors more than others in such circumstances. Nor is it arbitrary to presume that a non-bank risky in normal conditions would definitely be risky when times are difficult.

Second, the report, while a real contribution into how the council makes decisions, attempts to isolate particular aspects of the council's analysis and make arguments about inconsistency based on these aspects. But the designation decision is meant to be a holistic one, utilizing a number of different factors in a way that enables the council to consider a full picture of any particular nonbank's position.

Third, the council itself has been given the responsibility for taking a broad view of the safety of the financial system, and is the only part of the federal government with the power and the capability to do so. It has chosen to make designations in a manner that makes it possible to re-visit those designations. Only the three largest American insurance companies have been designated by it as systemically significant, as well as one large financing company, but it is important that the council retain its flexibility to adjust its assessments of risk in the future. Second-guessing small portions of large decisions is inconsistent with the necessary flexibility that Congress gave to the council.

II. The Report Prepared By the Republican Staff of the Committee on Financial Services

I congratulate the Republican staff of the Committee on Financial Services for preparing a careful report on FSOC's designation practices so far. The report tells us some things that we have not known about the council's practices. It will help observers and interested institutions make more sense out of the designation process. But the report’s conclusions are misguided.

The report subjects FSOC to a degree of technical second guessing that is simply unsustainable if the authority given to the council by Congress is to be exercised at all.

Congress constrained the council’s discretion in a number of ways, but it also afforded the council with plenty of flexibility to assess systemic riskiness in response to changing conditions. It declined to impose a cost-benefit analysis requirement on the council’s designation decisions, for example.[2] It did not establish a particular set of procedures that the

[2] Although one court has suggested that the council should be required to do a cost-benefit analysis, nothing in the text of Dodd-Frank requires, or even hints that this should be necessary. Metlife, Inc. v. Fin. Stability Oversight Council, 177 F. Supp. 3d 219 (D.D.C. 2016). That case is on appeal, at any rate. Moreover, a quantified cost benefit analysis requirement imposed on a financial regulator assessing the possibility of a catastrophic collapse would make no sense. The failure of a major, systemically important, financial institution is almost by definition a low probability event that, turns on a number essentially unquantifiable assumptions. As one court has observed, “the law does not require agencies to measure the immeasurable.” Inv. Co. Inst. v. Commodity Futures Trading

council was obligated to follow in making those decisions. Finally, it instructed the council to, among other things, consider in any designation decision "any other risk-related factors that the Council deems appropriate," a provision that fairly exudes an intention to ensure that the council exercises plenty of discretion in making designation determinations, rather than holding it to a hard and fast formula.[3]

As for the constraints, Congress required FSOC to designate firms under one of two standards: FSOC must find that the firm "could pose a threat to the financial stability of the United States" either (i) in the event of its "material financial distress," or (ii) due to "the nature, scope, size, scale, concentration, interconnectedness, or mix of [its] activities."[4] It enumerated nine other factors, that FSOC shall consider in deciding whether a firm meets one of these two designation standards.[5] It limited designation to firms "predominantly engaged in financial activities."[6] Additionally, it provided that designated firms are to be subject to annual reviews to determine whether the designation is still appropriate.[7]

FSOC has carefully elaborated a three stage process for designation in light of this congressional instruction. Firms that pass through a Stage 1 quantitative screen are then subject to a Stage 2 evaluation, during which the council "prioritizes" its analysis of them. In doing so, the council relies on "a wide range of quantitative and qualitative information" that it extracts from publicly available and regulatory sources. Firms that pass the first two stages proceed to

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Comm'n, 720 F.3d 370, 372-75 (D.C. Cir. 2013).

[3] Dodd-Frank Act § 113(a)(2)(K).

[4] Dodd-Frank Act § 113.

[5] Dodd-Frank Act § 113.

[6] Dodd-Frank Act §§ 102(a), 113. Such firms must derive 85 percent or more of their consolidated annual gross revenues from financial activities, or have 85 percent or more of their assets related to activities that are "financial in nature." *Id.* § 102(a).

[7] Id. § 113(d).

Stage 3, at which point they are informed that they are being considered for FSOC designation and invited to meet with council staff and submit relevant materials to the council. The council issues a preliminary decision, takes comment and a meeting from the designated firm if requested to do so, and then issues a final decision, which requires a supermajority vote of 7 of the 11 voting members of the organization.

The report's overly intense after-the-fact review misapprehends the underlying goal of FSOC's designation decisions. Those decisions are not meant to be, and nor can they be, hyper-specific rules promulgated in advance that work with machine-like precision to establish conclusively which non-bank financial institutions pose risk to the system and which do not. If we knew the answer to those questions, systemic financial regulation would be easy. But it isn't; instead, it is very hard.

Accordingly, the portions of the decisions that the report characterizes as arbitrary really just involve the application of broader standards to particular aspects of particular nonbank balance sheets and places within the financial ecosystem. In some cases, the discretion given the council by Congress has pointed to weighing some of ten factors articulated in Dodd-Frank particularly heavily. In other cases, other factors will carry more weight. But in all cases, it does not make sense to scrutinize a sentence or paragraph of a designation decision in isolation from the rest of the decision, or to worry about the council's analysis of one particular factor in a decision when it is supposed to balance ten of them.

In particular, the report made much of the idea that FSOC occasionally deemed some institutions to be systemically risky in unstressed times while evaluating others in the contexts of stress tests. But rather than being inconsistent, designating institutions that pose risks whether the economy or financial system is unstressed obviously means that they will pose risks in stressed periods as well. The council by observing that some institutions were risky no matter what the state of the economy or the potential for some other kind of shock was acting entirely consistently with its stated goal of figuring out which institutions would be the most likely to run into trouble during those unfortunate periods.

The report worries that the council has focused on the "material financial distress" inquiry in its designations at the second stage of the designation process, even though it concedes elsewhere that occasionally, such as when assessing the interconnectedness of nonbanks, it considered "the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities" of a company.

I saw in the report's characterization of the stage 2 memoranda consideration of both inquiries, and would be untroubled by a focus on material financial distress at any rate. Size and interconnectedness, after all can threaten systemic stability, and are especially likely to do so when such companies are experience material financial distress. Moreover, in some cases enormous nonbanks alone will create problems for the economy even if they themselves could survive a financial shock – if, for example, firms generating risky products like mortgage backed securities survive a shock to the housing market, but the firms that consumed the mortgage backed securities they generated do not. In such case, it makes sense to prioritize the size inquiry. In other case, prioritizing the stress inquiry will be more sensible. In neither case would an emphasis on one factor over the other be arbitrary. Moreover, in the four final designations that the council has made, both size and stress are considered – and it is the stress to the system and interconnectedness of the institution that are emphasized.

The report then posits that FSOC was focusing on "systemic" risk instead of "systematic" risk, though the difference between these two concepts appears to be marginal, and not one that FSOC has made use of, as far as I know. FSOC's procedures reflect the importance of the inquiry into systemic riskiness, and, rather than being an arbitrary focus, FSOC's the reliance on the term is an example of consistency. Systematic risks, as the report defines them, are risks of size that do not necessarily reflect interconnectedness; the report alleges that FSOC has failed to make this distinction. But big firms can pose systemic risks because, as size increases, the number and variety of counterparties may increase as well. At any rate, none of the designation decisions that I have read only focus on the size of the institution without considering their interconnectedness.

FSOC had made findings about the effect that distress would have on the broader financial marketplace in each case. In the designation of Prudential, the council noted that "Prudential is one of the largest financial services companies in the United States" and that it "is interconnected with global systemically important banks, nonbank financial companies, large insurance companies, and other companies of all sizes through its broad mix of institutional customers, debt holders, and other counterparties." It is difficult to know what more the council should do in this regard.

Moreover, it is unfair to suggest that the council failed to distinguish "whether interconnections between companies are likely to 'impair financial intermediation or financial market functioning,' or instead prevent that impairment," as the report does on page 15. Financial intermediation depends on interconnections – it is a transactional activity. The question for FSOC is *how* interconnected a nonbank is, and, whether, if its financing suddenly dried up or if it was subjected to some other shock, the nature of its interconnectedness would imperil the market as a whole.

The report also attempts to make something of the fact that in some cases the council worried about the use of collateral in certain financial transactions as a mitigating factor against designation and in other cases did not. Again, this is a narrow critique of what is necessarily a broader inquiry; at any rate, it is unclear what the problem is with the distinctions that the council has drawn.

The report singles out the council's concern regarding its treatment of collateral in the context of securities lending and repurchase agreements, which are agreements that insurance companies often engage in and that do create risks of bank runs. The report complains that FSOC did not explain why it treated some companies that had securities lending programs differently than others. Congress required the council, in this regard, to consider the interconnectedness of nonbanks, and their importance to the financial system, and "the amount and types of the liabilities of the company, including the degree of reliance on short-term funding."[8]

But the council's conduct does not in any way suggest that there has been some inconsistency in its treatment of collateral. Some companies that rely for financing on their securities lending programs would face risks if demand for the securities they lend out dried up.

Other companies that rely to a lesser degree on the securities lending programs for financing are less likely to run into trouble if those programs run into trouble. The staff has more access to information than the rest of us do. But it certainly looked to me like the council was assessing the riskiness of these programs in the context of the entire balance sheet of each company engaged in securities lending. It is eminently possible that companies that engage in more securities lending than their near-peers would nonetheless be less dependent for financing overall on securities lending programs. The report does not address that possibility.

It is clear in assessing systemic stability that the council cares about the counterparties with which non-banks are engaged in financing transactions, but while the report suggests that it had not engaged in this inquiry consistently. Yet we see the council explicitly conducting the inquiry in three of the four company memos quoted in the report. In the case of the fourth it may have concluded that the inquiry was unnecessary in wake of the other reasons discussed.

The report has access to information that I cannot see on the designation process but there is nothing in the apparent smoking guns that it has analyzed that suggests to me that the council

[8] Dodd-Frank Act § 113.

has made arbitrary distinctions between the companies it has designated and the companies it did not.

Emphasizing that the council assessed, for example, the vulnerability to financial distress of all of the companies that it investigated for systemic risk differently does nothing to suggest that making distinctions between these vulnerabilities was inappropriate or that the companies had not taken different steps to approach the material financial distress problem.

The flexibility that FSOC has retained for itself ensures that it can respond to new risks posed by non-banks rather than being straightjacketed to an extremely specified set of procedures that, likely as not, would make evasion easy, and thereby encourage, rather than discourage, risk-taking in this sector. It is also worth remembering that, like any standards based regime, or our great common law courts, we will know more about how the designation system will work the more experience we get with it. The right time to insist precision is not shortly after agencies have been asked to implement a new program designed by Congress, informed by a ten factor test. With four designations and (apparently) nine stage 2 memos, we are seeing a process that does not strike me as arbitrary in any way. As it continues to evolve, it will only become more predictable.

III. The Council's Role In Financial Regulation

FSOC is uniquely tasked with taking the broadest possible view of the safety and soundness of our financial system and acting to protect that system from the risky conduct of financial institutions. After years of academic research, we still do not know what, precisely, predicts financial crises and from what part of the financial infrastructure crises are likely to come. Sometimes crises have been created by unwise investments by banks, as was the case in the Latin American debt crisis of the 1990s. In other cases they come from shadow banks, as the collapse of Long Term Capital Management, a hedge fund, demonstrated. In the last financial crisis, the collapse of the insurance company AIG was a regrettable contributor to the worst days of the period.

This lack of certainty about what risks in the future will jeopardize the economy, potentially threatening businesses with large losses, and workers with job cuts, makes the council’s job challenging. But even more alarmingly, the consequence of a mistake in designation could be enormous for the financial system and the broader economy as a whole.

In those kinds of circumstances, a precautionary approach to regulation is better than one with elaborate and narrowly tailored procedures spelled out in advance. Where the nature of the risk is uncertain, and the downside enormous, deference to regulatory discretion is appropriate.

FSOC must be afforded the flexibility to address new risks that they identify, and to encourage all companies engaged in financial transactions to act safely in as cost-effective a way as possible. FSOC's non-bank insurance designation process does this. The council has spelled out the procedures for designation and has created a relatively elaborate three-stage architecture that it applies to every designation decision. But it has always retained for itself the flexibility to identify and respond to new potential sources of risk in the financial system based on the collective wisdom of the leaders of the financial regulators in the federal government, all of whom are members of the council.

FSOC’s nonbank designations have been restrained. Currently, three companies are designated (with one of those in litigation), while the council has lifted the prior designation of a fourth. These institutions are subject to extra supervision by the Federal Reserve on account of their systemic riskiness. The three designated companies are the three largest insurers in the United States, and include AIG, which collapsed so spectacularly during the last financial crisis.

In assessing whether a regulatory regime ought to prioritize process before making decisions, or flexibility about how those decisions are made, it is critical to focus on what the regime is supposed to do. Sometimes process is important. Presumably this is one reason why administrative adjudications at the Securities and Exchange Commission come with elaborate procedures that are designed to balance the agency's need to protect against securities fraud, against defendants' need to make their case before being subjected to sanctions.

But sometimes flexibility is critical. The council is the only institution in the government with the duty to assess risk across the entire financial system and to look for systemically significant sources of that risk and make sure that those sources are adequately regulated. All of its members have specific and limited authority and no other institution in the government has responsibility for governing the risks posed by all financial institutions not just banks. Reducing FSOC's authority to make designations in a way where its discretion is outlined but not entirely curtailed by its rules in advance would eliminate the country's early warning system and make the likelihood of expensive bailouts in the future more real. The process it has created includes an elaborate three stage evaluative approach, and a multifactor analysis of the systemic risk of nonbanks. Any multi-factor test creates ambiguities. But Congress instructed it to weigh these factors – the council cannot say no.

Moreover, an important purpose behind these designations is deterrence across an entire industry. Bright line rules that rule in some institutions as systemically significant, but that rule out others would not deter the “ruled outs” from taking on risk once they get their free pass.

Finally, the costs of designation are real, but they are easy to overstate. While GE Capital transformed itself in an effort to move away from designation, it is clear that there were business reasons to restructure the company anyway. And as the CEO of AIG has observed, designation “just simply isn't a binding constraint on our capital returns and our objectives. So, we don't spend too much time worrying about it.” For that insurance company, designation has not been a burden, but rather a regulatory requirement that has not imperiled its business or ability to make plans for the future.