Statement submitted to the United States Senate Committee on Banking, Housing, and Urban Affairs

On FSOC Accountability: Nonbank Designations

Transparency on FSOC Designations and its Relations with the FSB

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.
Chairman Shelby, Ranking Member Brown and members of the Senate Banking Committee:

Thank you for the opportunity to submit written testimony for this hearing.

My name is Peter J. Wallison. I am the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute. The opinions expressed below are mine alone and not necessarily those of the American Enterprise Institute.

The invitation for this hearing made clear that it is to be focused on transparency at FSOC, particularly transparency in the process of designating nonbank financial firms as systemically important financial institutions (SIFIs). In submitting this testimony, I want to challenge more than simply the transparency of the designation process; I want to challenge whether some nonbank firms have been properly designated as SIFIs, as well as the transparency of the FSOC’s relationship with the Financial Stability Board (FSB). The FSB, as this committee is aware, is a largely European group of financial regulators and central banks of which the Treasury, the Federal Reserve and the SEC are members. I do not believe the FSOC has made clear the degree to which the decisions of the FSB were influential in the FSOC’s designation of SIFIs or will be influential in the efforts of the FSOC and the Fed in the future to subject what the FSB calls “the shadow banking system” to prudential regulation.

**General comment on SIFI designations**

Before proceeding with a discussion of the FSOC and the FSB, I should note that I do not believe that any nonbank financial institution, no matter how large, can legitimately be designated as a systemically important financial institution (SIFI) in the United States. The provisions of the Dodd-Frank Act that authorize FSOC to designate SIFIs are based on the supposition that interconnections among large nonbank firms make them vulnerable to failure if one of them fails. This, in turn, will create instability in the US financial system.

Yet, when Lehman Brothers was allowed to fail in 2008 there was no evidence that the firm’s interconnections caused significant losses to others. Lehman was a $650 billion firm—one of the largest in the US financial system—and a major participant in the credit default swap markets. Even though the firm filed for bankruptcy suddenly and unexpectedly at a time of great market anxiety about the health of financial institutions, no other large financial institutions failed or became unstable as a result of its exposure to Lehman. That demonstrates—I think without question—that concern about “interconnections” among large financial institutions is misplaced. While interconnections of some kind certainly exist among financial firms, the exposures involved are simply not large enough to cause the insolvency of other large nonbank financial institutions when one of them fails.
To be sure, chaos followed Lehman’s bankruptcy. However, this was because the government had suddenly and unexpectedly reversed the policy of rescuing large firms that it had established in March 2008 with the rescue of Bear Stearns. Market expectations, as a result of this reversal, were completely upended. That caused some losses—most notably at the Reserve Fund, which probably anticipated it would be bailed out with a government rescue of Lehman—but even that money market fund only suffered losses of one or two percent. The purpose of SIFI designations should not be to prevent business failures, or losses to others when businesses fail, but only conditions in which business failures will bring down major portions of the US economy. As Lehman demonstrated, that does not happen even with the failure of a very large nonbank firm.

Accordingly, because the authority of the FSOC to designate nonbank financial institutions is unnecessary (and actually harmful to competition in the financial industry), it should be repealed.

The FSB’s influence on SIFI designations

The way the FSOC has exercised its designation authority is also a reason for repeal of this authority. When Congress authorized the FSOC to designate large nonbank financial firms as SIFIs, it assumed that the FSOC would follow a fair, objective, and fact-based process in exercising that authority. Although officials have asserted that the FSOC’s designation decisions have been the result of such a process, that is not supported by the facts.

The Treasury and the Federal Reserve Board are unquestionably the most important and influential members of the FSOC—the Treasury because the secretary of the Treasury is the chair of the FSOC and the Fed because it is by far the most powerful US financial regulator. Both the Treasury and the Fed are also members of the FSB, and it is reasonable to assume, given the importance of the US financial system, that the Treasury and the Fed are the most important and influential members of the FSB.

In 2009, the FSB was deputized by the G-20 leaders, including, of course, President Obama, to reform the international financial system. After receiving this mandate, the FSB determined to proceed by designating certain firms as “global SIFIs,” and on July 18, 2013, it designated nine large international insurers—including three large US insurers, AIG, Prudential and MetLife—as global systemically important insurers, or G-SIIs.¹ The FSOC had designated AIG as a SIFI before the FSB had made its designations, but Prudential was not designated as a SIFI until September 2013 and MetLife not until December 2014.²

The designation of SIFIs is what is called a quasi-judicial proceeding, where evidence is weighed against a statutory standard of some kind and an administrative agency applies the standard to a

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single party, as a court—based on evidence—would apply the law to a single defendant. Quasi-judicial proceedings are usually expected to meet certain standards of fairness and objectivity.

In testimony last week before the House Financial Services Committee, Treasury Secretary Lew stated that the FSB “acts by consensus.” A consensus literally means an agreement; synonyms of consensus in most dictionaries are concurrence, harmony, accord, unity and unanimity. So when these three firms were designated by the FSB as G-SIIs the Treasury and the Fed necessarily concurred in the decision.

This means that months before the FSOC designated Prudential or MetLife as SIFIs the Treasury and the Fed—the two most important members of the FSOC—had already determined as members of the FSB to designate Prudential and MetLife as G-SIIs. Obviously, if a firm is a G-SII on a global scale, it is going to be a SIFI in its home country. Thus, whatever process the FSOC might have followed in the designation of Prudential and MetLife, it could not be considered fair, objective and evidence-based if the chairman of the FSOC and the Fed—as members of the FSB—had already decided the issue months before.

Moreover, the FSB has not explained the basis for its designations of Prudential and MetLife, except to say that they were made in conformity with a methodology of the International Association of Insurance Supervisors. Although the methodology was made public, the FSB has never explained how the methodology applied to any of the insurers, including the three US insurers. So the need for an objective evidence-based decision-making process could not be cured in any way by whatever process the FSB may have followed in making its designations.

Clearly, then, the FSOC’s tainted designations of Prudential and MetLife cannot be considered the kind of deliberative process that was sanctioned by Congress when it authorized the FSOC to make SIFI designations.

In addition, there is evidence that the Treasury and the Fed believe they are bound by the decisions at the FSB, possibly including designation decisions. In early February, 2015, the chairman of the FSB, Mark Carney, sent a memorandum to FSB members, notifying them that the FSB considered them to be bound by its decisions. Because of the importance of the US as a member of the FSB, it is highly unlikely that the chairman would have sent this memorandum without the agreement of the Treasury and the Fed.

The memorandum noted that the FSB expects “full, consistent and prompt implementation of [its] agreed reforms.” When questioned about this by Chairman Jeb Hensarling at the HFSC hearing last week, Treasury Secretary Lew denied that the US was bound by these “agreed reforms.” Hensarling pointed out that the FSB had recently “exempted” three Chinese banks from the reforms and asked “if these are preliminary suggestions and not rules [by the FSB] why is it that the FSB found it necessary to grant exemptions, specifically to the Chinese?” Secretary Lew had no answer to this question at the hearing.

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If in fact the FSOC, the Treasury and the Fed believe they are bound by FSB decisions, there is a further reason for seeing the FSOC’s designation of Prudential and MetLife as illegitimate. The designation decision was in effect made by the FSB and not the FSOC.

**Do the FSOC and other US agencies have authority to implement FSB directives?**

Finally, another troubling matter came to light in the course of last week’s HFSC hearing. In answering the same question by chairman Hensarling, Secretary Lew stated that “what the FSB does is it raises global—the goal for global standards to a high level…We work in the FSB to try to get the kinds of standards that we think are appropriate in the United States to be adopted around the world so that the whole world will have high standards.”

The first thing to note about this statement is that it validates Chairman Hensarling’s concern that the FSB, as well as the Treasury and Fed, are treating the FSB’s decisions as binding on the FSB members. Obviously, if the US is trying to raise global standards through the FSB, it would be essential to have those standards viewed as mandatory rather than optional. This explains why the FSB gave an “exemption” to the Chinese banks; that wouldn’t have been necessary, as Chairman Hensarling suggested, if the FSB’s rules were not binding on China.

Secretary Lew’s statement also raises troubling questions about what the FSOC, the Treasury and the Fed believe about their authority to implement the ideas and policies adopted by the FSB. If, as the Secretary avers, the US is using the FSB as a mechanism for raising “global standards” to a level that “we think are appropriate in the United States,” this must mean that the Treasury and the Fed believe they have the authority to do in the United States what they are attempting to get the FSB to prescribe for all other FSB members.

This is the nub of the issue. In a policy paper dated August 29, 2013, the FSB said that in order to control and regulate what it calls the “shadow banking system” it is necessary to regulate “complex chains of transactions.” These, in the FSB’s view can create systemic risks even though pursued by entities that are not themselves systemic in size. Thus, the FSB continued, “[E]xperience from the crisis demonstrates the capacity for some non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability.”

The scope of this concept is startling. The capital markets function through chains of transactions—dividing up risks, distributing credit, buying and selling interests in securities or other credit instruments—so seeking to regulate complex chains of transactions among firms in the capital markets is tantamount to placing the entire capital market system under prudential regulation.

This idea has already been adopted by the FSOC, while using a slightly different form of words. In its December 18, 2014 Notice on Asset Management Products and Activities, the FSOC stated: “risks to financial stability might not flow from the actions of any one entity, but could

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arise collectively across market participants.” 5 The concept seems identical to a “complex chain of transactions.”

Although the Dodd-Frank Act provides authority for regulating entities that are deemed to be systemically important, it is difficult to find any statutory authority in Dodd Frank or any other financial regulatory system in the US for regulating “complex chains of transactions” or “risks…that arise collectively across market participants.” Yet, by concurring with—if not actually sponsoring—the FSB’s idea that complex chains of transactions should be regulated in order to control the dangers of shadow banking, it is apparent that the Treasury and the Fed believe that they would have the power to regulate those transactions when the directive from the FSB instructs them to do so.

The question that falls out of this analysis is simply this: where did the Treasury and Fed acquire the power to regulate a complex chain of transactions for the purpose of controlling what they call shadow banking?

This committee should seek the answer to that question. It would be troubling if US agencies believe their authority to follow the FSB’s directives flows from the G-20’s deputization of the FSB. That would mean that the US president can create regulatory authority in the US through an agreement with the leaders of other nations, and would call into question the unique authority of Congress under the US constitution to make the laws applicable in the United States.

Conclusion

Accordingly, while I certainly support the idea that additional transparency is necessary at the FSOC, the first and most important issue is transparency about three preliminary questions: (i) the nature of the FSOC’s relationship with the FSB; (ii) whether the FSOC, the Treasury and the Fed believe they have the authority to regulate complex chains of transactions in the US; and (iii) if they believe they have such authority, where they acquired it.