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THE ROLE OF THE FINANCIAL STABILITY BOARD IN THE U.S. REGULATORY FRAMEWORK

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE ROLE OF THE FINANCIAL STABILITY BOARD ON U.S. REGULATORS INCLUDING WITH RESPECT TO ITS INFLUENCE ON THE FINANCIAL STABILITY OVERSIGHT COUNCIL

JULY 8, 2015

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C O N T E N T S

WEDNESDAY, JULY 8, 2015

WITNESSES

Additional Material Supplied for the Record

THE ROLE OF THE FINANCIAL STABILITY BOARD IN THE U.S. REGULATORY FRAMEWORK

WEDNESDAY, JULY 8, 2015

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:01 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Richard Shelby, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

Today the Banking Committee will examine the role of the Financial Stability Board, or what we call the "FSB," in our domestic regulatory framework.

The FSB is an international body that monitors and makes recommendations about the global financial system. It was established in April 2009 by the G–20.

Most of the members of the FSB are political appointees and banking regulators. The three U.S. regulators who are members of the FSB are the Treasury, the Federal Reserve, and the SEC.

As I mentioned at a Banking Committee hearing on the FSOC in March, the FSB is not a U.S. regulator, and it is not accountable to Congress or the American people.

At this same hearing, when asked about whether the FSB has the power to designate U.S. firms as "systemically risky," Secretary Lew acknowledged, and I will quote him, that "the FSB cannot designate a firm for us." And yet Secretary Lew could not recall any particular instance in which the FSOC had deviated from the FSB. Interesting.

Furthermore, two out of the three insurance companies that the FSOC has designated were first designated by the FSB. The question that appears is whether FSB designations have become a substitute for the independent judgment of our regulators. And if they have, what do we know about the FSB's designation process?

The U.S. regulatory process should be open and transparent and should encourage public participation in the rulemaking process. Because the FSB process is opaque and devoid of public participation, very little is known about the specifics of its deliberations.

There remains much uncertainty regarding how a consensus is reached and the degree to which U.S. regulators are involved in FSB decisionmaking.

Ultimately, the FSB process should not allow U.S. regulators to avoid our own rulemaking process or congressional oversight.

In past hearings we have heard from the Treasury, the Fed, and insurance experts, among others, about the interplay between the FSB and the FSOC. Today the Committee here will receive testimony from those affected by the FSB process as well as experts who have studied and analyzed the FSB and its impact on U.S. companies.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. Welcome to the five witnesses today. Thank you for joining us.

This month, as we know, marks the fifth anniversary of the passage of Dodd-Frank and the Consumer Protection Act, over 7 years since the worst crisis since the Great Depression began to spread through the global financial system.

As the months and years pass, we cannot forget that damage that was done because we are still living with the after effects. This Committee can never forget that in its deliberations. We continue to see the damage done to Americans' finances and their lives. We must make sure that financial reform continues. That reform should not stop at the edge of our shores.

The financial crisis showed us and showed the world how interconnected our financial system had become, how fragile and fragmented the regulatory system actually is.

In 2009, the leaders of the G–20 nations outlined an agenda, agreed to an agenda to guide international financial reforms and "too big to fail." Improved capital standards make markets more transparent and resilient.

The Financial Stability Board was formed, and international reform initiatives were launched. We have heard over and over in this room the importance of international cooperation and the need for improved global standards.

In September 2009, SEC Commissioner Casey testified before a Banking Subcommittee, "International cooperation is critical for the effectiveness of financial regulatory reform efforts. The G–20 banking statement . . . " she went on, " . . . correctly recognizes that, due to the mobility of capital in today's world of interconnected financial markets, activities can easily shift from one market to another." She continued: "Only collective regulatory action can be effective in fully addressing cross-border activity in our global system."

In March 2012, Treasury Under Secretary Brainard appeared before this Committee and said, "We have secured agreement internationally to strengthen liquidity standards and limit leverage. We have identified the globally systemically important banks. We have agreed to a capital surcharge for these banks. We have developed a comprehensive set of enhanced prudential measures to address risks from globally active financial institutions."

She continued: "However, there is much work that needs to be done. We must remain vigilant against attempts to soften the national application of new capital and liquidity and leverage rules."

These statements, Mr. Chair, only begin to explain the need for international coordination and financial regulation, not a new concept. Basel dates back to the mid-1970s. The Financial Stability Forum, the predecessor to FSB, was formed 16 years ago. Cross-border cooperation is important because just in recent memory we have seen several domestic and international financial crises. From the savings and loan crisis in the 1980s and 1990s, the bailout of Mexico in the mid-1990s, the Asian financial crisis in 1997, which led to the failure and bailout of the hedge fund Long-Term Capital Management, through to the financial crisis, and the default and uncertainty facing Greece right now, we know that another financial crisis can happen and that it will happen. It will affect more than any single nation.

It is the desire to prevent the next crisis that should drive us to broad global efforts and higher regulatory standards so that no market falls behind and allows unchecked risk to accumulate. The world cannot afford another AIG or Lehman. To make sure it does not have to, the United States has led global reforms, passing comprehensive Wall Street reform quickly in 2010, pushing for higher capital requirements, improving derivatives regulation, building out resolution mechanisms.

We can and need to do more. Risks do not just build up overseas. They build up here in the shadows. Yesterday, IMF released its 5-year financial sector assessment of the United States. It identified several areas of so-called shadow banking where we still have work to do. We need to address gaps in regulation and oversight. We need to ensure that regulators communicate globally. We need to expose areas where excessive risk develops.

Given that all the systemic risk questions have not been answered and regulations are still being considered and implemented, it is clear our work is not done. I hope today's witnesses will highlight the importance of international coordination to a stable financial system. It would be a shame if instead criticism of a non-binding international coordinating body were used to weaken or stop the kinds of safeguards needed to prevent the next AIG.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you. Thank you, Senator Brown.

Without objection, at this point I would like to enter into the record statements from the following organizations: Property Casualty Insurance Association of America and the National Association of Mutual Insurance Companies. Without objection, it is so ordered.

Senator BROWN. Mr. Chairman, excuse me a second. If I could, Mr. Chairman, I have two statements I would like entered into the record: one from Michael Barr, University of Michigan Law School, and one from Professor Christopher Brummer of Georgetown Law School.

Chairman SHELBY. Without objection, so ordered.

Senator BROWN. Thank you, Mr. Chairman.

Chairman SHELBY. They will be part of the record.

Our witnesses today—I think we have a distinguished panel here—include the Honorable Dirk Kempthorne. He is no stranger to a lot of us. He is President and the CEO now of the American Council of Life Insurers. Governor Kempthorne has had a distinguished public service career and has previously served as Secretary of the Interior as well as mayor, U.S. Senator, and Governor of Idaho. Dirk, thank you.

Peter Wallison is no stranger to this Committee either. He is well known and distinguished in his own right. He is the Arthur F. Burns Fellow in Financial Policy Studies at the American Enterprise Institute. Mr. Wallison has held a number of Government and private sector positions over his notable career, and the Committee welcomes him again.

Mr. Paul Schott Stevens is President and CEO of the Investment Company Institute. Mr. Stevens is a well-known lawyer and previously served in senior Government positions at the White House and the Defense Department.

Mr. Eugene Scalia is a Partner at Gibson, Dunn & Crutcher. Mr. Scalia is a renowned administrative law scholar and practitioner who previously served as U.S. Solicitor at Labor and as a Special Assistant to the Attorney General of the United States.

Dr. Adam Posen, the President of the Peterson Institute for International Economics, will be our fifth witness. Dr. Posen is a member of the Council on Foreign Relations. He previously served as an external member of the Bank of England's rate-setting Monetary Policy Committee.

All of your full written testimonies will be made part of the hearing record, and, Dirk, we will start with you.

STATEMENT OF DIRK KEMPTHORNE, PRESIDENT AND CEO, AMERICAN COUNCIL OF LIFE INSURERS

Mr. KEMPTHORNE. Mr. Chairman, thank you so much. Chairman Shelby, Ranking Member Brown, and all Members of the Committee, thank you for this opportunity.

I would like to begin with a sincere thank you for shepherding through Congress last year important legislation that the Federal Reserve needed. Enactment of the Insurance Capital Standards Clarification Act, a fix to the Collins amendment, should enable the Federal Reserve to appropriately account for the fundamental differences in business models between banking and insurance. This was Congress at its best, bipartisan work to enact essential legislation.

ACLI is the principal trade association for the U.S. life insurance industry. Life insurers offer real solutions to help millions of American families. We help people plan and save for retirement. We help people cope when a loved one dies. We help people who are disabled and need long-term care. Government will face more problems without the solutions offered by life insurers.

I offer three observations:

First, the Financial Stability Oversight Council should utilize an activities-based approach to identifying systemic risk rather than designate individual companies based merely on size.

Second, the Federal Reserve should finalize their work on capital standards in a way consistent with congressional intent.

Third, common sense and good policy certainly should require that the United States write its own insurance capital standards before agreeing to any international standards. Getting our standards completed at home and done right needs to happen first. This will require Congress to continue proper oversight of the work of Federal agencies who represent the United States on the Financial Stability Board, the International Association of Insurance Supervisors, and FSOC should also be subject to congressional oversight.

I thank Chairman Shelby and Senators Heller and Tester for including language in pending legislation to increase opportunities for stakeholder input and congressional oversight.

With respect to capital standards, ACLI is grateful that the Federal Reserve will proceed with a methodical process that will include a formal rulemaking and public comment period. ACLI also commends the FSB and FSOC for considering an activities-based approach for assessing the potential risks of asset managers before systemic designations.

Yet with respect to insurers, I am troubled by the fact that these two organizations have made no similar effort. Instead, these organizations have chosen to designate individual companies as SIFIs without providing insight into the rationale for such designations or how the designations could have been avoided.

The fact is that the FSB named institutions as "globally systemic important insurers," or G–SIIs, and the FSOC followed suit. Designated companies were not accorded any ability to engage directly with the FSB over its review or to challenge a designation. The process is closed and opaque.

In a similar lack of transparency, FSOC also pursued the designation of individual insurance companies and provided the public with little, if any, rationale. FSOC's only independent voting insurance expert, Roy Woodall, former commissioner in Kentucky, raised serious concerns over the intersection between the FSB's actions and FSOC's decisionmaking. To quote Mr. Woodall, "Although not binding on the Council's decision, the declaration of Prudential as a G–SII by the FSB based on the assessment by the U.S. and global insurance regulators, supervisors, and others who are members of the IAIS has overtaken the Council's own determination process."

A relevant issue is how a company once designated a SIFI can exit being a SIFI. In other words, what is the off ramp to exit the SIFI highway? The answer to that question will help companies understand how they became SIFIs in the first place. Chairman Shelby, I thank you for working to provide the off-ramp exit in pending legislation.

It is important for the Federal Reserve's capital standards and the FSB's international capital standards to work in harmony, not in conflict. Quite frankly, there should be no rush in writing international capital standards for insurance companies in a very short period of time. After all, consider: It took 13 years to write Solvency II. It took 11 years to write Basel II. Life insurers want international standard setters to take the time to get it right, to avoid adverse or unintended consequences. This will help preserve the ability of insurers to provide financial and retirement security to millions of families.

To quote Senator Tim Scott, "the more successful the insurance company industry is, the less Government will have to do." We should embrace policies that enable Government to focus on those who are truly needy.

Mr. Chairman, that is why the issues that you have presented here today with the Committee are so vitally important. Thank you for being vigilant in guarding against unintended consequences of regulatory action wherever and whenever they occur.

Thank you, Mr. Chairman.

Chairman SHELBY. The Honorable Peter Wallison, welcome again.

STATEMENT OF PETER J. WALLISON, ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

Mr. WALLISON. Thank you, Chairman Shelby, Ranking Member Brown, and other Members of the Committee. Both the Financial Stability Board and the Fed have made clear in public statements that they want to impose prudential regulation on what they call the "shadow banking system." Both defined "shadow banking" as all financial intermediation outside the regulated banking system. This means broker-dealers, asset managers, mutual funds, insurance companies, hedge funds, and any other firm that is not a regulated bank.

Prudential regulation is the regulation of risk taking. This is normally the prerogative of a firm's managers. So what the FSB and the Fed mean by placing shadow banking under prudential regulation is they want to control the risk taking of firms in the capital markets. This would be a major change in the capital markets where firms are generally regulated for conduct and not told by regulators what risks are permissible. The free capital markets in the United States are the source of our economic growth. Prudential regulation would end that freedom.

The Treasury and the Fed are members of the FSB. Treasury Secretary Lew has repeatedly denied that the United States is bound by decisions made at the FSB. He told the House Financial Services Committee, "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." This tells us two things:

First, FSB is important because it provides a forum for negotiating rules that will be globally effective. The Fed cannot control shadow banking from the United States alone.

Second, Secretary Lew's statement makes sense only if the FSB's decisions can be implemented in the United States. No other country will abide by the FSB's decisions if the United States does not. This raises the question where the Treasury and the Fed think they have gotten the authority to implement the FSB's decisions in the United States.

Unfortunately, it may be in the Dodd-Frank Act. Section 113 of Dodd-Frank says that the FSOC can designate a firm of any size as a SIFI if its mix of activities could cause instability in the U.S. financial system.

A year ago, Fed Governor Daniel Tarullo, who leads the FSB's efforts on shadow banks, said it was necessary "to broaden the perimeter of prudential regulation both to certain nonbank financial institutions and to certain activities of all financial actors." The key word here is "activities."

In 2013, in outlining how it would regulate shadow banks, the FSB stated that "risk creation may take place at an entity level"—what they mean is in a SIFI, a single institution—"but it can also form part of a complex chain of transactions"—still quoting here—"in which leverage and maturity transformation occur in stages."

This is a highly implausible idea, I think, but it is the foundation of the FSB's efforts to impose prudential regulation on the shadow banking system. The FSB would do it through controlling "complex chains of transactions." But this is how business is done in the capital markets. Firms there buy, sell, securitize, finance, and trade risks and assets through complex chains of transactions.

Recently the Fed's Vice Chair, Stanley Fischer, adopted the same idea, saying in a speech that, "A complex chain of activity can increase the likelihood or severity of systemic stress." Thus, it appears that a global effort to control shadow banking will probably be based on an FSB agreement to regulate complex chains of transactions. But in the United States, because of the Dodd-Frank language quoted earlier, it will be based on regulating complex chains of activities.

Thus, the FSOC could threaten to designate nonbank firms as SIFIs if they do not cease a certain class of activities—unless the Fed approves the activity. That would, in effect, give the Fed the authority to approve activities only if done under the Fed's prudential rules.

If this Committee does not want to see prudential regulation of the capital markets, it has to make clear to the FSOC and the Fed that the term "activities" in Dodd-Frank cannot be used for this purpose.

Thank you very much for the opportunity to testify this morning.

Chairman SHELBY. Mr. Stevens.

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CEO, INVESTMENT COMPANY INSTITUTE

Mr. STEVENS. Thank you, Chairman Shelby, Ranking Member Brown, Members of the Committee. I am grateful for this opportunity to discuss the FSB and the role it plays internationally as well as here in the United States.

The Investment Company Institute is an association whose members include mutual funds and other regulated funds in the United States and in jurisdictions worldwide. ICI understands the importance of sound, tailored regulation in maintaining strong and resilient financial activities in a financial system.

In recent years, we have made numerous submissions to the FSB, including detailed responses to its successive consultations on asset management. Our experience with these consultations and with FSB more generally raises very serious concerns.

FSB asserts a very broad mandate, no less than the stability of the entire global financial system; but most of its members and virtually all of its leadership consists of central bankers or finance ministry officials. The FSB describes its efforts in the asset management sector as a review of "shadow banking." This disparaging term reflects the FSB's bias that all financial activity conducted outside of banks is inadequately regulated and, therefore, is "risky" because it is not subject to bank standards and bank regulatory supervision.

Compounding this predisposition are FSB's broad lack of expertise on funds and capital markets as well as its insufficient regard for empirical evidence on the regulated fund industry, including our historical experience, structure and practices, and existing form of regulation.

As a result, FSB's proposed methodology for G–SIFI designation proceeds on the basis of flawed assumptions and mere conjecture. Indeed, they appear almost reverse engineered to result in possible designation of certain large U.S. asset managers and the largest U.S. mutual funds.

Now, this is ironic. Unlike banks, the group of U.S. stock and bond funds that FSB would single out for possible designation demonstrated a high degree of stability during the financial crisis. Why? As we have repeatedly explained to FSB, mutual funds use little to no leverage. They do not "fail" like banks and do not require Government intervention. Their structure and regulation limit risk as well as the transmission of risk. And as history has repeatedly demonstrated, they do not experience "runs" or "fire sales" during times of stress.

In our view, FSB is not conducting its work with the same degree of rigor required of regulators in this country, nor is it operating with the same kind of transparency. We do not know the positions that U.S. representatives have taken on the methodologies proposed by FSB for possible G–SIFI designation. We do know that the whole work stream in this area is being led by the Fed.

It does seem plain that there are extensive links between FSB and FSOC. It seems certain that any final FSB methodology for possible G–SIFI designation of mutual funds and their managers, no matter how deeply flawed it may be, will influence FSOC's own review of asset management and financial stability.

In our judgment, a sector-wide appraisal of activities and practices is the best way to evaluate any potential risks in asset management. The Board of the International Organization of Securities Commissions, a global group of securities regulators with long experience in overseeing funds and asset managers, has recommended that a review of asset management activities "take precedence" over consideration of individual funds or asset managers as systemically important.

Clearly, FSB's work would be far better informed and far more effective if FSB were reconstituted to accord capital markets regulators an equal place and an equal voice at the table. It would appear that for both FSB and FSOC, however, designation of mutual funds or their managers remains a live policy option. Subjecting U.S. mutual funds or their managers to bank-like regulation will harm millions of Americans saving for long-term goals like retirement. The direct costs will be substantial while the overlay of enhanced prudential supervision will introduce a highly conflicted form of regulation, clearly not in the best interests of fund shareholders. So, in sum, ICI strongly commends this Committee for its oversight of the role of U.S. regulators in the FSB.

Regarding FSOC's designation process, ICI believes that before designating a company, FSOC should be required to specifically identify any risks and communicate those risks to the company and its primary regulator. It should provide a more meaningful role for the primary regulator to address risks, and it should provide companies under consideration with the opportunity to "de-risk" prior to designation.

We, therefore, strongly support Chairman Shelby's efforts to reform FSOC's designation process and are pleased that he has included these common-sense reforms in Title III of S. 1484, the Financial Regulatory Improvement Act.

Mr. Chairman, thank you for the opportunity to present our views. I look forward to your questions.

Chairman SHELBY. Thank you.

Mr. Scalia.

STATEMENT OF EUGENE SCALIA, PARTNER, GIBSON, DUNN & CRUTCHER LLP

Mr. SCALIA. Chairman Shelby, Ranking Member Brown, and Members of the Committee, thank you for the opportunity to appear before you today. It is an honor.

I speak to you today not as an expert on financial institutions, but as a lawyer who practices administrative law and who has represented clients in connection with the Financial Stability Board and designation as a systemically important institution by FSOC. This includes representing MetLife in connection with its designation as a SIFI, but today I testify in my individual capacity and not on behalf of any clients. The views I will express are my own.

I would like to touch on three legal points that I hope may frame the Committee's consideration of the FSB.

First, it is a basic principle of administrative law that, in the words of one court, an agency should not "adjudge the facts or law of a particular case in advance of hearing it." So in one case, the court found that there had not been due process of law when an agency decisionmaker had made a speech indicating that he had already reached a decision on a matter that was currently pending in a case before him. The person who had given the speeches was not the only decisionmaker involved in those proceedings, but the court in the case said, "Litigants are entitled to an impartial tribunal, whether it consists of one person or 20." And it added that there was no way of knowing what influence that one member had had.

There is no record of the role the U.S. members played in the FSB's designation of the three U.S. insurance companies we have heard about as systemically important. But to the extent that one or all of the U.S. members joined in those designations by FSB, it becomes a legitimate subject of inquiry what effect that subsequently had in FSOC proceedings.

Second, and related, the designation process before FSOC must not serve as a forum for implementing decisions essentially already made before the FSB. Dodd-Frank sets forth specific criteria for FSOC to apply. The FSB criteria are different to the extent that they can be discerned at all. Most important, Dodd-Frank establishes procedures for FSOC to reach its decisions. Under law, those procedures must present companies a real and genuine opportunity to make their case before open-minded decisionmakers.

The statements you have heard by FSOC Member Woodall that FSB's designations have "overtaken" FSOC's designation process are troubling. By way of analogy, if the judge wrote in dissent that her colleagues had based their decision on considerations other than applicable law, the facts in the record, and the explanations set forth in their majority opinion, we would regard that as a matter warranting further inquiry.

The third point I'll make is that weaknesses in FSOC's SIFI designation decisions to date give further reason to question whether the rationale in those decisions is a full account of what drove FSOC's decisionmaking. One such weakness is FSOC's insistence on a company-specific designation process for insurance companies even as it considers an activities-based approach for other entities.

In explaining in its MetLife decision why it was not taking an activities-based approach, FSOC used circular reasoning. It said that Dodd-Frank required it to consider specific statutory criteria when making a company-based designation and "an activities-based analysis is not one of the statutory considerations."

In other words, FSOC said that it was not considering an activities-based approach because it had not considered taking an activities-based approach. One is left to wonder again about the degree to which FSOC's designation of three specific companies designated by FSB resulted from that prior FSB action.

Mr. Chairman, the legislation you have introduced would address some of the concerns that I have raised today. Section 403 would provide visibility into FSB-type processes, including the positions taken by U.S. regulators on policies they may be called upon to address back home.

Section 302 addresses the uncertainty companies face about how to avoid being considered systemic. Under the bill, a company could submit a plan to FSOC for changing its corporate structure and operations so the company would not be deemed systemically important. If FSOC believed that plan was insufficient, it would have to explain why and what actions the company could take to avoid SIFI regulation. That change, like Section 403, would increase transparency, fairness, and thereby the quality of Government decisionmaking.

Thank you for this opportunity, and I look forward to any questions that you may have.

Chairman SHELBY. Thank you.

Dr. Posen.

STATEMENT OF ADAM S. POSEN, PRESIDENT, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Mr. POSEN. Thank you, Mr. Chairman and Ranking Member Brown, for this opportunity.

Let us begin sort of as Senator Brown did, to remember that international coordination and regulation remains in the U.S. interest. It remains in the U.S. interest because the rest of the world's banks and financial entities exist whether or not we want them to or not. And the spillovers of them screwing up are much bigger and much faster today than they have ever been. There is no simple defense against that. I realize no Members of the Committee are challenging that, but let us start there because that is where the FSB comes from.

It is also worth remembering that the FSB, like every other international financial institution since the war, is largely the child of success of American administrations, Democrat and Republican. When we think of the Financial Stability Forum, that was founded 16 years ago through U.S. efforts. The graduation of it to the FSB was, again, through U.S. efforts, through the U.S. Government, and it remains the fact that the United States is the dominant voice in this effort.

This is, in fact, because of our technological experience, our technical expertise, the depth of our markets, the fact that we still remain a model, and we have overweight influence in the FSB. Most of the complaints about the FSB abroad are because the United States is seen as having too much power, not too little. I think it is important to have that baseline as we go forward. We cannot simply live with the institutions and the misbehaviors of other countries' financial institutions.

So, therefore, what is it we want and what is it we get out of international regulation? We want to raise minimum standards, we want to increase cross-border transparency, and, most importantly, we want to prevent regulatory arbitrage. We want to prevent, whether it is U.S.-based entities or foreign entities, getting around the legislated regulations from Congress and from Congress' appointees by going to other jurisdictions and inflicting damage on the United States. The FSB is actually making a major contribution to diminishing this—not getting rid of it, but certainly diminishing it.

There are instances where the FSB is messing up, and I will indicate that I actually share some views with some of the other witnesses on the insurance industry where I think the FSB does have it wrong. But these are instances of where they are getting a specific decision wrong, not something inherent to the process or inherent to the relationship between the FSB and the FSOC or the U.S. Government.

Now, why is the FSB useful? There has been a lot of talk about the fact that it is opaque, it is not accountable. However, I think it is important to recognize several attributes that are positive. The first is it involves all of the major countries that have major financial centers and all of the minor countries that have major financial centers, which is a body that we need if we are going to plug these holes.

It also, for that matter, is small enough that it can make decisions, which is a key attribute. As we know from, say, the IMF or the WTO, when every member gets a vote, it deadlocks, you get nothing.

It is cutting across regulatory and turf barriers, perhaps not always in a way the other witnesses would like, but it importantly gets us out of this cognitive capture that both United States and other regulators can get when they are only in their own silo.

It is coordinated directly with the G–20 economic leaders' meetings and processes, which means there have to be transparent progress reports, there have to be public accountings, and things that reach the G–20 level can be brought to the public for buy-in.

By including central banks and finance officials, you are not only getting the right experts in the room; you are getting it past the narrow bank supervisors, which is an important quality.

And, finally, I would argue that, in addition to the bipartisan U.S. legacy, it has rightly a soft-law legacy. They are not legislating for us. They are setting standards that we and others might adhere to, and if they are good standards, there will be market and peer pressure and public pressure to adhere to them by others. All the FSB can do is name and shame. It cannot enforce anything.

Now, I think we can get some specific areas where the FSB has done great work. People who believe in resolution as a key cause of the financial crisis can see huge progress there, certainly bank capital standards, certainly liquidity standards. These are important aspects.

I do believe the FSB is wrong about insurance companies because of a general problem in the FSB, but also a general problem in the FSOC. We do not have a coherent U.S. representative of expertise on insurance companies at that level. Therefore, the European Commission, which has a pre-made, pre-baked Solvency II, gets to shove that through, and their companies who are going to be stuck with it want to be sure that their competing foreign companies also get stuck with it. That is not a good reason for a law, and if the U.S. representatives of the insurance companies were better equipped and had better arguments at FSB, we could prevent Solvency II from causing harm. Solvency II harm is not because it engages in prudential risk regulations, as Mr. Wallison said; it is because they interfere with long-term capital in ways that are not efficient for insurance companies by making them act like banks. That is a mistake. But it is an intellectual mistake of the FSB that the FSOC and U.S. representatives have the power to correct. It is not an inherent problem of the FSB.

Thank you for this opportunity.

Chairman SHELBY. Thank you, Dr. Posen.

A lot of concerns have been raised in testimony today and at previous hearings we have held here about the role of the FSB and its regulatory influence in the United States. As I have mentioned, the FSB is neither a U.S. regulatory body nor is it accountable to Congress and the American people.

Could each of you succinctly elaborate, if you can do that, on your top concerns with the work, the transparency, and accountability of the flexibility and what Congress can do to address some of these concerns? Governor, we will start with you.

Mr. KEMPTHORNE. Mr. Chairman, thank you very much. In visiting with different members of the FSB, in one instance where it was a central bank president of another country, but he made the point—he said one of the things that we should do is give much greater exposure to the insurance industry because we do not know much about it. We have had other members of FSB say it is interesting at times to see what the International Association of Insurance Supervisors say they must do in the name of FSB, and that somebody should press them on that. There are a variety of things.

And then, Mr. Chairman, as mentioned earlier, the close connection between FSB actions and FSOC actions, where within days AIG is named as a G–SII, the three that are now designated as

SIFIs were all named as G–SIIs first by the FSB. Why did they not coordinate? Why did they not say to those that have the expertise in this country, “Where do you think there may be a problem?” And that is why, again, Mr. Chairman, we ask that the activities-based approach should be taken. That has not occurred. There is no transparency. The FSB does not communicate to the companies why they made the decision they did. We would like greater transparency.

Chairman SHELBY. Mr. Wallison, succinctly.

Mr. WALLISON. I will try.

Chairman SHELBY. I know, I know. Thank you.

Mr. WALLISON. My concern, as I expressed in my oral testimony, is that the FSB is intending to regulate shadow banks and the shadow banking system. I think that would be a major mistake, and if that idea is brought into the United States, it would substantially weaken our financial system.

I would like to see a lot more transparency and accountability at the FSB so that we understand why they are trying to regulate shadow banks, other than the fact that banking regulators in general are trying to get control of everything that is not a bank. But, of course, we are not getting that. To the extent we can, that would be helpful. But the most important thing I think we have to worry about is the idea that our capital markets will ultimately be put under prudential regulation by an organization like the Fed.

Chairman SHELBY. Mr. Stevens.

Mr. STEVENS. Mr. Chairman, there are any number of issues. One, for example, is that the full record of comments that the FSB receives is not made public, so you do not really have an idea of who or what may be influencing its decisions.

Second, it does not appear that the FSB feels obliged as a U.S. regulatory agency would actually to take into consideration and respond to the commentary it receives. This pack of papers in front of me represents just what the ICI has put in front of the FSB. Much of it has been, frankly, disregarded. We have no idea what the positions are that the U.S. representatives are taking, but when recommendations emanate from the FSB, it is clear they have been front-run in terms of the FSOC process, and certain decisions have already been made, which are then revisited here in Washington. It is sort of like being both the pitcher and the umpire in a baseball game.

Chairman SHELBY. Mr. Scalia.

Mr. SCALIA. Transparency certainly, you have heard. Transparency also into the influence that might exist, FSB upon the FSOC, which has not been provided and should be avoided in the future.

Second, a balance. Dr. Posen’s point about insurance representation is a very important one, I think.

And, third, FSB should hesitate and think long and hard before making company-specific decisions. That implicates principles of due process, the opportunity to be heard and the like, that really change the nature of what it is doing.

Chairman SHELBY. Dr. Posen.

Mr. POSEN. Thank you. I am much more concerned about the substance than the process. I think the substance has gotten too bank-captured, too bank-controlled, too much bank supervisor mind-set, as my colleagues and I have discussed. I think they remain a little too timid on surveillance, and they need to extend what needs to get the Chinese banks, which, of course, are in the news right now, which are becoming major systemic actors. We need to be willing to open up the governance enough because we need to get them in and get them observed.

And I sort of echo Mr. Scalia's point. I think there has been too much time wasted and too much distraction on individual designations, and that is a fight we cannot have. But at the same time, if the FSOC and the FSB come up with completely different designations, that is a recipe for regulatory arbitrage because national champions will cheat around our rules.

Chairman SHELBY. Thank you.

Governor Kempthorne, could you briefly describe the key differences between the U.S. and European regulation of insurance? And given those differences, is it appropriate for the FSB to influence insurance regulations in the United States?

Mr. KEMPTHORNE. Mr. Chairman, it is a totally different system that is used in the European Union than in the United States. I have stated in international forums that the idea of Solvency II, it may work for Europe. It will never, ever work here in the United States. We are State-regulated, and as Secretary Geithner said after the 2008 crisis, the insurance industry came through it "quite well." So we have a program that has worked for decades.

Chairman SHELBY. Even AIG did not get in trouble on insurance. They got in trouble doing something that they probably wish they had never known about.

Mr. KEMPTHORNE. Mr. Chairman, you are absolutely correct. It had nothing to do with their insurance element within AIG.

Chairman SHELBY. Thank you.

Dr. Posen, in your testimony you highlighted several troubling FSB outcomes. For example, you noted that calling all nonbank financial companies "shadow banks" and regulating them as banks endangers the very financial diversity that enabled the United States to recover from the financial crisis better and more quickly than our global counterparts.

You also noted, and I will quote you, "We do not want any global regulatory process to interfere with this diversity in U.S. finance."

What are your concerns with the FSB potentially interfering with the U.S. financial system's strength and diversity?

Mr. POSEN. My concerns are more theoretical, to be honest, than practical at the moment. I do not think the FSB is a direct threat. I do think that it is important that the U.S. regulators and your representatives make it clear that it is a good thing to have capital markets as well as banks. It is a good thing to have lively risk taking as well as lending. It is a good thing to have nonconcentrated banking systems. And it is entirely possible and consistent with part of the FSB process to make that the agenda.

I do not think there is a need for absolute convergence. The example I chose to give of the insurance companies is the one place where I do feel there is a costly effort being under way from the FSB. I do not think this is motivated so much because the leadership of the FSB wants convergence, although some people do. I think it is motivated by an excessive—some people have mentioned rush to judgment. The FSB is trying very hard to wrap up what it considers its post-crisis duties very quickly, and I think it is trying to force everything with off-the-shelf solutions because it is rushing too much.

Chairman SHELBY. The last question will be directed to Mr. Scalia. As an administrative law practitioner, among others, you are familiar with our domestic rulemaking process. For example, the Administrative Procedures Act governs the way, as I understand it, in which Federal and administrative agencies may propose and establish regulations in the United States. But none of those processes apply to the FSB. In fact, according to the FSB, "The organization operates by moral suasion and peer pressure to set international standards."

Mr. Scalia, in your opinion, would FSB's reactions and decisions pass legal muster in the United States? And what are your main concerns with the role and impact of the FSB on our regulatory process?

Mr. SCALIA. Mr. Chairman, no, the FSB processes would not pass legal muster in the United States. One principle that is absent is that of notice, of providing notice to the public in advance of what might be coming down the pike.

Now, that furthers interests of fairness, but I think more importantly it leads to better decisionmaking, because when the public has notice, it has an opportunity to weigh in, provide guidance, and regulators benefit from those insights. So I think that is one important difference.

A second I will mention is the opportunity to be heard and appear and defend your rights and interests. And I think when FSB finds itself making company-specific designations, the absence of that is striking as a matter of the perspective of U.S. law, or really I think any perspective.

A third difference that I will mention—and then I will stop in the interest of time, although I could go on—is an opportunity to appeal. You know, in the United States, when there is regulatory——

Chairman SHELBY. Basic due process.

Mr. SCALIA. Basic due process, being able to go to court and say, respectfully, we believe this was a mistake, you erred. And that also is absent from the FSB process.

Chairman SHELBY. Thank you.

Senator Brown, you have been very patient. Thank you.

Senator BROWN. Thank you, Mr. Chairman, as you always are, so thank you for that.

These hearings are especially important, and I am appreciative that we have them so that we do not forget the cost of the financial crisis. I live in a Zip code in Cleveland, Ohio, 44105, which had more foreclosures in 2007 than any Zip code in America. I still see the cost in that neighborhood, and neighborhoods all over my State, as I think is true in so many places. I think these hearings force us to remember, and should, what Dodd-Frank and what the consumer protections did for our financial system and for consumers and for people that work and use the financial system. And I think it helps—these hearings help us recognize how much more we still have to do.

Let me start with you, Dr. Posen. You mentioned cognitive capture today. I remember some maybe 3 years ago, I was on a panel with Governor Huntsman and at that point just former head of the FDIC, Sheila Bair, and I believe you were moderating it, and you used that term at the Peterson Institute 1 day of "cognitive capture," where regulators begin to hold the same world view as the companies which they oversee.

It seems that one of the benefits of a single body with broad international membership and different agencies is that you can avoid a single nation or regulator protecting one of its companies or industries by avoiding regulation.

My question is this: Dr. Posen, we know inconsistent regulatory standards create the potential for substantial risk. Would you discuss the importance of coordinating standards to address regulatory arbitrage and other systemic risks, please?

Mr. POSEN. Thank you very much, Senator Brown. You have already hit the issue in your question, so let me try to document the issues you raise.

What I think has to be looked at when we look back at the financial crisis in the United States and the other major Western economies in recent years was that everyone was pulling in the same direction. Banks, their lobbyists, Congress people, Fed officials, Treasury officials, both parties—they were all largely on the same line that less regulation, infinitely less regulation was better, self-regulation was better. And as a result, when we look for a cause of the crisis, there is a clear failure of behavior, of regulation, of supervision, but it is so dispersed. It was not one person's decision, nor was it one person's bribe. It was, as I put it, cognitive capture, that everyone bought into this being the way of the world.

And the FSB has been successful in breaking that down, not just because it has a mandate to look at regulations, a mandate to improve regulations, but because it is, as you say, cross-border.

We had a world in which AIG financial products, as mentioned, got away with doing something that an insurance company or, for that matter, no one ever should have done, because it took place in London instead of New York and because it took place in a subsidiary that was supposedly not part of the insurance, and so, therefore, it had a loophole to get to. And we all know the repercussions of that.

We had bad lending on mortgages, be it in Spain, be it in the United Kingdom, and certainly here in the United States. And that was not because of Fannie and Freddie. As former Fed Governor Randall Kroszner has pointed out, it was because of bad standards in the banking system, bad enforcement of standards in the banking system. And that allowed other countries to get their mortgages paid for, distributed, and the standards to be lower throughout the world.

So how do we stop this? We make our best efforts. We make our best efforts to come up with best practice; we make our best efforts to challenge assumptions; we make our best efforts particularly to assure that no one country, be it France, be it Japan, or even the United States, gets to say, "The interests of my banking system, as companies not as a public interest, trump the need for decent regulation." And the FSB has been pursuing that goal at least.

We have had various aspects where in the past, as created the euro crisis, French banks and German banks were bailed out at the public's expense, leaving Greece with the bill. This is the kind of thing that the FSB is meant to avoid by breaking down these barriers and subjecting these kinds of bad behaviors to global scrutiny and raising these bad behaviors. I agree, activity-based not so much institution-based, up to the G–20 level where they can be properly addressed as well.

I will finally say that the—this is where I differ on the due process point. I think it is important that international regulations be done by sovereign nations agreeing and creating standards that are soft power, that when countries or companies do not comply, it is up to the market and the public to punish them; it is not some supranational agency to do it. And I think the FSB is making huge strides and getting more plugging of holes of the AIG financial products kind because it involves this voluntary shaming and voluntary invoking of the market rather than legislating.

Senator BROWN. Dr. Posen, speak to the designation process in terms of interconnectedness related to securities lending and derivatives, the risk of runs, the potential for fire sales, if you will.

Mr. POSEN. Yes. Obviously, the question of how to handle the asset management industry is a crucial factor here, mutual funds and other asset managers. So much of our private savings, so much of our people's pensions and long-term savings are there, for understandable reasons.

But as we saw with the money market mutual funds during the crisis, they were able to act as though they had an implicit Government guarantee and then eventually an explicit Government guarantee, because no one wanted to see them break the buck, and because it was so politically unpopular to see them not have deposit insurance like the banking system, even though inherently they are much more short term than the banking system.

Paul Volcker, who is hardly a radical, has bemoaned this fact at great length before this Committee, I believe.

This is just one example of how it is correct and right for the ICI and others to go out there and say you cannot treat mutual funds and asset managers like banks. They are not the same as banks. You have to judge the regulation appropriately. But it is not an argument that there should be no regulation or that we have sufficient regulation at this point.

We have seen repeatedly that asset managers may not themselves cause leverage, which is a good thing and should get them some points. But we have also seen that fire sales can and do occur. We saw this with the European crisis in the past in which we have seen the sell-off of European bonds, which then led to losses in the U.S. system, which also exacerbated the European financial crisis in 2010–11.

Fire sales, we may not have the right answer. Circuit breakers are not necessarily a perfect thing, as we have seen with the U.S. stock market. We have to think hard about how to do it, and we do not need to rush to regulate it in the next 5 minutes. There clearly is a gap in regulation in this area.

Mr. STEVENS. Senator, since this is now touching on——

Senator BROWN. Thirty seconds, because my time has run out, and I want to ask Mr. Kempthorne—but, Mr. Stevens?

Mr. STEVENS. The ICI has insisted all along that there be an evidence-based analysis of things like fire sales. The documentation we have in front of the FSB is very clear. In the 75-year history of U.S. stock and bond funds, there has never been the kind of fire sale or panicky sell-off that Dr. Posen is describing. It is hypothetical. It is a matter of conjecture. It is not a matter of historical experience or empirically demonstrated. And the money market fund example, which central bankers go back to all the time, has already been addressed in two successive rulemakings by the SEC. It is important to note the FSB's focus here is not money market funds; it is ordinary stock and bond funds. And so the issue is, I think, a false scent to raise the experience of money market funds in the crisis, because FSB's focus is elsewhere.

Senator BROWN. Governor Kempthorne, let me shift to something else. A number of my colleagues and I worked to pass and sign into law clarifications of insurance capital standards. You mentioned that a moment ago. Would you update us on your talks with the Fed to implement them?

Mr. KEMPTHORNE. Yes. Senator Brown, thanks very much. It was critical for the solution that Congress came up with. The Fed acknowledged that. They said, "Absent that, we were not able to differentiate the business models between banks and insurance."

Since then, we have a group of companies that are under the banner of ACLI that leadership has met with Fed officials. They now have put in place what will be a series of just working sessions. We appreciate the fact that the Fed is saying while we have been for decades dealing with banks, this is a new area for us, and so they have asked the industry to please have the dialogue so that they can understand some of the nuances and some of the elements with regard to the insurance industry.

We certainly as an industry cannot predict the outcome of what the Fed would recommend, but at least we appreciate this dialogue that is taking place.

Senator BROWN. Thank you.

Thanks, Mr. Chairman.

Chairman SHELBY. Senator Heller.

Senator HELLER. Mr. Chairman, thank you, and thanks to the witnesses for being here today. It is a good group, and I appreciate your knowledge on these issues.

I want to echo what has been said. It is no doubt that regulators are looking at risks associated with activities—should be looking at risks associated with activities and not just the size of an institution. One of the frustrations is, instead of working to decrease systemic risk, it seems regulators just want to make more SIFI designations. I think most of the panel would agree with that.

I think some of the best solutions, Mr. Chairman, is what you put together in your bill and what this Committee passed recently. I think the legislation does a great job in the nonbank SIFI designation process, and I would like to hear from the Governor and Mr. Stevens their thoughts on the Chairman's bill, specifically Title III and the reforms of FSOC's designation process.

Mr. KEMPTHORNE. Yes, Senator Heller, thank you very much, Mr. Chairman. We greatly appreciate the efforts of the Chairman and Members of the Committee. Specifically, one of the elements that we think is absolutely critical is the off ramp for a SIFI, because I do not think any of the companies can tell you what were the elements that put them into a SIFI designation. So perhaps by having an off ramp, it will give us those elements now so that a company knows how it can get off. It may help other companies from ever getting on.

Also, I would just note that with regard to a lawsuit that has been referenced in this hearing, again, we think that will bring additional light to what were the elements that were utilized in actually putting a company in that situation.

It can put an adverse competitive problem to those that may be designated SIFIs. One element may be additional capital requirements, different regulations that may put them at a disadvantage in a competitive marketplace. We need to have a highly competitive marketplace and not disadvantaged some of those elements.

I would also say, Senator Heller, as I indicated in my opening comments, to you and Senator Tester, we greatly appreciate language, which you have included, that would help bring about much greater transparency, the idea that it would require that those entities in the United States, which have been termed "Team USA," would on an annual basis have to submit a report to this Committee and would have to come to a hearing so that the Members of the Committee can ask them, "What is taking place at FSB, at FSOC?" I think that is a tremendous benefit, and I compliment you.

Senator HELLER. Is this your view or ACLI's view?

Mr. KEMPTHORNE. I will tell you, Senator, that this is a view that I have heard repeatedly by industry. We need much greater transparency, and this would help accomplish that.

Senator HELLER. Mr. Stevens?

Mr. STEVENS. Senator, thank you for your question. The purpose of addressing potential systemic risk is not simply to identify it and admire it. Presumably it is to deal with it. And so common-sense provisions like those that are in the Chairman's bill that would, prior to designation, allow either a primary regulator or a firm to address and mitigate or eliminate the risks seems to me to be an improvement on the mechanisms in Dodd-Frank, and a sensible one as well.

I think that it would require the FSOC to be specific about what risks it thinks exist, but if the FSOC cannot be specific and cannot articulate what they are, they probably should not be designating in the first place.

So it seems to me that the provisions in Title III of the bill in that respect make eminently good sense and are consistent with the broad objectives of the statute.

Senator HELLER. Let me ask you a follow-up question. If some of these asset managers are labeled SIFI designations, who bears the cost of these increased regulations?

Mr. STEVENS. Well, you have to be mindful of what that entails under Dodd-Frank. There is a mandatory 8 percent capital requirement. There are various fees and assessments. There would be putting the fund into a bailout pool for large banks or other SIFIs that may fail in order to make sure the taxpayer is not on the hook. It is just another way of putting some of our taxpayers on the hook.

And then, finally, it would subject them to enhanced prudential supervision, which essentially is the Fed coming in and telling the portfolio manager potentially how to run the fund. I think that a fund so designated is not going to be too big to fail. It is going to be too burdened to succeed because there are lots of alternative funds in the competitive marketplace for mutual funds in the United States, and many investors, being sensitive to costs, will simply say, "Well, I will not invest in that fund. I will take my money somewhere else where I am not paying these kinds of penalties."

Senator HELLER. So what you are saying is ultimately there will be cuts in their returns on their investments.

Mr. STEVENS. It will be paid by millions of Americans who are seeking to save for retirement.

Senator HELLER. OK. Mr. Chairman, thank you.

Chairman SHELBY. Senator Menendez.

Senator MENENDEZ. Well, thank you, Mr. Chairman.

International coordination to address systemic risk is not easy, but as we learned during the financial crisis, I think it is critically important. As we saw with companies such as Lehman Brothers and AIG, systemic risk can easily cross national borders, and a company large enough to create systemic risk will most certainly have activities affecting or occurring in multiple countries.

We also saw the need for harmonization; otherwise, risk can just flow to the darkest and least regulated corner of the system, where it can build unchecked beyond the reach of countries whose citizens could bear significant costs if things go wrong.

Now, the Wall Street Reform Act made important reforms to address systemic risk here at home, and internationally, the United States and other countries have established forums such as the Financial Stability Board to improve coordination and close gaps across jurisdictional lines.

Now, I understand that some companies have legitimate concerns about whether and how particular measures might be applied to them. And it is important that we distinguish these substantive concerns from procedural ones so that we are able to make appropriate improvements on both fronts. But if you are concerned about a SIFI designation, it would be overkill to destroy the entire process for designating anyone else as systemically important, too.

So as always, from my perspective, in the 23 years that I have spent in the Congress, it is about getting the balance right at the end of the day.

So I think individual cases may be able to illuminate ways that both the domestic and international processes can be improved, as we have already seen in some of the changes the Financial Stability Oversight Council has made to strengthen its review process. So with that focus in mind, I have a few questions for our witnesses.

Dr. Posen, many have raised concerns about the sequencing of actions by U.S. authorities and international bodies such as the FSB, and this really gets at the heart of the challenges we face in terms of coordination with other major markets. So to me, it is important that concerns about sequencing be dealt with, but not be used as an excuse for inaction or obstruction. There are real questions about how to keep the domestic and international tracks moving together at the same pace.

So why do you think international bodies such as the FSB have chosen to move ahead of individual countries' authorities in certain areas, whether SIFI designation or articulating a framework or principles for something like capital standards? What are the benefits of doing that?

Mr. POSEN. Thank you, Senator, and as you rightly said in your remarks, it is a question of balancing risks. The idea is that the United States has to be engaged with the international process not so much because of defending the United States from overregulation, but defending us from underregulation and poor performance abroad. And there has to be some willingness to tradeoff not the U.S. sovereignty and not the U.S. oversight, but occasionally officials want to be able to say I am much more at risk of something terrible going wrong, as you say, in the dark corner of some country that is eluding the safety net, eluding the regulators, than I am about the X pennies cost of slight overregulation in the United States. And that is a legitimate kind of tradeoff to make.

And so in the real world, just as the case in Congress, as we saw with the TPA vote last week, the Senate and the House are not always perfectly sequenced. What matters is that in the end they come to an agreement. Nothing terrible is going to happen with them being out of sequence for a short while. What matters is the debate and the eventual convergence and compromise.

Similarly, the FSB in part because it is more closed, in part, however, because, as I said to Senator Brown, they are also less subject to any individual country or interest group's lobbying, is able to make decisions faster. It does not mean they are right. It does not mean they should always do them at maximum speed. But in the case of the SIFI designations, for example, I think it was an important decision that was made about the balance of risks, that leaving the uncertainty about who was going to be a SIFI, at least as far as the FSB was concerned, had unfair costs to those private sector entities and had costs to the regulatory process. And so, therefore, it made sense for them to go forward, and if it turns out that the FSOC or other national regulators were to push back, those are, as you said, individual cases that could be corrected.

The process, the fact that this appearance of timing is not the subject of a conspiracy or even of undue pressure on the FSOC, it is just we are iterating to the right goal.

Senator MENENDEZ. Thank you. One last question. I think the sequencing in the Congress would go better if the House of Representatives would understand the enlightened process of the Senate. But, Mr. Stevens, let me ask you, how do you feel the feedback you have given at the domestic level, in terms of how different metrics might apply differently in the asset management context than they would to other kinds of financial market participants, is carrying through the international level? And to the extent that you have the concerns you have expressed about whether actions at the international level might reduce opportunities for a full and well-informed process here in the United States, what are some of the top recommendations that you would make to improve the process without effectively killing it overall?

Mr. STEVENS. Thank you, Senator. As I elaborate in my written statement, I do think there is a cognitive capture at FSB, and it is because virtually all of its members and all of its leadership consists of central banks. If its mandate is to look at the financial system in its totality, it needs to be reconstituted, in our judgment. It should not simply be bankers with their point of view trying to impose bank-type regulatory models on everyone. The capital markets regulators and securities regulators ought to sit as co-equals at the table when you are talking about areas like asset management. Insurance regulators ought to be there as co-equals at the table when you are talking about insurance. That would be a meaningful form of international collaboration and international exchange, and I think it would solve many of the problems.

We have an example now of IOSCO basically saying that it thinks that the FSB is headed in a completely wrong direction with respect to asset management, putting the cart before the horse, trying to find what the solution is before it has even identified the problem. And so IOSCO has said let us look at activities and products straight across the asset management sector instead of, as the FSB's process essentially is doing, picking a handful of large U.S. mutual funds and U.S. advisers and recommending them for designation as SIFIs.

So I think the fundamental reform of the FSB is to reconstitute it in a significant way and break up the club of central bankers who have only one view of the world.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Kirk.

Senator KIRK. For Mr. Scalia, I would ask you a question about—what would you think of applying notice and comment provisions of the U.S. Administrative Procedures Act to the FSB deliberative process so that U.S. insurers could have notice and time to comment on potential actions? I have been very worried over time that the process of providing insurance to millions of Americans is different than banking in international circles, that if we provide the wrong standards, we could make insurance products much more expensive and less available to Americans.

Mr. SCALIA. Thank you, Senator. I think it would be a valuable improvement for there to be advanced notice and opportunity for public comment, and also consultation, which are some features that I believe the Chairman's bill would achieve before the FSB takes action.

As I mentioned, notice is in part simply about fairness, giving people a heads up and a chance to speak up, assert their rights and interests. But it is also about reaching better decisions through information, consultation and the like. So those benefits would certainly exist.

Dr. Posen has drawn the analogy to the House and Senate, and I am sure all of us could identify respects in which we think the House and Senate could do their jobs even better than they do. But one very important thing they do have going for them is the openness of the debate that occurs and the like, and we do not have that in connection with the FSB.

Dr. Posen also referred to the House and Senate coming to agreement, which is what they do. It is also what the FSB does. And, yes, it purports to act through moral suasion, but there certainly appears to have been an influence exerted on the FSOC process as a result of the FSB designations. At least it is something worth examining as the Committee is seeking to do today.

Finally, with respect to your comments, Senator Kirk, about insurance and the FSB, there seems to be perhaps consensus among members of the panel that the FSB would benefit from representation of a broader set of expertises and that one area of expertise that is underrepresented currently is insurance, and it may well be that had that insurance expertise been present in 2013, the designation decisions that were made might have been approached differently.

Senator KIRK. Thank you. Mr. Chairman, I will be considering legislation to provide notice and comment provisions with regard to insurance matters in the FSB. I think that would—as one commentator said, the FSB was as clear as mud. To provide the notice and comment provisions, to provide much more transparency, would calm people's irrational fears.

Chairman SHELBY. Thank you, Senator Kirk.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. It is good to be sitting beside you.

Because our financial institutions can transfer assets around the globe in the blink of an eye, they can effectively choose which country regulates many of their riskiest transactions. That means that regulators around the world must be vigilant and must coordinate their efforts in overseeing the world's largest financial institutions. The Financial Stability Board is the main forum for that kind of coordination, which makes its work critical in preventing another financial crisis.

Now, while the FSB is not legally binding on the United States, its decisions are not, those decisions can certainly influence our domestic policies, and that is why it is important that the FSB have the same kind of transparent, data-driven decisionmaking that we ask of our own regulators.

For example, here in the United States, a company may be designated by FSOC as systemically important, but the designation can be reversed if the company restructures its operations so that it creates less risk. That means there are now two ways to manage risks posed by a big bank—the bank can change its business model to produce less risk or it can face the stricter regulations and greater oversight. The bank decides which is less costly, and the result we get is what we want, and that is, less risk.

Now, Governor Kempthorne, as you have noted, many of your members have been designated systemically important by the international FSB. Are you aware of any process that the FSB has for allowing those companies to reverse their designation by changing their business activities?

Mr. KEMPTHORNE. Senator Warren, thanks for the question. I am not aware of any FSB off ramp to get the G–SIIs out of there. It would have been extremely helpful if they would have announced what were the elements that caused them to be name G–SIIs in the first place, and also, was there an opportunity to correct that, as you are alluding to, before they were designated?

Senator WARREN. OK. So let me just break this down. So the answer to the question—Was there any process for reversing the designation?—you are not aware of any process for reversing it. I do want to talk about whether or not companies were informed about what the criteria would be. Does the FSB provide designated companies with the information they need to understand why they were designate and how they could potentially change their business activities to pose less risk?

Mr. KEMPTHORNE. Senator Warren, based on the input I have received from those companies, the answer is no.

Senator WARREN. All right. Would you support changing the FSB process so that designated companies would have a chance to change their operations and possibly reverse their designation?

Mr. KEMPTHORNE. Senator, yes, because we must have greater transparency; we must have greater communication. And, again, before a designation, why not identify what is the risk and then a company may determine it could take its own actions to remove the risk, or it could change its operation, or you could ask the primary regulators: Would you please deal with this issue?

Senator WARREN. Mr. Stevens, would you agree with that? Would you support such a proposal?

Mr. STEVENS. I am trying to puzzle out, Senator, how it would actually work in the methodologies that have been proposed with respect to mutual funds. The methodology basically is based solely on size. What the FSB has proposed is if you are a mutual fund with $100 billion in assets under management, you will be automatically within a materiality threshold recommended for consideration.

So to change the business model, I suppose, you would either have to split the fund in half—and now the manager has got two $50 billion mutual funds. Maybe that makes it less risky. I think what it does is says that the original materiality threshold is nonsensical.

Senator WARREN. So I take it, though, Mr. Stevens, what you are concerned about is you believe—although I am not sure if it is posted, but you believe that in an area—there is an area where FSB says size is all that is ever going to matter to us, we do not care what your practices are? But I take it there are also many that are pulled into designation because of their specific business practices, some combination of the risks they present, because of size, and because of the activities they engage in. This is what I understand Governor Kempthorne to be talking about, that there is no information right now about what it is that causes this designation and no off ramp for the companies that are willing to adjust.

So my question is: Does it make sense to at least ask the FSB for more clarity around what it is that causes someone to be so designated and to provide off ramps if there are multiple factors that are involved?

Mr. STEVENS. I certainly would never argue against more clarity. In fact——

Senator WARREN. Good.

Mr. STEVENS.——we have even asked for them to justify the materiality thresholds that they have put into their methodologies, and, Senator, they are nothing more than just numbers picked out of the air.

Senator WARREN. Mr. Scalia.

Mr. SCALIA. Thank you, Senator. I think it is a very important question you have asked. One other point that I would make is that if FSB were to make that change, it is not clear at this time what difference that would make for companies that have already been designated by FSOC, because it is FSOC that has designated them and the Fed that will regulate them.

What we are told is that FSOC is not influenced by FSB decisions. But an FSB un-designation would only matter to an FSOC-designated company if, lo and behold, FSOC were influenced by FSB.

So I think it is a very important question, but it is only getting at one part of the problem the companies face.

Senator WARREN. I appreciate that point, although at least we have within FSOC—we have had the testimony here that there are off ramps, there are possibilities for coming out from underneath an FSOC designation. And so what we are looking for is can we get the same kind of thing over at FSB. And I take it you would support that sort of change in the approach that FSB uses.

Mr. SCALIA. Yes. I think it would be a valuable step forward if FSB considered the sort of changes that the Chairman's bill would make in the FSOC process.

Senator WARREN. Well, so this is—Governor Kempthorne, I think you wanted—I am sorry, Mr. Chairman. I think we are running over.

Mr. KEMPTHORNE. Senator Warren, thanks very much for the line of questioning, and just a clarification. There currently is not an FSOC off ramp from designation. There is language that is proposed in Senator Shelby's bill that would provide that off ramp.

Senator WARREN. I think we have had testimony, though, from those on the FSOC saying that adjustment is possible so that if risk is reduced, then FSOC designation changes, which sounds to me an awful lot like an off ramp.

Mr. KEMPTHORNE. Again, Senator Warren, based on the input I have received from the member companies that have been so designated, I do not believe they know what would be elements necessary to be de-designated.

Senator WARREN. All right. Fair enough on the transparency point, and one we have certainly had this conversation, I think with those who have testified before us. But they have indicated there are ways to change FSOC designation and that it is important to review how much risk is posed.

You know, I just want to make the point, as I see it—and we have heard the testimony repeatedly in front of this Committee that once a company is designated as systemically important here in the United States, the company should have a chance to reverse that designation if it can show that it no longer poses a systemic risk.

The United States, according to those who have testified in front of us, say that we now permit this, and I believe the FSB should do so as well. It seems to me that is fully consistent with the FSB's important mission of making global financial markets safer.

Thank you, Mr. Chairman. Sorry to run over.

Chairman SHELBY. Senator Warren, I believe Mr. Wallison has a comment.

Senator WARREN. Yes.

Mr. WALLISON. I just have a small point here, but the problem is that we do not understand the metrics that either the FSOC or the FSB uses to designate a company as a SIFI. And we could avoid a lot of problems, including the need for an off ramp, if it were clear to companies before they were designated what they could do to keep from being designated. That is not available to anyone, but it is in the Chairman's bill and makes a certain amount of sense. We reduce a lot of the legal costs and other problems that companies have if they are condemned to be SIFIs and regulated by the Fed.

Senator WARREN. Well, as I said earlier, I think it is important that there be transparency about what it is that causes an FSOC designation and that it is important that the company have the alternative of choosing to reduce its own risk so that it has an exit ramp from FSOC designation.

Thank you very much, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Warren. Thank you for raising the question.

Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chairman, and thank you all for your testimony.

As a strong supporter of our State-based insurance regulatory system, I share the concern of many of my colleagues and some of the witnesses that an international body would set standards for U.S. financial institutions. During the trade debate that we just had, I supported Senator Warren's amendment to the Trade Promotion Authority Act that would limit the inclusion of financial services in future agreements. Unfortunately, we did not pass that amendment. I wish otherwise. But I am concerned about international organizations setting structures that might diminish our regulation of risk within our own American economy. So U.S. officials at the very least should have a say in efforts to change or influence our financial regulatory system.

The conversation about the FSB, we are represented right now by the Federal Reserve Board, the Treasury Department, the Securities and Exchange Commission. Governor Kempthorne, as a representative of the life insurers, do you see this as sufficient or the appropriate representation or specific recommendations for how that might be changed?

Mr. KEMPTHORNE. Senator Merkley, thanks for the question. Without question, with regard to Treasury, they need to have developed the additional expertise on the insurance industry. There is a step forward in the designation by Dodd-Frank of the Federal Insurance Office. Director Mike McRaith is doing a commendable job in that position. But I think some of the reports that perhaps have not come out in the timeframe first suggested may suggest that the vetting of those reports is more difficult because there is not the insurance expertise at this point within Treasury, with regard to the Federal Reserve; and, again, we appreciate Governor Tarullo's approach where he is now having opportunities of working groups to just discuss the elements of the industry. With regard to the Fed, they have added Tom Sullivan, a former State insurance commissioner, who is doing a fine job at the Fed.

But I would add, Senator Merkley, when we had post crisis and the Fed decided to put in a low interest rate environment, we sent teams of two to four insurance industry CEOs to every regional Fed President, and I will tell you that the comments were such as: "We did not even have anecdotal evidence about your industry." "We did not realize that you were the number one U.S. investor in corporate bonds." "We did not realize that, on average, you hold your investments for 17 years, quite different than banks." "We did not realize what a capital source you could be for infrastructure."

So I think through those comments, Senator, you realize that those who are now given responsibility with regard to the well-being and the regulation of the industry have a learning curve. They are on the curve. We appreciate their efforts. But there is still a tremendous amount that needs to be done.

I would add that is true of the FSB as well, which is populated in a great deal by banks.

Senator MERKLEY. Well, your points are well taken. Thank you. And if I could just summarize it, it is not so much who is there as how they proceed to educate themselves on the issues, the huge range of issues that are important, and in your cases specifically the life insurance industry.

I just would like to ask the parallel question, if anyone else wants to chip in, about ways that U.S. representation could be improved on the FSB. Mr. Stevens?

Mr. STEVENS. Senator, I think it is a substantive issue, not just a process issue. But you have to look closely at the FSB as an organization and ask yourself who its members are. By and large, the members are central bankers and finance ministry officials. They do have some capital markets regulators, like the Securities and Exchange Commission. Virtually the entire leadership—that is to say, the head of the FSB, the head of its important working committees, and things of that sort—are all central bankers. I think the IOSCO statement makes it very clear that having now experienced over a couple of years an effort collaboratively within the FSB to work, that they have said this is not going to be satisfactory, we have got to take a different approach.

And so what we take from all of that is the need to reconstitute some international body and to give capital markets regulators, and insurance regulators for that matter, a co-equal place at the table. Because if the mandate is to look at the entire global financial system, that is much more than banking, and you need to bring the right expertise and background and experience to bear. The FSB simply cannot do that as it is currently constituted.

Senator MERKLEY. Thank you. Yes?

Mr. POSEN. Senator Merkley, just very rapidly, as I said in my written testimony, like others here, I support filling the particular gap that we have in insurance knowledge where I think the European regulators are going amok. But that said, I think it is very important that we pick up on something Senator Brown and I exchanged upon earlier, which is that the FSB by its international nature also provides a certain amount of insulation against industry lobby groups and against national champions of various companies. And I think it is important that we do not make this into a body that, for all our desire for admin law, not oppressing any individual company that does not—that gets captured in the way that various specific regulators got captured in the past. And we always have to be suspicious when you can say central bankers have limitations. I am one of that breed, and I certainly have mine. But the fact remains that we know that there are particular industry-designated regulators who become captured either in corrupt terms or intellectual terms by those industries, and we do not want this to become that again.

Senator MERKLEY. And so if I can capture your comment, while expertise is essential in order for the FSB to have insight on key industries in various countries, you are raising the concern that the regulators, the FSB, not be intellectually captured by those industries.

Yes, Mr. Wallison?

Mr. WALLISON. I would like to add one thing here, and that is, we have to understand that the FSB as well as the FSOC, whatever decision they come to, is an agreement among regulators. Regulators have an interest in having more power and more opportunity to control the direction of their respective economies. So although it is a good idea to have regulators talk to one another, discuss ways that they can address things, I think we have to recognize that regulation can be imposed because regulators want it to be imposed, and from the standpoint of the United States, where we have very free capital markets which have kept us ahead of almost the rest—actually created the economy that we have in the United States today, which is the best in the world, we have to be concerned that someone is speaking from the standpoint of the United States. And when we look at what the Fed wants to do, which is to get control of shadow banks, which is basically our entire capital market system, we have to be worried about that and be sure that whatever the FSB does, or even the FSOC, it is consistent with what Congress wanted when it created the Dodd-Frank Act. And I am afraid that we are not exactly clear on that right now.

Senator MERKLEY. Thank you very much, and my time has expired. Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Stevens, I would like to ask you a question about mutual funds and the model. It is totally different from banking, as we know. We know insurance is different. We know that you are dealing with financial products and so forth. And you brought it up earlier. If you are a $100 billion mutual fund, you have that under management. Now, if you are 25, that does not change the risk, does it? If you are big, you might be so well run and so forth. But explain basically the difference in the model of a bank and a managed fund, just for the record.

Mr. STEVENS. Well, in the case of United States mutual funds, Mr. Chairman, irrespective of their size, there are still certain principles that apply.

Chairman SHELBY. Absolutely.

Mr. STEVENS. They use little to no leverage, which dramatically distinguishes them from banks. They act as agents, not principals, so that the adviser is not retaining risk at the adviser's level. Whatever the——

Chairman SHELBY. They are spreading the risk, aren't they?

Mr. STEVENS. That is correct, and——

Chairman SHELBY. They are spreading the risk. If I buy mutual funds, I am taking a risk in a sense. I am hoping it goes up, but it could go down. Right?

Mr. STEVENS. And it does both over a cycle.

Chairman SHELBY. Sure.

Mr. STEVENS. But all those investment risks are then experienced by the underlying shareholders in their millions. They are also highly transparent, Mr. Chairman. The amount of information you can get about how a mutual fund and its portfolio and the like are managed is really quite dramatic.

There is also extensive regulation that is calculated to control risks, and, frankly, that is why even these largest funds exhibited a remarkable degree of stability in the financial crisis. Now, this is the second worst financial crisis since the early 19th century. Some of our stock and bond fund investors lost very substantial portions. Equity funds went down 40, 45 percent—even more. There was no panicky sell-off——

Chairman SHELBY. The same thing with 401(k), our pension funds, everything up and down. That is the market.

Mr. STEVENS. That is exactly right.

The other thing, Senator, is that our industry in the United States is largely a retail industry. Upwards of 90 percent of our investors are individual investors who are saving for very long-term purposes. So they do not look at mutual funds as a short-term trading proposition. They look at it as something that they are going to stick with—and they did stick with them during the crisis—for the very longest term and most important financial goals that they may have.

Chairman SHELBY. Let me ask you this. Let us say I could buy through a mutual fund part of an index fund, right?

Mr. STEVENS. Yes.

Chairman SHELBY. How are you going to regulate the index fund which is based, say, on the S&P 500 or some other model like that? Basically you are tracking the market, aren't you?

Mr. STEVENS. That is exactly right, Senator, and in the FSB's methodologies, there are a number of very large index funds that would be captured, because they tend to grow above $100 billion as they are sponsored by some firms in the United States.

So you ask yourself then, that recommendation comes to the FSOC, and were the FSOC to say, yes, you know, you are right, FSB, we need to designate that fund, how then would the provisions of Title I of Dodd-Frank apply in that case? They are actually nonsensical as you think of them in the context of a mutual fund, and to me that is the very best evidence that when Congress put

Dodd-Frank together, it never intended the result that Title I of Dodd-Frank would be brought to bear against our largest mutual funds unless that title is looked at as a roving commission by the Federal Reserve simply to get more and more and more of the U.S. financial system under its jurisdiction. I think Congress did not intend that at all.

Chairman SHELBY. I agree. But, Mr. Wallison, let me ask you a question, and then any comment you want to follow up on that. The ramp in the legislation, some of it I proposed, if you are designated—and Senator Warren got into this, which I think was an excellent topic. If you are designated, that is not an easy thing. That is tough. Most people have a way through process to get undesignated or get off the hook, so to speak, probation or whatever you want to call it. I do not believe that they have, although they alluded to it here, that there is a way to get off, because it is not explicit, it is not transparent. There is no mechanism that I understand to do it. Once you are designated, you know, a lot of people say you are damned in a way. Do you want to comment on that?

Mr. WALLISON. Well, I think it is absolutely true, Mr. Chairman, that once you are designated, unless there is a clear way for you to exercise an off ramp in some way, you are damned. But look at it this way: If you do not know why you have been designated——

Chairman SHELBY. That is exactly right.

Mr. WALLISON. And that is where we are today.

Chairman SHELBY. Well, that is what Senator Warren got into——

Mr. WALLISON. Right, and she is completely right. If you do not know why you have been designated, there is no way that you can exercise the off ramp unless the regulating agency, like the FSOC, is willing to say to you, well, you were designated for this particular reason or these four particular reasons, and if you eliminate all of those things, well, then, we will un-designate you. But apparently we have no indication that the FSOC at least is willing to do that, and certainly not the FSB.

If I may follow up, Mr. Chairman, on one issue——

Chairman SHELBY. Go ahead. Go ahead.

Mr. WALLISON.——you were talking about with Mr. Stevens, and that is, mutual funds, the key issue here is what is called "maturity transformation." Mutual funds and other investment organizations do not involve maturity transformation. That happens to be the riskiest thing that banks do. They borrow money short term and lend it out long term. That is maturity transformation, and it is very risky because the funds you lent out could be withdrawn by depositors when you are a bank. Mutual funds do not have that problem and should not——

Chairman SHELBY. And neither do insurance companies.

Mr. WALLISON. And insurance companies, too. Mutual funds and insurance companies and other capital markets operators generally do not have that problem at all. Yet the FSB says, as I said in my oral statement, the FSB says that complex chains of transactions can create maturity transformation collectively. That raises the question of whether all of these small firms operating in the capital markets, engaged in these complex chains of transactions, could be designated by the FSOC. Certainly that is what the FSB is after. And whether the FSOC has the power to do that is the problem.

Chairman SHELBY. Mr. Scalia, do you want—I know you want to answer that, too—to get into due process? It seems like there is lack of due process here, but go ahead.

Mr. SCALIA. Thank you, Mr. Chairman. In a sense, that is what I wanted to comment on. This exit ramp idea is a very important one. It would be a significant contribution of your bill, and it would be good if agencies, FSOC in this case, disclosed to companies what FSOC needed to be done in order for that company not to be systemic.

But I think we would want to avoid a circumstance where a company's fate depended on FSOC's opinion or FSOC's whim, FSOC saying, "We have decided you do this, that, or the other thing, and then you will be OK."

Obviously what we need as well is discernible, ascertainable legal and empirical standards that the public can look to and judge for themselves what they need to do, and if FSOC, for example, declines to de-designate, that those entities can have the confidence that they could go to court and say, "Look at all we did, but FSOC is not letting us out of the pen."

Mr. Stevens mentioned the importance of evidence-based approaches, and that has been lacking as well in FSOC's decisionmaking. So I think in addition to providing the off ramp, it will be very important in the future for FSOC to base its decisions more on a closer empirical and evidentiary approach toward its task.

Chairman SHELBY. Governor?

Mr. KEMPTHORNE. Mr. Chairman and, again, Senator Warren, I think this answers a bit to what we were discussing and that is with regard to the off ramp that may exist. In the Dodd-Frank Act, it does call for an annual review of a designated company by FSOC. However, as Mr. Wallison pointed out, they do not know what was the criteria, the metrics that made them designated in the first place.

If there was an existing off ramp, I think a major company would not have felt that they needed to go through a legal process. Currently there is no appeal process with regard to designation of a SIFI, and that is why we do commend and support the concept of an off ramp of a designation so you can de-designate knowing what it was that put you there in the first place.

Chairman SHELBY. Thank you.

Senator Warren, do you have any comments?

Senator WARREN. No. I am good. Thank you, Mr. Chairman.

Chairman SHELBY. I thank all of you for the hearing. This is very important, and we appreciate your contributions here today. Thank you very much.

Mr. KEMPTHORNE. Thank you.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

PREPARED STATEMENT OF DIRK KEMPTHORNE

PRESIDENT AND CEO, AMERICAN COUNCIL OF LIFE INSURERS

JULY 8, 2015

Chairman Shelby, Ranking Member Brown, and Members of the Committee, I am Dirk Kempthorne, President and CEO of the American Council of Life Insurers (ACLI). ACLI is the principal trade association for U.S. life insurance companies with approximately 300 member companies operating in the United States and abroad. ACLI advocates in Federal, State, and international forums for public policy that supports the insurance marketplace and the 75 million American families that rely on life insurers' products for financial and retirement security. ACLI member companies offer life insurance, annuities, reinsurance, long-term care and disability income insurance, and represent more than 90 percent of industry assets and premiums.

ACLI appreciates the opportunity to address the impact of the Financial Stability Board (FSB) on the U.S. regulatory framework. ACLI recognizes the important role of the FSB in enhancing international cooperation and coordination among financial supervisory organizations. The FSB was formed in 2009 by the G20 to promote financial stability through reform of the international financial regulatory structure. Its membership includes financial regulators from 25 major nations, including the European Union; international financial institutions, such as the IMF and World Bank; and standard-setting bodies, including the International Association of Insurance Supervisors (IAIS) and the International Organization of Securities Commissions (IOSCO). The U.S. representatives to the FSB are the Department of the Treasury, the Federal Reserve, and the Securities and Exchange Commission.

My testimony focuses on two standard-setting actions by the FSB and its member organizations that intersect with the powers and authorities of the Financial Stability Oversight Council (FSOC) and the Federal Reserve Board. Those standard-setting actions are the designation of "globally systemically significant" insurers and the establishment of an international capital standard for insurers. More specifically, ACLI is concerned that——

- FSB's designations of G–SIIs have prejudged FSOC's designations and placed designated insurers at a competitive disadvantage in the marketplace;
- The FSB and FSOC have not applied consistent standards to the designation of nonbank financial companies; and
- There is a potential for conflict between insurer capital standards being developed by the Federal Reserve Board and those under development by the IAIS. These new standards may also unnecessarily deviate from the existing, proven insurance risk-based capital regime U.S. State insurance regulators use today.

To address these concerns, ACLI is recommending that——

- The designation process for insurers should be replaced with "activities-based" regulation that avoids the negative consequences of designating individual companies merely because of size.
- The Federal Reserve Board should finalize the capital standards mandated by Congress last year in a manner that is consistent with the Insurance Capital Standards Clarification Act before agreeing to capital standards developed by the IAIS; and
- This Committee should exercise vigorous oversight of the capital standard-setting process by the Federal Reserve Board and the IAIS to ensure that the intent of Congress and the competitiveness of the U.S. insurance industry is preserved.

Before I address those issues, however, I would like to commend Chairman Shelby and the Committee for The Financial Regulatory Improvement Act of 2015.

Financial Regulatory Improvement Act

The Financial Regulatory Improvement Act reflects many of the principles of transparency, accountability, and due process that are supported by ACLI and its member companies. In particular the bill:

(1) Proposes important, meaningful reforms that would strengthen Financial Stability Oversight Council procedures and ultimately facilitate a reduction in systemic risk;

(2) Increases opportunities for stakeholder input and Congressional oversight of the International Association of Insurance Supervisors regarding the develop-

ment of international capital standards. ACLI commends Senators Dean Heller (R–Nev.) and Jon Tester (D–Mont.) for their strong leadership on this issue;

(3) Requires the Federal Reserve Board to plan for the different kinds of nonbank financial companies, including insurance companies that it supervises; and

(4) Includes language from the Policyholder Protection Act of 2015, which would afford insurance policyholders in the context of a savings and loan holding company structure the same protections as those currently provided under the Bank Holding Company Act.

ACLI urges the Committee to move this important legislation to the full Senate for consideration.

FSB's Designations of Globally Systemically Important Insurers (GSIIs) Seems to Have Prejudiced FSOC's Designations and Placed Designated Companies at a Competitive Disadvantage

Both FSB and FSOC have designated three U.S. insurers as "systemically important." In July 2013, the FSB, in consultation with the IAIS, designated nine insurers as G–SIIs, including three U.S. insurers: AIG, Prudential and MetLife.[1] These designations were based upon a methodology developed by the IAIS.[2] The FSB envisioned that designated companies would be subject to certain policy measures, which would be developed by the FSB and IAIS and implemented by member countries. Those policy measures include recovery and resolution planning requirements, enhanced group supervision, and higher loss absorbency requirements for nontraditional activities.

FSOC also has designated AIG, Prudential and MetLife as systemically important, subjecting them to supervision and regulation by the Federal Reserve Board. FSOC's designation of AIG occurred on July 8, 2013, just days before the FSB initial designations.[3] Prudential was designated by FSOC in September 2013,[4] and MetLife was designated in December 2014.[5] The regulation of these companies by the Federal Reserve Board includes heightened capital standards, resolution planning requirements, liquidity requirements, and risk management standards.

FSOC's independent member having insurance expertise, Roy Woodall, has raised serious concerns about the timing of these designations. In his dissents to both the Prudential and MetLife designations, Mr. Woodall noted that the FSB's designations were taken in consultation with members of FSOC, and that these discussions appear to have pre-judged FSOC's independent designation process:

> Although not binding on the Council's decision, the declaration of Prudential as a G–SII by the FSB based on the assessment by the United States and global insurance regulators, supervisors, and others who are members of the IAIS has overtaken the Council's own determination process.[6]
>
> It is clear to me that the consent and agreement by some of the Council's members at the FSB to identify MetLife a G–SIFI, along with their commitment to use their best efforts to regulate said companies accordingly, sent a strong signal early on of a predisposition as to the status of MetLife in the United States—ahead of the Council's own decision by all of its members.[7]

ACLI shares Mr. Woodall's concern. FSOC has a mandate to designate nonbank financial companies for supervision by the Federal Reserve Board based upon criteria established by Congress, and FSOC's designation decisions should not be predetermined by the actions of the FSB.

A lack of transparency and due process compounds this concern. While the FSB has stated that it follows a designation methodology developed by the IAIS, the FSB designations are not accompanied by any explanation or rationale. Nor are des-

[1] Global Systemically Important Insurers (G–SIIs) and the Policy Measures That Will Apply to Them, Financial Stability Board, July 18, 2013.

[2] Global Systemically Important Insurers: Initial Assessment Methodology, International Association of Insurance Supervisors, July 2013.

[3] Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc., Financial Stability Oversight Council, July 8, 2013.

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

[5] Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc., Financial Stability Oversight Council, December 18, 2014.

[6] *http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf.*

[7] *http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.*

ignated companies accorded any ability to engage directly with the FSB or challenge a designation. Moreover, there is no transparency surrounding the FSB's actual directions to the IAIS, other than what the IAIS or FSB chooses to announce after the fact.

The immediate and potential negative consequences of designation are significant. The insurance industry is highly competitive, and the additional regulation imposed upon a designated company can place that company at a significant competitive disadvantage relative to its nondesignated competitors. Capital standards are the most obvious example. If capital requirements on designated insurers are materially different from those imposed by the states, designated insurers may find it difficult to compete against nondesignated competitors, resulting in a loss of business or an altered product mix. Less competition or less product availability is not in keeping with a healthy market that best serves insurance consumers. Even before any additional regulation is implemented, the prospect of such regulation has an immediate impact as it forces designated companies to manage their operations taking into account looming but unspecified regulatory requirements.

FSB and FSOC Should Pursue "Activities-Based" Regulation of Insurers Rather than Designating Individual Companies

FSB and FSOC have taken markedly different approaches in their treatment of different categories of nonbank financial companies. While FSB and FSOC have designated three U.S. insurers for heightened supervision and regulation, they are pursuing an "activities-based" approach for asset managers rather than the imposition of heightened regulation on individual companies merely because of size.

Recent public statements by Federal Reserve Board Governor Daniel Tarullo and by Greg Medcraft, the Chairman of IOSCO, have acknowledged this different treatment accorded asset managers over insurers.[8]

The difference in treatment also is evident in the manner in which FSOC has approached the evaluation of insurers and asset managers. Instead of designating asset managers, FSOC has directed its staff to "undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry."[9] This request followed the release of a study by the Office of Financial Research on asset management and financial stability, which FSOC had requested "to better inform its analysis of whether—and how—to consider such firms for enhanced prudential standards and supervision."[10] This request also followed a conference on the asset management industry by FSOC "to hear directly from the [asset management] industry and other stakeholders, including academics and public interest groups, on [the asset management industry and its activities]."[11] At that conference, FSOC members heard from representatives of the Securities and Exchange Commission, the Bank of England, New York University, Columbia Business School, and the Wharton School, as well as several asset management companies. No such public hearing was conducted to engage insurers and other stakeholders about the insurance industry.

In sum, the FSOC's actions with regard to the asset management industry stand in sharp contrast to FSOC's treatment of the insurers. FSOC has pursued the designation of individual insurance companies and provided the public with little, if any, insight into the rationale for those designations or how designations could have been avoided.

Moreover, FSOC has pursued this approach despite the fact that one of the principal authors of the Dodd-Frank Act has stated publicly that he sees no difference between the asset management industry and the insurance industry when it comes to systemic risk. In a hearing before the House Financial Services Committee last year, former Congressman Barney Frank told the Committee that "I don't think asset managers or insurance companies that just sell insurance as it's traditionally

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[8] See, Conversation with Governor Tarullo, Institute for International Finance, North American Summit, June 4, 2015; *https://www.youtube.com/watch?v=dV1tJMX-z2c&feature=player_embedded;* and Remarks of Greg Medcraft, Chairman, International Organization of Securities Commissions, to the National Press Club, Washington, DC, on "IOCSO and the International Reform Agenda for Financial Markets," June 22, 2015.

[9] Press Release, U.S. Treasury Department, Financial Stability Oversight Council Meeting, July 31, 2014.

[10] Office of Financial Research, Asset Management and Financial Stability, Sept. 2013. 11 Press Release, U.S. Treasury Department, Financial Stability Oversight Council (FSOC) to Host Public Asset Management Conference, March 28, 2014.

[11] Press Release, U.S. Treasury Department, Financial Stability Oversight Council (FSOC) to Host Public Asset Management Conference, March 28, 2014.

defined are systemically defined . . . Their failure isn't going to have that systemic reverbatory [sic] effect."[12]

ACLI finds this disparate treatment of insurers inexplicable and distressing. Why has FSOC undertaken a thoughtful analysis of one category of nonbank companies, but not another? Why has FSOC concluded that an "activities-based" approach to regulation is appropriate to asset managers, but not insurers?

The Dodd-Frank Act gives FSOC two principal powers to address systemic risk. One power is the authority to designate nonbank financial companies for supervision by the Federal Reserve Board. The other power is an "activities-based" authority to recommend more stringent regulation of specific financial activities and practices that could pose systemic risks.

FSOC's power to recommend more stringent regulation of specific activities and practices has distinct public policy advantages over its power to designate individual companies for supervision by the Federal Reserve Board. FSOC's power to recommend primary regulator action brings real focus to the specific activities that may involve potential systemic risk and avoids the competitive harm that an individual company may face following designation. As I have noted above, in certain markets designated companies can be placed at a competitive disadvantage to non-designated companies because of different regulatory requirements. Finally, the power to recommend avoids the "too-big-to-fail" stigma that some have associated with the designation of individual companies.

FSOC's recommendations for more stringent regulation of certain activities and practices must be made to "primary financial regulatory agencies." These agencies are defined in the Dodd-Frank Act to include the SEC for securities firms, the CFTC for commodity firms, and State insurance commissioners for insurance companies. A recommendation made by FSOC is not binding on such agencies, but the Dodd-Frank Act includes a "name and shame" provision that encourages the adoption of a recommendation. That provision requires an agency to notify FSOC within 90 days if it does not intend to follow the recommendation, and FSOC is required to report to Congress on the status of each recommendation.

ACLI believes that FSOC and FSB should both pursue an "activities-based" approach to insurers through their processes and not rely on designations, in the same manner that they are pursuing such an approach to asset managers. Failure to do so raises a fundamental question of fairness and casts doubt on the legitimacy of the policies and practices of FSOC and the FSB.

The Federal Reserve Board Should Finalize the Capital Standards Mandated by the International Capital Standards Clarification Act Before Agreeing to IAIS Standards

Both the Federal Reserve Board and the IAIS are developing insurance capital standards that are likely to have significant impacts on life insurance companies. Considered together, these two initiatives directly affect approximately 60 percent of the direct premiums of ACLI member companies. If these standards are bank-centric or inconsistent with capital standards developed by State insurance supervisors, they will disrupt the marketplace and undermine the ability of life insurers to provide long-term, guaranteed retirement products to savers and retirees.

To ensure the best possible outcome for policyholders, the Federal Reserve Board should adhere to the intent of Congress as reflected in the Insurance Capital Standards Clarification Act, which was unanimously approved by Congress last year, and develop an insurance capital standard that is appropriate for U.S. insurers and the insurance business model. We are encouraged by the fact that the Board has indicated its intent to undertake a methodical, thoughtful approach to the development of these standards. Moreover, the Federal Reserve Board should partner with the other U.S. representatives to the IAIS (FIO and State insurance supervisors) to ensure that any international insurance standards reflect the unique strengths of the U.S. system of insurance supervision.

It is essential that policymakers correctly address insurance capital standards here in the United States first, so that our representatives to the IAIS, "Team U.S.A.," have a stronger, unified position in any international discussions. Common sense suggests that the United States should conduct its own process for the development of an insurance capital standard before agreeing to any international standards. The ACLI believes that it is in the best interests of the United States to focus on domestic rulemaking first and ensure that the domestic process is as thoughtful, informed, and transparent as possible.

[12] Assessing the Impact of the Dodd-Frank Act Four Years Later Before the H. Comm. On Fin. Serv., 113th Cong., Statement of the Honorable Barney Frank during question and answer session, unofficial transcript.

The Federal Reserve Board's capital setting process should include formal rulemaking with notice and public comment, and ACLI is grateful that the Federal Reserve Board has indicated it will proceed in this way. Any insurance capital standard must reflect the long-term nature of life insurers' investments and the need to match investments with the long-term duration of insurance liabilities. Bank standards that favor short-term assets simply do not work for the insurance company business model, in which commitments to provide benefits to insurance policyholders and annuity contract holders often last many decades.

The ACLI has been actively engaged with the Federal Reserve Board on a proposed capital regime for insurance companies. The IAIS timeline must accommodate the Federal Reserve Board's implementation of the Insurance Capital Standards Clarification Act. These processes should not be abbreviated or confused by a rushed IAIS timeline. Just last month, the IAIS released a proposal for higher loss absorbency capital standards and reiterated plans to finalize these standards by the end of this year. The Federal Reserve Board's rulemaking process should proceed normally and allow ample time for notice and public comment. The three U.S. representatives to the IAIS should not agree to anything at the IAIS that would interfere with a robust and thoughtful rulemaking process here in the United States. In fact, the IAIS process would benefit from the work being conducted by the Federal Reserve Board and should adjust its timeline accordingly.

ACLI is encouraged by the recent IAIS announcement to develop international insurance capital standards, particularly the ICS, through a staged and incremental process that will be more respectful of and informed by jurisdictional developments.[13] This is a clear example of Team U.S.A. working on all cylinders to achieve a positive outcome for U.S. insurers and insurance markets. However, much work remains to be done, including further and deeper consideration and analysis of what types of activities actually create systemic risk in the insurance model. Getting our standards completed at home needs to happen first.

ACLI commends the three U.S. representatives to the IAIS for the important partnership that they have established in the Team U.S.A. approach. Only by working together, meeting regularly, coordinating their efforts, and agreeing to common objectives, the Federal Reserve Board, FIO, and State insurance supervisors are best positioned to represent the United States and secure the best outcome for U.S. consumers and insurers. The Team U.S.A. concept constitutes an effort to speak with a strong, unified voice as part of any IAIS discussions and ACLI fully agrees with the wisdom of this approach.

ACLI urges this Committee to exercise vigorous oversight of the capital standard-setting process by the Federal Reserve Board and the IAIS to ensure that the intent of Congress and the competitiveness of the U.S. insurance industry are preserved. Congressional oversight of the development of a workable domestic capital standard for U.S. insurers will help support the goal of a well-capitalized and competitive insurance industry that continues to serve the needs of U.S. consumers.

PREPARED STATEMENT OF PETER J. WALLISON *

ARTHUR F. BURNS FELLOW IN FINANCIAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE

JULY 8, 2015

Chairman Shelby, Ranking Member Brown and Members of the Senate Banking Committee:

Thank you for the opportunity to testify in this important 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.

This testimony will discuss the relationship among the Federal Reserve, the Financial Stability Oversight Council (FSOC) established by the Dodd-Frank Act, and the Financial Stability Board (FSB). As this Committee is aware, the FSB is a largely European group of financial regulators and central banks which was deputized by the G–20 leaders in 2009—after the financial crisis—to reform the international

[13] "The IAIS Risk based Global Insurance Capital Standard (ICS): Ultimate and Interim Goals, Principles for Development and Delivery Process" June 25, 2015.

* The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

financial system.[1] The Treasury, the Federal Reserve and the SEC are members of the FSB.

Summary of this testimony

This testimony makes the following points:

- Both the FSB and the Fed have determined to impose prudential regulation—*i.e.,* regulation of risk-taking—on what they call the "shadow banking system." They define the shadow banking system as all financial intermediation outside the regulated banking system.
- Shadow banks, then, are essentially all the nonbank firms that operate in in today's U.S. capital markets-broker dealers, asset managers, hedge funds, mutual funds, insurance companies and many others.
- The FSB and the Fed believe that "complex chains of transactions" among these firms can create risks to financial stability that are similar to the failure of a large financial firm.
- On this basis, the FSB could decide that all member countries should impose prudential regulation on firms active in the capital markets-that is, shadow banks.
- The question is whether an agreement at the FSB to impose prudential regulation on complex chains of transactions can be enforced in the United States under the Dodd-Frank Act.
- Section 113 of the Dodd-Frank Act provides the FSOC (and thus the Fed) with authority to designate firms as SIFIs because of their "mix of activities." These activities could be deemed to include participating in "complex chains of transactions."
- Although this would be a major extension of the language in the Dodd-Frank Act, it is possible that the courts would defer to the FSOC's interpretation.
- If the Committee does not want prudential regulation imposed on the capital markets, it must act to prevent this outcome, through amending Dodd-Frank or through aggressive oversight of the Fed, FSOC and Treasury.

Introduction

In recent years, both the FSB and the Fed have both expressed a determination to impose "prudential regulation" on what they call the "shadow banking system." Prudential regulation generally refers to a regulator's ability to supervise or control the risk-taking of regulated firms, and the shadow banking system—as defined by the FSB—includes *all* financial intermediation that is not subject to bank-like prudential regulation.[2] The Fed also accepts this definition. Stanley Fischer, vice chair of the Fed, refers to "nonbank financial intermediation" as including "insurance companies, finance companies, Government-sponsored enterprises, hedge funds, security brokers and dealers, issuers of asset-backed securities, mutual funds and money market funds."[3] These are most of the major participants in the U.S. capital markets, and thus the prudential regulation of shadow banks is the same thing as prudential regulation of the U.S. capital markets.

In general, although capital market firms like broker-dealers, finance companies, hedge funds and other types of funds and fund managers are subject to regulations of various kinds, these are mainly conduct regulations. Some, such as insurers and broker dealers, have capital requirements, but they are all generally free to take the risks that their managements consider prudent. Under prudential regulation, as bank supervisors see it, they are entitled to examine and criticize management risk-taking decisions. For example, the Fed has recently been telling banks that it does not want them to make leveraged loans, which the Fed considers excessively risky.

The Fed has clearly decided that bringing "shadow banking" under prudential regulation should be a priority of the agency, and in this effort the Fed and the FSB are working together. The Fed's position was made clear by Governor Daniel Tarullo a year ago:

> The turmoil that attended the collapse of several large nonbank financial institutions, and the extraordinary Government measures necessary to contain the turmoil, had quickly changed into a consensus—previously a

[1] Financial Stability Board, "Overview of Progress in Implementation of the G20 Recommendations for Strengthening Financial Stability" *Report of the Financial Stability Board to G20 Leaders,* September 5, 2013, p3.

[2] See, for example, FSB, "Consultative Document/Strengthening Oversight and Regulation of Shadow Banking/An Integrated Overview of Policy Recommendations," November 18, 2012, p1.

[3] Stanley Fischer, speech at a Bundesbank conference on March 27, 2015, p2.

minority view—that prudential regulation should be broadened to better safeguard the financial system as a whole.[4]

The Fed is devoting a great deal of attention to this FSB project—and for good reason. Governor Tarullo, is leading the FSB's work in this area. The close collaboration between the Federal Reserve and the FSB is happening because controlling "shadow banking" is not something the Fed can do alone; it is too easy for financial activities to be conducted outside the Fed's U.S. jurisdiction. The Fed cannot control shadow banking if they focus solely on the United States; pressure on the shadow banking system in the United States will only stimulate the development of shadow banking activity in other developed markets. The FSB, therefore, is the ideal venue for an international agreement to impose coordinated prudential regulation on shadow banking, which in effect means prudential regulation of the international capital markets. In one of its first statements on the need to regulate shadow banking, the FSB pointed this out: "It is also important to note that different parts of the [shadow banking] chain are frequently located in different jurisdictions, underscoring the need for a global approach to monitoring and policy responses."[5]

The FSB is the successor to something called the Financial Stability Forum, an organization of the same developed countries that was formed in 1999 as a discussion group to promote financial stability. In April 2008, the group delivered a series of recommendations to the G–7 for increased prudential regulation. After the financial crisis, in 2009, the group was deputized by the G–20 leaders to reform the international financial system, and changed its name to the Financial Stability Board. Since then, it used its mandate to broaden its reach and elevate its profile. Its statements regularly refer to the fact that the G–20 leaders have approved or authorized its activities. In 2011, according to the FSB, the G–20 leaders agreed to "strengthen the oversight and regulation of the shadow banking system,"[6] and remarkably they did this before the FSB had actually defined what shadow banking was. Nevertheless, the FSB has no enforcement powers and—at least in the United States—no authority by virtue its G–20 mandate. The FSB says that it is relying on its members to enforce its decisions within their own jurisdictions, if they have the authority to do so.

An apt analogy might be the agreements that are reached among bank regulators from many nations under the auspices of the Basel Committee on Bank Supervision. The decisions reached there are applied in each of the countries that are participants. This might even be seen by the U.S. regulators as a precedent for the enforceability of any agreement reached at the FSB, but this would be incorrect. The U.S. bank regulators already have the statutory authority to impose the capital requirements that are agreed in Basel. Congress has not (to my knowledge) ever questioned that authority.

This raises the question whether the Dodd-Frank Act or any other U.S. law has given U.S. regulators the authority to impose on U.S. firms the decisions that originate in an agreement at the FSB. It is not true, as some may believe, that Dodd-Frank does not provide authority that can be used for this purpose. Unfortunately, as I will discuss below, the excessively broad language of the Dodd-Frank Act may permit the FSOC and the Fed to impose substantially the same regulations in the United States as the FSB will prescribe for its other members. Moreover, U.S. officials seem to believe that if the FSB adopts prudential regulation for the capital markets—that is, the shadow banking system—U.S. regulators will be able to impose it in the United States. If this effort succeeds, it will be a disaster for robust economic growth in the United States. Accordingly, this testimony will also explore the authorities that the FSOC and Fed might use, at the behest of the FSB, to control shadow banking in the United States.

In March, 2015, the FSB issued what it called its Second Consultative Document on Methodologies for Identifying NonBank Non-Insurer Global Systemically Important Financial Institutions (the Second Consultative Document).[7] This is similar to a U.S. regulatory agency taking a second set of comments on a proposed regulation under the Administrative Procedure Act. The Second Consultative Document is basically a roadmap for FSB members to follow if they wish to subject nonbank firms

[4] Daniel Tarullo, Speech at the Federal Reserve Bank of Chicago, May 8, 2104, p2, *http://www.federalreserve.gov/newsevents/speech/tarullo20140508a.htm.*

[5] FSB, Shadow Banking: "Scoping the Issues: A Background Note of the Financial Stability Board," April 12, 2011, p5.

[6] FSB, "Strengthening the Oversight and Regulation of Shadow Banking," April 16, 2012, p 1.

[7] FSB, "Consultative Document (2nd)/Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions/Proposed High-Level Framework and Specific Methodologies," March 4, 2015.

within their jurisdictions to prudential regulation. There is little question that under the Dodd-Frank Act the FSOC could designate any financial firm as a systemically important financial institution (SIFI), and in fact after the FSB designated three U.S. insurers as global SIFIs, the FSOC did the same.

Many of the comments submitted by U.S. firms on the Second Consultative Document reflected concern that the FSB will designate large U.S. firms—especially large investment funds and asset managers—as global SIFIs. That concern arose, presumably, because of fear that an FSB designation would provide a foundation for the FSOC to do the same. To forestall this possibility, the FSB was urged instead to consider regulating "activities" rather than designating SIFIs. *This approach, as discussed below, is not without risk. Limiting the FSB and the FSOC to regulating activities, instead of designating SIFIs, may not prevent the FSOC and the Fed from imposing prudential regulation on virtually all firms that operate in the capital markets, including asset managers, regardless of size.*

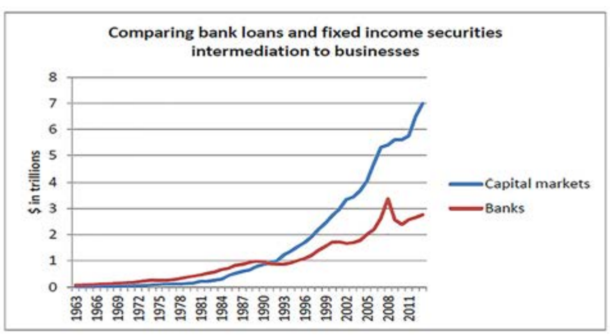
In a recent speech, Governor Tarullo said that he favors "activities-based regulation" for asset managers,[8] and with Tarullo's support it is likely that the FSB will oblige. But as I will show several provisions of Dodd-Frank, if interpreted broadly by the FSOC and the Fed, could enable the Fed to place many transactions that are routine activities in the U.S. capital markets under what is essentially prudential control.

The need to cover these activities was outlined by Governor Tarullo a year ago: "Prudential regulation," he said, "must deal with threats to financial stability whether or not those threats emanate from traditional banking organizations. Hence the need to broaden the perimeter of prudential regulation, both to certain nonbank financial institutions and to certain *activities* by all financial actors."[9] [emphasis supplied] This is a statement of determination; if the Dodd-Frank Act provides the necessary authority, we may see an effort by the FSOC and the Fed to impose prudential regulation on activities—that is, what they see as excessive risk-taking—in the capital markets.

If this is not acceptable to this Committee it should act to modify these provisions before the FSB, the FSOC and the Fed act to impose prudential restrictions on the entire U.S. financial system.

Efforts by the FSB and the Fed To regulate shadow banking

The widespread concern among bank regulators about "shadow banking" is best understood in the context of the competitive challenges facing the heavily regulated banking business. Since the mid-1980s, the capital markets have outcompeted banking in the financing of corporate and business borrowers. The chart below shows the growing gap between banks and capital markets financing. The existence of this gap was recently confirmed by Stanley Fischer, the vice chair of the Fed, when he told a banking audience: "In recent years, about two-thirds of nonfinancial credit market debt has been held by nonbanks, which includes market-based funding by securitization vehicles and mutual funds as well as by institutions such as insurance companies and finance companies."[10]



Source: Federal Reserve Flow of Funds

[8] John Heltman, "Fed's Tarullo Favors Activities-Based Regulation for Asset Managers," *American Banker,* June 4, 2015.

[9] Daniel Tarullo, Speech at the Federal Reserve Bank of Chicago, note 4 above, p1.

[10] Stanley Fischer, "Nonbank Financial Intermediation, Financial Stability, and the Road Forward," March 30, 2015, p.1. *http://www.federalreserve.gov/newsevents/speech/fischer20150330a.htm.*

To a significant degree, this gap is the result of the relative efficiency of obtaining credit through the capital markets rather than banking, and left to itself this gap is probably irreversible. However, nonbank competition for banks restricts bank regulators' freedom in regulating banks. Tightening bank regulation simply makes banks even less competitive with the capital markets. A partial solution, then, is to gain some kind of regulatory control over the capital markets—the shadow banking system—so that some regulatory burden can also be on shadow banking. The financial crisis was a disaster for the American people, but it has provided a unique opportunity for bank regulators to seek greater authority over the whole financial system, despite their failure to prevent the failure or near-failure of the largest banks (and hundreds of smaller banks) in the financial crisis.

Whatever the motive, the FSB's analysis of the dangers of shadow banking rests heavily on the risks associated with "maturity transformation," an inherent risk of traditional banking. When banks take deposits withdrawable on demand and use those funds to make long-term loans they are engaged in what is called maturity transformation. By its nature, this is a risky activity because the supporting deposits can be withdrawn while the loan is still outstanding, threatening the bank's liquidity position. Banks are subject to prudential regulation and have access to the Fed's discount window in part because of this inherent risk.

The FSB has argued that the shadow banking system is also subject to this risk. For example, in a paper outlining its effort to gain some control of shadow banking, the FSB stated:

> [E]xperience from the crisis demonstrates the capacity for some nonbank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability (longer-term credit extension based on short-term funding and leverage). Such risk creation may take place at an entity level but it can also form part of *a complex chain of transactions, in which leverage and maturity transformation* occur in stages, and in ways that create multiple forms of feedback into the regulated banking system.[11] [emphasis added]

As the FSB sees it, then, many entities in the shadow banking world work together to produce the maturity transformation that is the risky element of traditional banking. This might seem somewhat dubious as an idea, but former Fed chair Ben Bernanke—a strong and persistent backer of regulating shadow banks—tried to provide an example of a "complex chain of transactions" in a 2012 speech:

> As an illustration of shadow banking at work, consider how an automobile loan can be made and funded outside of the banking system. The loan could be originated by a finance company that pools it with other loans in a securitization vehicle. An investment bank might sell tranches of the securitization to investors. The lower-risk tranches could be purchased by an asset-backed commercial paper (ABCP) conduit that, in turn, funds itself by issuing commercial paper that is purchased by money market funds.[12]

The problem with this, Bernanke went on, is that "Although the shadow banking system taken as a whole performs traditional banking functions, including credit intermediation and maturity transformation, unlike banks, it cannot rely on the protections afforded by deposit insurance and access to the Federal Reserve's discount window to help insure its stability."

Thus, to the extent that Bernanke's views reflect the underlying ideas circulating in the FSB—a good bet given the importance of the Fed in the world's financial system—the effort to control shadow banking is based on the idea that while it can create risky maturity transformation it does not have the necessary access to either deposit insurance or the Fed's discount window, both of which supposedly would protect shadow banks against runs or other instability. It follows that the risks taken by unregulated participants in the capital markets can only be mitigated by access to a bank-like Government safety net—and absent these protections must be modulated by strict prudential regulation. Of course, access to a bank-like safety net, as the President of the New York Federal Reserve Bank has noted, "would entail substantial prudential regulation of entities—such as broker-dealers—that might gain access . . . [since this would be] required to mitigate moral hazard problems."[13] Thus, more regulation begets more risks for the taxpayers, and more regu-

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[11] FSB, "Strengthening Oversight and Regulation of Shadow Banking," August 23, 2013, pii.

[12] Ben Bernanke, "Fostering Financial Stability," Speech at 2012 Federal Bank of Atlanta Financial Markets Conference, p2.

[13] William C. Dudley, "Fixing Wholesale Funding to Build a More Stable Financial System," February 1, 2013.

lation after that to protect the taxpayers from the risks the regulators failed to foresee the first time.

Pursuing this idea, the FSB is developing a theory that would allow regulators in member countries to impose prudential regulations on capital markets firms. The basis for this regulation is the claim that "complex chains of transactions" can create risks to market stability that are similar to the risks created by maturity transformation.

The Fed's pursuit of shadow banking

There is no doubt that the Fed is an active partner of the FSB, maybe even the driving force in the effort to gain some control of shadow banking.

In remarks at a meeting in New York on December 2, 2014, Stanley Fischer, the Fed's vice chair who also heads an internal systemic risk committee at the agency, described the Fed's then-current effort to control shadow banking. To the extent that the Fed itself does not have the authority to exert this control, he said that the Fed intends to use the authorities of the FSOC for this purpose.

At the meeting, Fischer was interviewed by Larry Fink, chairman of BlackRock, one of the largest asset-management firms in the world. According to a transcript of the interview, Fischer was asked by a member of the audience: "Stan, can you talk a little bit more about the shadow banking system and what, if anything, you think should be done at a policy level to ensure that there is the financial stability over this 80 percent that you don't—you have less control over?"

Fischer responded:

> FISCHER: Well, the—you know, there are real institutions—in the shadow banking system. There are hedge funds. There are insurance funds.
>
> FINK: Even asset managers.
>
> (LAUGHTER)
>
> FISCHER: Even asset managers, I've been reliably informed.
>
> (LAUGHTER)
>
> And other financial institutions, some of those have regulators. The insurance companies, for instance, have regulation. Others do not have—have regulation. And what is being done right now is mapping out this system. One of the most complicated maps you've ever seen was produced in the New York Fed showing the shadow banking system and the interactions between it and, you know, everybody is talking to everybody else, doing business with everybody else, it's to understand that [sic] that system is as a system, how it interacts with the banking system, and who has any authority that will enable them to take action—undertake actions to deal with a firm, which is if it's large enough or interconnected enough, would create a big problem if it failed.
>
> That's what we're doing now. And then, if it's—if we the Fed have the authority to regulate it. Then on the basis of that analysis, we would then go ahead, if we have the authority—for instance, we have control over margin requirements—and if we don't, then it goes to the FSOC and is discussed there.[14]
>
> The identity between the work of the FSB and the work of the Fed on shadow banking is nowhere better exemplified than in a statement by Mr. Fischer to a banking audience at a conference sponsored by the Federal Reserve Bank of Atlanta in March 2015:
>
> [N]onbank intermediation often involves *complex chains of activity* encompassing many entities and markets. Such chains tend to increase the web of interconnections in the financial system that, in some circumstances, can increase the likelihood or severity of systemic stress . . . It is often said that stronger regulation of the banking sector will cause activity to move outside the perimeter of regulation. The evolution also could lead to greater complexity, such as longer chains of interconnection, which make it more difficult for market participants to understand the risks arising from their exposures. *Examples of migration that have already occurred include the movement of many loans made to large corporations from banks to*

[14] Bloomberg transcript.

> *collateralized loan obligations, the securitization of many credit card receivables, and the securitization of mortgages.*[15] [emphasis supplied]

Although the FSB's "complex chains of transactions"—a way of describing the shadow banking system—became "complex chains of activity" in Mr. Fischer's telling, the concept is the same. The use of the term "activity," as we will see, ties it more closely to the relevant Dodd-Frank language. In both cases, these unregulated complex chains are seen as increasing risks in the markets, and the migration of lending from banks to nonbank financial intermediation—"regulatory arbitrage" to bank regulators, but in fact the inevitable outcome of greater efficiency—is an example of the problem the Fed and the other bank regulators are facing.

The FSB's influence on SIFI designations

The way the FSOC has exercised its designation authority suggests that it is also cooperating with, if not leading, the FSB's efforts. In any event, the FSOC has been implementing the FSB's decisions in the United States. 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 and well-resourced U.S. financial regulator, especially after the extraordinary authorities it received in Dodd-Frank. Both the Treasury and the Fed are also members of the FSB, and it is reasonable to assume, given the importance of the U.S. financial system, that the Treasury and the Fed are the most important and influential members of the FSB.

After receiving this mandate from the G–20 in 2009, 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 U.S. insurers, AIG, Prudential and MetLife—as global systemically important insurers, or G–SIIs.[16] 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.[17]

The designation of SIFIs by the FSOC 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 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. This fairness and objectivity was missing in the FSOC's treatment of at least two of the U.S. insurers designated as G–SIIs by the FSB.

In March testimony before the House Financial Services Committee, Treasury Secretary Lew stated that the FSB "acts by consensus."[18] 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, the Fed and the chair of the SEC—the three most important members of the FSOC and perhaps the FSB as well—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, the Fed and the SEC—as members of the FSB—had already decided the issue months before.

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[15] Stanley Fischer, "Nonbank Financial Intermediation, Financial Stability, and the Road Forward," Remarks at Central Banking in the Shadows: Monetary Policy and Financial Stability Postcrisis, Federal Reserve Bank of Atlanta, March 30, 2015. [emphasis supplied]

[16] FSB, "Global systemically important insurers (G–SIIs) and the policy measures that will apply to them" July 18, 2013, *http://www.financialstabilityboard.org/wp-content/uploads/r__130718.pdf?page__moved=1.*

[17] FSOC, U.S. Department of the Treasury, Designations, Feb. 4, 2015, *http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.*

[18] See transcript of Hensarling/Lew exchange, March 25, 2015. *http://www.aei.org/publication/exchange-between-rep-jeb-hensarling-and-treasury-secretary-jacob-lew/?utm__source=paramount&utm__medium=email&utm__campaign=wallison-kupiec-newsletter.*

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 U.S. insurers. So the need for an objective evidence-based decisionmaking 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.

Finally, there is now reason to believe that the FSOC's designation of MetLife was not the result of an objective study of evidence. In 2015, as part of its legal challenge to the FSOC's designation, MetLife filed a brief that, for the first time, made publicly available the evidence that FSOC had produced to support its position. The brief showed that FSOC does not have any significant evidence that MetLife's financial distress or failure would cause financial instability in the United States.

In the regulations it adopted to implement the designation process, the FSOC outlined two principal ways that the distress or failure of a firm could cause instability in the financial system as a whole: by causing losses to others financially exposed to the failing firm (called the Exposure Channel) or through a "fire sale" liquidation of assets that drives down asset prices and thus weakens other firms holding the same assets (the Liquidation Channel).

MetLife's brief demolishes the factual underpinnings of both ideas.

In addressing Exposure Channel, MetLife submitted evidence that showed other major firms had very small exposures to MetLife. For example, in the unlikely event that the largest U.S. banks were to lose 100 percent of their exposure to MetLife, that loss would not exceed 2 percent of their capital. In a point that would be funny if weren't so serious, MetLife showed that the fines recently levied on the largest U.S. banks by the Justice Department were *four times* larger than the biggest loss that any large bank would suffer in a total MetLife collapse, yet these fines had no observable effect on the health of the banks involved.[19]

With respect to the Liquidation Channel, a study done for MetLife by Oliver Wyman showed that even in the implausible event that all policyholders were to surrender their policies and ask for return of their cash values—and all other MetLife liabilities that could accelerate would immediately become due—the firm could still liquidate enough assets to cover its liabilities "without causing price impacts that would substantially disrupt financial markets."[20] According to the brief, the FSOC produced no data to contradict this evidence, but summarily asserted that these assets sales "could" have an adverse effect on the broader economy.

These facts raise the question of why FSOC chose to designate MetLife. Although the actions of the FSOC have consistently mirrored the decisions of the FSB, including the designation of the same three insurers, the FSOC has always denied that these decisions were in any way related to or compelled by similar decisions of the FSB. However, the designation of MetLife with so little evidence of its systemic importance adds weight to the idea that the FSOC is simply following the directives of the FSB.

There is also evidence that the FSB, as well as the Treasury and the Fed, believe they, as members of the FSB, are bound by FSB decisions. In early February, 2015, Mark Carney, the chairman of the FSB, 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 United States as a member of the FSB, it is highly unlikely that the FSB chairman would have sent this memorandum without the prior agreement of the Treasury and the Fed.

The memorandum noted peremptorily that the FSB expects "full, consistent and prompt implementation of [its] agreed reforms."[21] This sounds like the FSB's decisions are binding, but when questioned about this by Chairman Jeb Hensarling at the HFSC's March hearing, Treasury Secretary Lew denied that the United States 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

[19] MetLife Brief, p46–7; *https://www.metlife.com/sifiupdate/important-updates/index.html?WT.ac=GN_sifiupdate_important-updates.*

[20] MetLife Brief, p52.

[21] Mark Carney, Memorandum to G20 Finance Ministers and Central Bank Governors, February 4, 2015, *http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chair-letter-to-G20-February-2015.pdf.*

it necessary to grant exemptions, specifically to the Chinese?" Secretary Lew had no answer to this question at the hearing.[22]

If in fact the FSOC, the Treasury and the Fed are committed to the idea that FSB members 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.

In a June 2014 letter to Congressman Scott Garrett, chair of a HFSC subcommittee, the Treasury secretary and the chairs of the Fed and the SEC denied that FSB designation decisions are binding on the United States: "The identification of a firm as a G–SIFI does not have legal effect in the United States or any other country; rather, any action to implement heightened supervision of an identified G–SIFI within a particular country would need to be taken by that country pursuant to its own laws."[23]

However, the notion that United States is not obliged to follow FSB decisions is questionable in light of Treasury Secretary Lew's description—in the same March 25 HFSC hearing—of the purpose of the United States involvement in the work of the FSB. When asked by Chairman Hensarling whether FSB decisions were binding on the United States, the secretary replied: "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." Clearly, if that is the Obama administration's purpose, it must itself accept and be bound by the FSB's decisions; if the United States isn't bound, the effort to get others to comply will never be successful. So Secretary Lew, at least, seems to be operating under the assumption that the FSB's decisions will eventually be imported into and adopted by the United States.

In this connection, it is important to recall that the FSB's authority ultimately derives from the G–20 leaders. As S. Roy Woodall, the Independent Member Having Insurance Expertise on the FSOC noted in testimony before this Committee in April 2015: "[I]nternational agreements and commitments made by the U.S. members of the FSB . . . are commitments made under the auspices of the G–20. As such, they carry considerable weight. Although it is true that they are not legally binding, such commitments are expected to be implemented as part of the G–20's regulatory reform agenda."[24] President Obama was a member of the G–20 when it directed the FSB to regulate shadow banks, and all the voting members of the FSOC are political appointees of President Obama. It is a small step in logic for the members of the FSOC—all of whom are appointees of President Obama—to believe that in following the directions of the FSB they believe they are carrying out the President's own policies.

Thus, while the FSB's decisions have no direct legal effect in the United States, it seems that the U.S. members of the FSB believe that they have sufficient authority to agree to the FSB's decisions and impose them in the United States. Whether they actually have that authority is covered in the next section.

Do the FSOC and other U.S. agencies have authority to implement FSB directives?

If, as Secretary Lew avers, the Obama administration 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.

Where is this authority?

Although the Dodd-Frank Act clearly provides authority for regulating *entities* that are deemed to be systemically important, the authority for regulating "complex chains of transactions" is not as clear. 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.

Indeed, a concept similar to "complex chains of transactions" has already been articulated 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 stat-

[22] See transcript, note 15 above. See also, Peter J. Wallison and Daniel M. Gallagher, "How Foreigners Became America's Financial Regulators," The Wall Street Journal, March 19, 2015.

[23] Letter dated June 20, 2014, to Scott Garrett, chair of the HFSC subcommittee on Capital Markets and Government-Sponsored Enterprises, p2.

[24] S. Roy Woodall, Testimony Before the Senate Banking Committee, April 28, 2015, p5.

ed: "risks to financial stability might not flow from the actions of any one entity, but could arise *collectively* across market participants."[25] [emphasis supplied]

Most of the attention to the FSOC's designation of SIFIs has focused on the agency's efforts to designate large financial institutions which, if they become financially distressed, could cause instability in the U.S. financial system. The underlying idea here is that, because of its interconnections with other firms, the financial distress or failure of a nonbank firm could drag down others, causing the financial instability that the Act is intended to prevent.[26]

However, the FSOC's authority is not limited to designating SIFIs because their financial distress could cause instability in the U.S. financial system. It also has authority to designate as SIFIs—and consign to regulation by the Fed—many firms that are not large and whose failure alone would not cause financial instability. For example, Sec 113(a) of Dodd-Frank states:

> The Council . . . may determine that a U.S. nonbank financial company shall be supervised by the Board of Governors and shall be subject to prudential standards . . . if the Council determines that material financial distress at the U.S. nonbank financial company, *or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities* of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States. [emphasis supplied]

In addition, Sec. 112(a)(2)(H) describes the duties of the FSOC as follows:

> [R]equire supervision by the Board of Governors for nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure, or *because of their activities* pursuant to section 113; [emphasis supplied]

Finally, Sec. 120 provides that

> The Council may provide for more stringent regulation of a *financial activity* by issuing recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards, including standards enumerated in section 115, for a financial activity or practice conducted by bank holding companies or nonbank financial companies under their respective jurisdictions, if the Council determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities.

Finally, under Title VIII of Dodd-Frank, the Fed, with the approval of the FSOC, has authority to impose "risk management standards"—these are undefined—on any financial firm engaged in payment, clearance and settlement (PCS) activities. These provisions are sometimes seen as applicable only to clearinghouses and other financial market utilities, but in fact they are also applicable for financial firms that engage in payment, clearing and settlement activities. PCS are very broadly defined in Title VIII and could provide another avenue through which the FSOC and the Fed could gain prudential controls over the firms that make up the capital markets.[27]

All of these provisions are important because the FSB and the Fed are both focusing on a "complex chain of transactions"—or as the Fed describes it, a "complex chains of activity"—as a way to describe how the shadow banking system operates. The term "activities" could be interpreted to refer to a "complex chain of transactions" and thus provide the Fed and the FSOC with the authority to impose prudential standards on ordinary transactions in the capital markets.

[25] FSOC, "Notice on Asset Management Products and Activities," December 18, 2014, p4.

[26] The historical record does not support these claims. When Lehman Brothers failed—from the market's perspective suddenly and without a Government rescue in September 2008—it did not drag down any other significant financial firm, even though Lehman was one of the largest nonbank financial institutions in the United States. There was certainly chaos after Lehman's bankruptcy, but that was because the Government suddenly reversed the policy of rescuing large financial firms that it appeared to have established 6 month earlier with the rescue of Bear Stearns. This reversal completely upended the expectations of market participants, creating a panic in which institutions and investors sought and hoarded cash. The draining of liquidity from the financial system after the Lehman bankruptcy is what we now know as the financial crisis.

[27] Peter J. Wallison, "The Regulators' War on Shadow Banking," *AEI Research,* January 22, 2015. *http://www.aei.org/publication/regulators-war-shadow-banking/*.

Thus, there is a plausible argument based on this language that the FSOC could designate as SIFIs all firms that engage in certain defined transactions—say, buying the commercial paper of asset-backed trusts—or participate in those transactions to an extent that exceeds some dollar amount. The danger of being designated for these suspect transactions would be enough to give the Fed the ability to approve or disapprove transactions of that kind on a case-by-case basis—a plausible substitute for prudential regulation.

The FSOC and the Fed would defend their position by arguing that it was transactions like those they are banning that caused the financial crisis. In addition, if the FSOC determines that a firm's activities should be regulated by the Fed under Section 112 or 113, the Fed is arguably then the firm's primary financial regulator for purposes of Section 120.

We don't know, of course, how the courts will respond to interpretations like these. It is a distortion of the statutory language, but the courts often accord deference to agencies' interpretation of the scope of their statutory authority, especially if they believe that the agency is attempting to address a serious problem that is within the "spirit" of the legislation. The FSOC and the Fed, in carrying out a mandate of the FSB, could claim that they have authority to take these steps because they are attempting to prevent another financial crisis, and no one might be willing—or have the standing—to challenge them. Cases like this suggest the Supreme Court—as suggested recently by Justice Thomas, should revisit *Chevron.*[28]

If the FSOC and the Fed are successful in controlling what the FSB has now defined as shadow banking—that is asset managers, securities firms, investment funds, finance companies and hedge funds, among others—they will succeed in stifling the continued growth of the securities and capital markets in the United States, which have been far and away the main sources of financing for U.S. business.

What to Do

If this Committee believes that applying prudential regulation to capital markets activities should be unacceptable, it should act to prevent this from happening. The FSB is not the problem; as noted earlier, it has no legal authority in the United States; nor would a G–20 statement or an agreement by U.S. regulators at the FSB by itself confer this authority.

The problem is that there is language in the Dodd-Frank Act that could be interpreted to confer the authority on the FSOC and the Fed to control the so-called shadow banking system by imposing prudential regulation on ordinary activities in the capital markets. Section 113 of Dodd-Frank refers to "mix of activities" as a basis for designation of a SIFI, but it does not refer to the control of chains of transactions or an entity's participation in chains of transactions or chains of activities. In any event, the list of items in Section 113 for which firms can be designated ("nature, scope, size, scale, concentration, interconnectedness, or mix of activities") is far too broad and contains no inherent limit. Did Congress really intend to give the FSOC authority to designate a firm as a SIFI because of its "nature?" If the doctrine of unconstitutional delegation of legislative authority were still alive, this would be a perfect candidate. Congress should repeal this list. Alternatively, Congress could make clear that the term "activities" was not intended to include specific chains of transactions, but the best solution would be to remove the term "activities" from the Act.

Conclusion

Complacency about what the FSB, the FSOC and the Fed are doing to control shadow banking is not only unwarranted, it is a grave danger to U.S. economic growth. "Shadow banks," as these agencies conceive it, are the firms active in the capital markets in the United States. The freedom of these firms to take the risks their managements find acceptable is the foundation of the innovative and efficient financial system that has made the U.S. economy the world's unquestioned leader. The financial crisis may have given bank regulators new powers that they can use to impose prudential controls on capital market firms. Indeed, several provisions of the Dodd-Frank Act could be creatively interpreted to provide the legal authority to do so. If this Committee agrees that bank—like prudential controls over the capital markets would be harmful to economic growth, it should take steps today to cutoff the legal authorities on which these agencies are likely to rely.

[28] Michigan v. EPA, 576 U.S.__(2015) (slip op., at 4–5) (Thomas, J., concurring).

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STATEMENT

OF

PAUL SCHOTT STEVENS
PRESIDENT & CEO
INVESTMENT COMPANY INSTITUTE

BEFORE THE

U.S. SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

ON

THE ROLE OF THE FINANCIAL STABILITY BOARD IN THE
U.S. REGULATORY FRAMEWORK

JULY 8, 2015

EXECUTIVE SUMMARY

- ICI supports appropriate regulation to ensure the resiliency and vibrancy of the global financial system. We likewise believe it is appropriate for regulators to examine asset management to identify potential risks. Any such review, however, must be thorough, balanced, fact-based and led by those with relevant expertise—i.e., capital markets regulators.

- From the outset, the Financial Stability Board ("FSB"), whose membership consists largely of central bankers and finance ministers, has been predisposed to view virtually all financial activity conducted outside of banks as "shadow banking" and inadequately regulated because it is not subject to bank standards and supervision. As it relates to regulated funds and their managers, this orientation is deeply troubling in light of the FSB's ability to influence financial policy in its participating jurisdictions. U.S. mutual funds and other regulated funds differ fundamentally from banks, and are among the most transparent and comprehensively regulated parts of the financial system.

- The FSB has proposed methodologies for identifying and potentially designating global systemically important financial institutions ("G-SIFIs") within the asset management sector. Broadly speaking, these methodologies have been advanced without due regard for empirical evidence, historical experience, industry structure and practice, existing regulation, and other factors that might bear on the existence or severity of the risks posited by the FSB.

- There are fundamental problems that pervade the FSB's work.

    - First, the FSB's proposed methodologies conceptually derive from regulators' experience with banking, not asset management. Thus, for example, the FSB posits risks of "distress" and "disorderly failure" derived from the experience of banks as a starting point for its G-SIFI methodologies for asset management. This is despite overwhelming public commentary to the FSB that these concepts have little relevance to investment funds and asset managers.

    - Second, the FSB affords an inadequate role to subject matter experts. Of particular concern to ICI, capital markets experts are leading neither the FSB's work on asset management nor some other key projects focused on non-bank entities and activities.

    - Third, the FSB simply discounts empirical data and actual experience that do not comport with the conjecture and theories on which the proposed G-SIFI methodologies are based. Those theories include the potential for "fire sales" of investment fund assets, the transmission of risk from an investment fund to other market participants, and destabilizing effects to the global financial system. ICI believes the FSB has vastly overstated the potential for such effects. And, in the seventy-five year history of stock and bond funds in the U.S., there is no historical or empirical basis for the FSB's concerns.

- Fourth, there is reason to question whether the FSB's work on G-SIFI methodologies in asset management is simply results-oriented and based on little more than size as a criterion that would capture principally the largest U.S. funds and managers. The FSB has ignored public commentary on significant aspects of its proposed methodologies and offered no empirical basis for its criterion.

- Fifth, as set forth in detail below, we have strong reservations about the transparency and fairness of the process that the FSB has followed in developing its proposed methodologies and the process it envisions for evaluating investment funds and asset managers under these methodologies.

- In many of the five areas enumerated above, we see similar deficiencies in the FSOC's SIFI designations and its review of asset management.

- The G-SIFI designation process set in motion by the FSB is intended to exert multilateral influence on "national authorities" with respect to the regulation of asset management. In the case of the U.S., this presumably may mean the FSOC and its designation authority under Title I of the Dodd-Frank Act. If adopted, the methodologies proposed by the FSB would have the effect of calling for an unprecedented expansion of the reach of the Federal Reserve Board to regulated U.S. funds and their managers and, by extension, U.S. capital markets. There is a clear prospect of harmful consequences for regulated U.S. funds, their investors and the capital markets. These include bank-like standards required by the Dodd-Frank Act that are ill-suited to funds, including capital requirements (possibly at the level of minimum bank capital standards, which is 8 percent), added fees and assessments, and prudential supervision by the Federal Reserve Board.

- Although there is movement, both in the U.S. and globally, toward an activity-based approach in asset management, there is much cause for continuing concern. Neither the FSB nor the FSOC has taken designation of individual regulated funds or their managers off the table. And if an activity-based approach is led not by capital markets experts but instead by central bankers, the same types of poor policy outcomes outlined above could result.

- To address several of our concerns with the FSB, ICI recommends that the Committee:

  - Continue to monitor closely U.S. agencies' participation in the FSB's policy work and seek to ensure that their FSB participation does not conflict with the best interests of U.S. investors and the capital markets.

  - Encourage the U.S. officials who participate in the FSB to support a full review of asset management activities and products, led by the International Organization of Securities Commissions (and the setting aside of further work on investment fund and asset manager G-SIFI assessment methodologies).

- Use its influence to encourage the reconstitution of the FSB, with equal roles for capital markets, banking and insurance, to advance the dual objectives of mitigating risk to the financial system, while promoting vibrant markets and economic growth.

- With regard to the FSOC, Congress should enact legislation, such as Title III of S. 1484, to codify in statute important improvements to the SIFI designation process that will advance the Dodd-Frank Act's dual goals of reducing systemic risk while reserving SIFI designation as a tool to be used only in truly exceptional cases.

I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute ("ICI") and I am pleased to appear before the Committee today to discuss the role of the Financial Stability Board ("FSB") and its impact on U.S. regulators and entities. Thank you, Chairman Shelby, Ranking Member Brown, and members of the Committee for inviting me to testify.

ICI is the national association of U.S. registered investment companies, including U.S. mutual funds, closed-end funds, exchange-traded funds and unit investment trusts.[1] ICI seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interests of funds, their investors, directors and managers. ICI members today manage approximately $18.2 trillion in assets and serve more than 90 million U.S. investors.

This year marks the 75th anniversary of the enactment of the key statutes—the Investment Company Act and the Investment Advisers Act—that regulate and govern funds and their managers. As administered by the Securities and Exchange Commission ("SEC"), those statutes have supported the growth of the modern fund industry, which today helps American investors meet their most important financial goals, such as saving for college, purchasing a home or providing for a secure retirement.

ICI members, as both issuers of securities and investors in capital markets worldwide, understand the importance of sound, tailored regulation in maintaining a strong and resilient financial system. For this reason, ICI and its members seek to engage actively with policymakers and regulators and to provide meaningful input on financial policy matters that may have significant implications for funds and their investors. As financial policy continues to take on a greater global dimension, so too have ICI's efforts to monitor the work of, and engage with, policymakers and regulators outside the U.S.[2]

In the years since the global financial crisis, the FSB has asserted an expanding role on the world stage. The FSB claims a broad mandate, nothing less than the entire global financial system, but it is dominated by central bankers and finance ministers. This membership is predisposed to viewing financial activity conducted outside of banks as "shadow banking" and to considering such activity to be inadequately regulated because it is not subject to bank standards and supervision. Not surprisingly, we

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[1] In this testimony, the term "regulated funds" includes "regulated U.S. funds" (or "U.S. mutual funds," where appropriate), which are comprehensively regulated under the Investment Company Act of 1940 ("Investment Company Act"). This testimony generally addresses regulated stock and bond funds and not money market funds, given the significant regulatory reforms that have been adopted for money market funds.

[2] The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.7 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

strongly disagree with this portrayal and are deeply troubled by the FSB's ability to influence financial policy in its participating jurisdictions.

Our particular concerns about the FSB arise in the context of its work on asset management and financial stability. For some time, the FSB has been working on designing methodologies for identifying and potentially designating global systemically important financial institutions—or G-SIFIs—within the asset management sector. The proposed methodologies (one for investment funds, the other for asset managers) set forth in the FSB's two consultations have been advanced without sufficient weight to empirical evidence, historical experience, industry structure and practice, existing regulation, and other factors that might bear on the existence or severity of the risks posited by the methodologies.[3] We thus are concerned not only about the substance of the FSB's work—which appears to target the largest regulated U.S. funds and asset managers—but also by the processes giving rise to this work.[4]

Several of ICI's concerns with the FSB parallel those we have with the Financial Stability Oversight Council ("FSOC") here at home.[5] In March, I testified before this Committee regarding the FSOC's framework for assessing non-bank financial companies for possible SIFI designation and the FSOC's own review of asset management and financial stability.[6] There are, moreover, links between the FSB and FSOC efforts on asset management. For this reason, and given the Committee's interest in the activities of both policymaking bodies, my testimony will highlight ICI's concerns with, and suggest some improvements relating to, both the FSB and the FSOC.

In Section II below, we discuss the composition and structure of the FSB and provide background information on its efforts to develop methodologies by which to assess investment funds and asset managers for possible G-SIFI designation. Section III highlights the five reasons why the FSB's work on asset management has been woefully deficient, and explains that some of these reasons apply equally to the FSOC's SIFI designation process and its own asset management review. In Section IV, we discuss

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[3] ICI has provided extensive data and analysis to demonstrate that regulated funds and their managers do not pose risks to financial stability. *See* Letters from Paul Schott Stevens, President & CEO, ICI to the Financial Stability Board, dated April 7, 2014 and May 29, 2015, available at https://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf and https://www.ici.org/pdf/15_ici_fsb_comment.pdf, respectively. These letters also make the case that SIFI or G-SIFI designation is not necessary or appropriate for regulated non-U.S. funds (i.e., funds organized or formed outside the U.S. and substantively regulated to make them eligible for sale to retail investors).

[4] We expressed similar concerns in a recent letter to the heads of the U.S. agencies that are members of FSB. *See* Letter from Paul Schott Stevens, President & CEO, ICI to the Honorable Jacob J. Lew, Secretary, Department of the Treasury, The Honorable Mary Jo White, Chair, SEC, and The Honorable Janet Yellen, Chair, Federal Reserve Board of Governors, dated May 28, 2015 ("Lew/White/Yellen Letter"), available at https://www.ici.org/pdf/15_ici_fsb_lew_yellen_white.pdf.

[5] *See* Letter from Paul Schott Stevens, President & CEO, ICI to the Financial Stability Oversight Council, dated March 25, 2015, available at https://www.ici.org/pdf/15_ici_fsoc_ltr.pdf.

[6] *See* Statement of Paul Schott Stevens, President & CEO, ICI before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, on FSOC Accountability: Nonbank Designations (March 25, 2015) ("Stevens Testimony"), available at https://www.ici.org/pdf/15_senate_fsoc.pdf.

the clear prospect of harmful consequences for U.S. regulated funds, their investors and the capital markets. Section V explains why the future direction of asset management work in the U.S. and globally is uncertain and continues to raise serious concerns. Finally, in Section VI, we provide our recommendations, including with regard to the involvement of U.S. officials in FSB policymaking.

II. THE FSB: BACKGROUND INFORMATION FOR THE COMMITTEE

To provide important context for our concerns with the FSB and its work, below is brief background information about: (1) the FSB's mission, organizational structure, and membership; (2) its focus on "shadow banking;" and (3) the proposed methodologies to identify G-SIFIs in the asset management sector.

A. FSB Mission, Organizational Structure, and Membership

Established by the Group of 20 in 2009 as the successor to the Financial Stability Forum, the FSB by its charter has two broad objectives. These are: (1) to coordinate at the international level the work of national financial authorities and international standard setting bodies in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies; and (2) in collaboration with the international financial institutions, to address vulnerabilities affecting financial systems in the interest of global financial stability.[7] Although the FSB's decisions are not legally binding on its members, the FSB nevertheless is able to forge global recommendations regarding those activities perceived to pose systemic risk and to require international attention.

By any measure, the FSB is a bank-centric organization. Among the FSB's members, central bank officials, finance ministers, and representatives of banking-related bodies (e.g., the Bank for International Settlements ("BIS"), International Monetary Fund ("IMF"), and the Basel Committee on Banking Supervision) far outnumber capital markets regulators. And central bankers hold key leadership positions, chairing the FSB, its Steering Committee, its four standing committees,[8] its six regional consultative groups,[9] and certain workstreams (including the "Workstream on Other Shadow Banking Entities"). In addition, of particular relevance to today's hearing, the FSB's membership

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[7] *See* Charter of the Financial Stability Board (as amended and restated June 2012) ("FSB Charter"), available at http://www.financialstabilityboard.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf, at Section I, Article 1.

[8] The standing committees are: (1) Standing Committee on Assessment of Vulnerabilities; (2) Standing Committee on Supervisory and Regulatory Cooperation; (3) Standing Committee on Standards Implementation; and (4) Standing Committee on Budget and Resources.

[9] There are six regional consultative groups, one each for the Americas, Asia, Commonwealth of Independent States, Europe, Middle East and North Africa, and Sub-Saharan Africa region. They are designed to expand upon and formalize the FSB's outreach activities beyond the membership of the G20 and to reflect the global nature of the financial system.

includes three U.S. regulators: the Board of Governors of the Federal Reserve System ("Federal Reserve Board"), the SEC, and the Treasury Department.[10]

The FSB's "main mechanism for identifying and assessing risks and vulnerabilities in the financial system is its Standing Committee on Assessment of Vulnerabilities, or "SCAV."[11] The SCAV has 32 members, at least 29 of which are central bankers or finance ministry representatives.[12] Four participants are U.S. regulators, but only one of these (the chief economist of the SEC) comes from the agency charged with oversight of the U.S. asset management industry and capital markets. The others are: the member of the Federal Reserve Board who leads the FSB workstream on proposed G-SIFI methodologies for investment funds and asset managers; a Treasury Department official; and the President of the Federal Reserve Bank of New York (acting in his capacity as a representative of the BIS).

While the FSB has its own legal identity and governance structure, the BIS hosts the FSB's Secretariat, which operates out of the BIS's head office in Basel, Switzerland.[13] The BIS's website touts the fact that through this arrangement, the FSB receives "synergies of co-location; flexibility and openness in the exchange of information; and support from BIS expertise in the field of economics, banking and regulation."[14]

The FSB's charter further solidifies the organization's banking orientation. The charter specifies that as part of its mandate, the FSB will "assess vulnerabilities affecting the global financial system and identify and review on a timely and ongoing basis *within a macroprudential perspective*, the regulatory, supervisory and related actions needed to address them, and their outcomes."[15] Thus, incorporated into the FSB's organizational documents is a directive to approach its work on vulnerabilities to the global financial system "within a macroprudential perspective"—i.e., the perspective of central bankers.

B. Shadow Banking Focus

From the perspective of central bankers, non-bank financial entities arouse skepticism based on the fact that they are not regulated in the same way as banks. Central bankers pejoratively refer to financial

[10] Under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Treasury Secretary and the chairs of the Federal Reserve Board and SEC are members of the FSOC; the Treasury Secretary also serves as the FSOC's chair.

[11] *See* http://www.financialstabilityboard.org/what-we-do/vulnerabilities-assessment/.

[12] The SCAV membership is listed at http://www.financialstabilityboard.org/about/organisation-and-governance/members-of-standing-committee-on-assessment-of-vulnerabilities/.

[13] The BIS's mission is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks. *See* http://www.bis.org/about/index.htm.

[14] *See* http://www.bis.org/about/basel_process.htm.

[15] FSB Charter, *supra* note 7, Section I, Article 2(1)(a) (emphasis added).

entities and activities outside of the banking system as "shadow banks" and "shadow banking"—without regard to how those entities and activities in fact are regulated.

In 2011, the FSB commenced its efforts to address "shadow banking" by instituting five workstreams to strengthen oversight and regulation of non-bank credit intermediation.[16] In a comment letter to the FSB at the commencement of this work, ICI agreed that it was appropriate for the FSB "to consider whether additional or different regulatory measures for non-bank financial entities may be important to strengthening the global financial system."[17] But—in addition to taking the FSB to task for using inherently inaccurate and misleading terminology—our letter made a number of broader points that continue to be relevant, including:

- It is imperative for the FSB to acknowledge and respect the differences that exist between banking and securities and their respective regulatory frameworks.
- Banks and capital markets have existed alongside one another in the U.S. for centuries, with parallel bodies of regulation and oversight, and the U.S. financial system and our economy at large have thrived on the benefits that banks and capital markets provide.
- There are significant benefits and efficiencies to having the capital markets, in addition to banks, provide maturity and liquidity transformation services.
- Bank-like regulation is not appropriate, necessary or workable for funds registered under the Investment Company Act of 1940.

Unfortunately, the FSB's work since 2011, including its work on G-SIFI assessment methodologies for the asset management sector, shows that our comments have gone unheeded.

C. Proposed Assessment Methodologies to Identify G-SIFIs in the Asset Management Sector

During the global financial crisis, governments stepped in using public funds to prevent the distress or disorderly failure of certain large financial and other entities from having cascading effects throughout the financial system. In an effort to avoid the systemic and moral hazard risks associated with such bailouts in the future, a key priority on the FSB's financial stability agenda has been "Ending 'Too Big to Fail' (TBTF)."[18] Starting with banks and then turning to insurance companies, the FSB's approach

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[16] *See, e.g.*, FSB Published Recommendations to Strengthen Oversight and Regulation of Shadow Banking (press release dated 27 Oct. 2011), available at http://www.financialstabilityboard.org/2011/10/financial-stability-board-publishes-recommendations-to-strengthen-oversight-and-regulation-of-shadow-banking/.

[17] Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Secretariat of the Financial Stability Board, dated June 1, 2011 (responding to an FSB background note entitled "Shadow Banking: Scoping the Issues"), available at http://www.ici.org/pdf/25258.pdf, at 4. We expressed support for "the efforts of the FSB and the regulatory bodies it represents to study ways to monitor non-bank financial intermediaries, such as by improving and expanding data collection from these entities, as necessary, to help regulators identify and manage systemic risk." *Id.*

[18] *See, e.g., Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF), Report of the Financial Stability Board to the G-20* (2 September 2013), available at http://www.financialstabilityboard.org/wp-content/uploads/r_130902.pdf.

has been to develop assessment methodologies for identifying financial entities "whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity across jurisdictions."[19]

Having already identified 30 banks and 9 insurance companies as G-SIFIs, the FSB more recently commenced work on developing assessment methodologies to identify non-bank, non-insurer ("NBNI") G-SIFIs.[20] A January 2014 FSB consultation on this topic included a proposed methodology for identifying global systemically important investment funds.[21] On the basis of their size alone, the methodology singled out 14 highly regulated U.S. funds as the *only* funds that automatically would be subject to further review for possible G-SIFI designation. This was a curious and very troubling result, especially given that these funds belong to the part of the financial system that proved most stable during the global financial crisis.

After receiving extensive public comments, including from ICI, the FSB issued a second consultation in March 2015 that includes a revised methodology for investment funds and a new proposed methodology for asset managers.[22] The second consultation discounts key aspects of the public comment record on the initial consultation. The current proposals continue to place undue emphasis on size, thus continuing to single out large, highly regulated U.S. funds (and mostly U.S. asset managers) as candidates for potential designation.

As ICI's comment letters explain in detail, even the largest regulated U.S. stock and bond funds do not pose risks to financial stability because:

- Regulated funds use little to no leverage.
- Regulated funds do not have disorderly failures and do not rely on government intervention.
- Regulated funds do not exhibit heavy redemptions leading to fire sales.
- Regulated funds' structure and regulation limit risks and transmission of risks.

But the consequences of designating regulated funds or their managers would be highly adverse to investors and the capital markets. As we discuss in Section IV below, application of the bank-oriented "remedies" prescribed by the Dodd-Frank Act would increase costs and reduce returns for fund

[19] *See, e.g., Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (8 January 2014), available at http://www.financialstabilityboard.org/publications/r_140108.pdf, at 2.

[20] The FSB has stressed as an overarching goal consistency with the treatment of G-SIFI banks. We discuss the implications of this goal in Section III.A below.

[21] The consultation also included proposed methodologies for market intermediaries (securities broker-dealers) and finance companies.

[22] Consultative Document (2nd), *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (4 March 2015) ("FSB Second Consultation"), available at http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf.

investors, distort the fund marketplace, introduce a conflicted model of regulation, and compromise the important role that funds play as a source of financing in the economy.

III. FUNDAMENTAL PROBLEMS PERVADE THE FSB'S WORK—AND THAT OF THE FSOC—RELATING TO ASSET MANAGEMENT

ICI supports appropriate regulation to ensure the resiliency and vibrancy of the global financial system. As a related matter, we believe that regulators can—and should—examine different sectors of the financial system, including asset management, to identify potential risks to financial stability. But reviews of this nature must be thorough, balanced and fact-based—and, to those ends, led by policymakers with requisite expertise. For asset management, this means capital markets regulators. Clearly, these regulators are best positioned to determine whether regulated funds and their managers do or do not pose potential risks to financial stability.

The FSB's work relating to asset management falls far short of these basic standards. We highlight five specific areas of concern below. In many of those areas, unfortunately, we see similar deficiencies in the FSOC's SIFI designations and its review of asset management.

A. Misconception of the Business of Asset Management

The FSB's propensity to view the world through a banking lens is readily apparent in its work on asset management and financial stability. In designing methodologies for identifying and potentially designating global systemically important financial institutions—or G-SIFIs—within the asset management sector, the FSB has emphasized repeatedly that making those methodologies consistent with the methodology it uses to identify G-SIFI banks is an overarching goal.

In particular, the FSB conceptually bases its approach to asset management on concerns with "distress" and "disorderly failure" derived from the experience of banks and banking regulators. The FSB clings to these assumptions even though public commentary on the initial consultation clearly demonstrated that these concepts have little relevance to asset management. In fact, the FSB states frankly that "the NBNI G-SIFI assessment methodologies aim to measure the impact that an NBNI financial entity's failure can have on the global financial system and the wider economy, rather than the ***probability*** that a failure could occur."[23] We continue to question how the FSB can simply assume its way past such a fundamental question—that is, whether an investment fund or asset manager might actually experience such distress or disorderly failure.

As ICI repeatedly has advised, regulated funds and their managers are not banks. They do not "fail" like banks do. They are highly substitutable. Regulated funds generally use little to no leverage. Fund managers act as agents, not principals. They invest on behalf of their clients, leaving the risks—and rewards—to the end investors, who knowingly accept this tradeoff.

[23] FSB Second Consultation, *supra* note 22, at 10 (emphasis in the original).

Although the FSB does acknowledge some of the defining characteristics of asset management, many of the FSB's choices as reflected in its proposed methodologies for investment funds and asset managers remain stubbornly bank-focused. For example:

- Based on the misguided idea that the size of a fund alone can indicate the potential to pose risks to financial stability, the proposed methodologies would continue to single out large, highly regulated U.S. funds for possible designation.
- The proposed methodology for assessing asset managers would sweep large asset managers into the designation net, possibly based entirely on the amount of assets they manage, resulting in the identification of candidates for potential designation that are almost solely U.S. firms.
- The FSB continues to espouse an unsupported theory about the potential for destabilizing "fire sales" of investment fund assets that relies, in part, on conjecture by other banking-oriented regulators and discounts an extensive public record providing compelling evidence to the contrary. We discuss this below in greater detail.

In blindly striving for consistency with the treatment of banks, the FSB has persisted in pursuing an "entity-based" approach to identifying and addressing potential risks to global financial stability in the asset management sector—even though the characteristics that distinguish investment funds and asset managers from banks (e.g., substitutability) suggest that true mitigation of any risks identified in the asset management sector can only come from activity-based regulation.

B. Inadequate Role for Subject Matter Experts

As discussed in Section II above, the FSB's membership largely consists of central bankers, finance ministers and representatives of banking-related bodies. As a result, capital markets experts are not leading either the FSB's work on asset management or some of its other projects focused on non-bank entities and activities.

For example, as discussed further in Section V below, the SCAV is heading up a new asset management workstream looking at potential industry-wide risks. In addition, in the case of the five "shadow banking" workstreams the FSB instituted in 2011, the FSB tapped the International Organization of Securities Commissions ("IOSCO") to play a leading role for only two of those workstreams. In the workstream on "shadow banking" entities other than money market funds (also known as "workstream 3"), the bank-dominated FSB has the reins.

To its credit, the FSB has seen fit to involve IOSCO in its work on the G-SIFI assessment methodologies for investment funds and asset managers. It is our understanding, however, that rather than establishing an equal partnership with IOSCO or deferring to IOSCO members' expertise in this area, the bank-dominated FSB has remained firmly in charge of the project.[24]

And why is this a problem? As ICI explained in its comment letter on the second NBNI G-SIFI consultation, since the global financial crisis, we have seen a continued propensity of banking-oriented regulators to view the asset management industry through the lens of banking—in particular, the "safety and soundness" goals of bank regulation, the inherent riskiness of the highly-leveraged bank model, the significant problems that banks experienced during the crisis, the unprecedented level of government intervention needed to safeguard the banking system, and the various regulatory tools that have been employed to strengthen individual banks and the overall banking sector. When applied to investment funds and asset managers, this ill-fitting lens has predictably led to the view that the largest funds and managers, in case they are not regulated like banks, may pose unaddressed and unacceptable risks to other market participants and the financial system as a whole.

Domestically, we have had similar concerns. For example, as I discussed in my March 2015 testimony before this Committee, the FSOC's review of asset management began most inauspiciously with a highly flawed 2013 report on asset management written by the FSOC's research arm, the Office of Financial Research ("OFR"). Among the range of sharp criticisms the report drew were that it reflected a deeply inaccurate understanding of the asset management industry.[25]

In addition, as with the FSB, the composition of the FSOC is weighted toward bank regulators. This would appear to give bank regulators the upper hand in designation decisions and other matters—even if they are not the experts with respect to the subject matter under consideration. We have seen this concern play out in the insurance industry, where the FSOC has designated firms as SIFIs despite the objections and misgivings of the presidentially appointed independent member of the FSOC with insurance expertise.

C. Reliance on Conjecture and Theory Rather than Empirical Data and Actual Experience

The FSB discounts empirical data and analysis that does not comport with the theories on which its proposed methodologies are based. Those theories include the potential for "fire sales" of investment fund assets, the transmission of risk from an investment fund to other market participants, and destabilizing effects to the global financial system. We believe the FSB has vastly overstated the potential for such effects. And, in the seventy-five year history of the modern U.S. fund industry, there is no historical or empirical basis for the FSB's concerns.

[24] As discussed in Section V below, IOSCO's Board recently recommended that a full review of asset management activities and practices should take precedence over consideration of how to designate funds or asset managers as G-SIFIs. *See* IOSCO: Meeting the Challenges of a New Financial World (media release dated 17 June 2015) ("IOSCO media release"), available at https://www.iosco.org/news/pdf/IOSCONEWS384.pdf.

[25] Stevens testimony, *supra* note 6, at 13.

To the contrary, ICI's comment letter on the FSB's first consultation offered extensive data and analysis showing that regulated funds and their investors simply do not behave in the manner that the FSB envisions. Yet this data and analysis does not appear to have persuaded the FSB to re-examine its hypothesis that individual funds could, in certain circumstances, experience "fire sales" that could have negative spillover effects on other investment funds, fund counterparties, or particular markets.

Instead, in its second consultation, the FSB relies on the conjectures of other banking-oriented regulators or their representatives—including the FSOC—as support for its position. For example, the FSB appeared to endorse certain statements set forth in the FSOC's December 2014 notice seeking comment on asset management products and activities. The FSB repeated, without empirical or historical support, the FSOC's conjectures about a "first mover advantage" for investors in investment funds that offer redeemable interests, particularly funds investing in less liquid asset classes. This bank-regulatory "echo chamber," in which the FSB cites the mere speculations of the FSOC as evidence or authority supporting its proposed methodologies, is a matter of deep concern. It simply ignores the demonstrable, real-world experience of regulated funds. In fact, ICI's comment letter on the FSOC's notice provided detailed analysis and data to refute these purported risks in regulated U.S. stock and bond funds.

Also troubling is the fact that individual members of the FSB are perpetuating these conjectures through other means. We offer several examples.

First, the Chair of the SCAV (the FSB standing committee responsible for assessing risks and vulnerabilities in the financial system) is a Governor of the Reserve Bank of Australia, the staff of which recently issued a bulletin entitled *Recent Developments in Asset Management*.[26] The bulletin's discussion of asset management and systemic risk relies heavily on the FSB's two consultations and the widely-discredited 2013 report by the Office of Financial Research. It states baldly—without citation to any source, much less empirical or historical evidence—that "[o]pen-ended funds that offer daily redemptions are susceptible to bank-like runs." The bulletin concludes by stating that the asset management industry "poses potential risks to financial stability"—an observation that would appear to front-run the work by SCAV, which commenced this spring.[27]

Along the same lines, the BIS—which funds the FSB's work and houses the FSB Secretariat within its offices—included in its most recent annual report similar conjectures about the risks posed by the asset

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[26] *See* Fiona Price and Carl Schwartz, Reserve Bank of Australia, *Recent Developments in Asset Management*, Bulletin, June Quarter 2015, at 72. The bulletin's reference to open-ended funds appears to be targeted to stock and bond funds. *Id.* at 71-72 and Graph 4. The bulletin is available at http://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-8.pdf.

[27] Letter from Mark Carney, Chairman, FSB to G20 Finance Ministers and Central Bank Governors, dated 9 April 2015 ("Carney Letter"), available at http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chairs-letter-to-G20-April-2015.pdf, at 3 (explaining that following the February meeting in Istanbul, the FSB developed a work programme to "understand and address vulnerabilities in capital market and asset management activities").

management industry.[28] The report states, for example, that "asset managers' business models . . . incentivize short-sighted behaviour that can be destabilising in the face of adverse shocks" and that "[t]he decisions taken by a single large asset manager can potentially trigger fund flows with significant system-wide repercussions."[29]

And in April, the IMF released its most recent Global Financial Stability Report (GFSR), including a chapter on "The Asset Management Industry and Financial Stability."[30] It appears to be a robust analysis based on empirical data sufficient to support the IMF's declaration that "even simple investment funds such as mutual funds can pose financial stability risks."[31] Closer examination, however, reveals that the chapter contains numerous data errors, misinterpretations, and misleading charts.[32] By and large, these issues arise because the IMF lacks expertise in, and institutional knowledge of, regulated funds.

D. Indications of Intended Results Driving Methodologies

ICI has taken advantage of every available opportunity to participate in the public consultation process regarding the FSB's proposed asset management methodologies.[33] Frankly, it is frustrating to see how little impact the extensive public comment record has had on the substance of the consultation.

Despite extensive public commentary that size alone does little to indicate the potential for systemic risk, the second consultation continues to place undue emphasis on the size of a fund, thus singling out many large regulated U.S. funds for potential designation. It also adds criteria to sweep large asset managers into the designation net, possibly based entirely on the amount of assets under management.

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[28] *See* Bank for International Settlements, *85th Annual Report, 1 April 2014–31 March 2015* (Basel, 28 June 2015)("BIS Annual Report"), available at http://www.bis.org/publ/arpdf/ar2015e.htm.

[29] BIS Annual Report at 118, 119.

[30] IMF, *The Asset Management Industry and Financial Stability*, Chapter 3, Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks (April 2015) ("Asset Management Chapter"), available at http://www.imf.org/external/pubs/ft/gfsr/2015/01/pdf/c3.pdf.

[31] *See Plain Vanilla Investment Funds Can Pose Risks*, IMF Survey Magazine: Policy (April 8, 2015) (describing the IMF's conclusions in the Asset Management Chapter), available at http://www.imf.org/external/pubs/ft/survey/so/2015/POL040815B.htm.

[32] ICI economists have written a series of blog posts explaining various problems in the IMF's analysis of the asset management industry. *See The IMF Is Entitled to Its Opinion, but Not to Its Own Facts*, ICI Viewpoints (April 10, 2015); *The IMF Quietly Changes Its Data, but Not Its Views*, ICI Viewpoints (April 21, 2015); *The IMF on Asset Management: The Perils of Inexperience*, ICI Viewpoints (May 28, 2015); *The IMF on Asset Management: Which Herd to Follow?* ICI Viewpoints (June 1, 2015); *The IMF on Asset Management: Sorting the Retail and Institutional Investor "Herds,"* ICI Viewpoints (June 4, 2015). All of the blog posts in this series can be accessed at https://www.ici.org/viewpoints/view_15_imf_gfsr.

[33] We also have participated in numerous meetings with FSB officials and staff.

The approach, too, would result in identification of asset managers that are almost solely U.S. firms as candidates for potential designation.

This is not the only example of the FSB ignoring public commentary on a significant aspect of its proposed methodologies. Virtually all commenters agreed with the FSB's reasoned decision in the initial consultation not to focus on individual asset managers because of the agency nature of their business. In other words, the FSB recognized that fund investors and other clients of an asset manager, rather than the manager itself, are the bearers of investment risk. Nevertheless, in the second consultation, the FSB chose to ignore public comments *and* its own counsel by adding a separate assessment methodology for asset managers.

What could account for this sharp reversal of views? It is possible that the FSB could have been influenced by the views of commenters whose identities, like their comments, have not been made publicly available.[34] An alternative, and equally unsettling, explanation is that the FSB could have been attempting to reverse-engineer the proposed methodologies to achieve a specific outcome.

The scope of the FSB's work to date on asset management also appears contrived. The second consultation proposes to exclude pension funds and sovereign wealth funds from any assessment for systemic risk. Some of these large pools of managed assets are many times the size of the U.S. stock and bond funds that the proposed G-SIFI methodology would target. We do not suggest that pension funds and sovereign wealth funds should be assessed for systemic risk based on their size alone. The FSB's justification for excluding them, however, lacks an empirical basis and is facially unconvincing. We question whether those investment vehicles are as comprehensively regulated or as transparent as the U.S. stock and bond funds that would be identified—solely on the basis of *their* size—for review.

Similarly, in the U.S., the way in which the FSOC has approached the question of non-bank SIFI designation has every feel of a results-oriented exercise as opposed to an objective analysis. In none of its non-bank designations thus far has the FSOC chosen to explain the basis for its decision with any particularity. Instead, it appears to have relied on a single metric (a company's size) to the exclusion of the other factors in the Dodd-Frank Act that are meant to be part of the FSOC's analysis. The FSOC also has theorized about risks instead of conducting the kind of thorough, objective, empirical analysis that should underlie its decisions. And by avoiding any meaningful discussion of the particular aspects or activities of the company that are thought to pose systemic risks, the FSOC not only forecloses the prospect of any reasoned justification for its decisions, but also frustrates Congressional intent.[35]

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[34] *See* FSB Second Consultation, *supra* note 22, at 3 (stating that all comments will be published "unless a commenter specifically requests confidential treatment.").

[35] For further detail, *see* Stevens Testimony, *supra* note 6, at Section III.

E. Insufficient Transparency and Accountability in Consultation and Designation Process

ICI is concerned by the process the FSB envisions for evaluating investment funds and asset managers under the proposed methodologies. Among the serious shortcomings of the process are the following:

- Because the FSB has agreed to hold comments in confidence, the entire process may be heavily influenced by submissions that are kept from public view and scrutiny. In addition, there is no public information about what position U.S. regulators participating in the process have taken with respect to the proposed methodologies. This is a matter of particular concern because the FSB's work in this area is being led by a Federal Reserve Board Governor, and that work seems bent on producing recommendations to the FSOC calculated to expand the Federal Reserve Board's own authority over U.S. asset management and capital markets.
- Investment funds or asset managers being considered for G-SIFI designation may have little or no information as to the basis upon which specific decisions are being or will be made.
- There is no required notice that an investment fund is being evaluated (*i.e.,* for funds that do not meet the materiality threshold but are considered by national authorities to be "potentially globally systemic") or that a fund will *not* be designated (for funds that do meet the materiality threshold).
- There is no assurance that an investment fund or asset manager will be permitted to provide information that they believe is relevant to a designation determination (or that any such information would be considered by the FSB and the relevant national authority).
- There is no requirement to consider the relative costs and benefits of a potential designation.
- There is no formal (or informal) mechanism for an investment fund or asset manager to challenge a G-SIFI determination.

In our recent comment letter to the FSB, we recommended various procedural reforms that, in our view, would help address concerns that the FSB process has a predetermined outcome in mind—*i.e.*, naming the largest investment funds and asset managers as G-SIFIs—rather than seeking to identify demonstrable risks to global financial stability and to pursue the most effective and efficient means of mitigating them. Our recommendations included three important reforms:

- First, the FSB should provide an entity under review with sufficiently detailed information about the potential risks of concern to the FSB.
- Second, the process should include greater reliance on an entity's primary regulator, including consideration of whether potential risks posed by the entity are better addressed through regulation targeted to the relevant activity, rather than through G-SIFI designation.

- Third, the entity should have the opportunity to propose changes to its business, structure or operations to address the risks identified by the FSB, and should receive a response from the FSB to these proposed changes.

The FSOC SIFI designation process likewise would benefit from these types of common-sense improvements.[36] As the Committee is aware, ICI and many other stakeholders, including members of this Committee, have expressed concerns with the FSOC's SIFI designation process.[37] In a December 2014 letter to the FSOC, for example, ICI highlighted the following areas for potential reform: greater engagement with companies under evaluation; greater involvement by a company's primary financial regulator; allowing a company to propose a "de-risking" plan as an alternative to SIFI designation; greater transparency, which would give other companies and the broader public more insight into the FSOC's concerns about systemic risk and the business activities or practices giving rise to such risks; and periodic comprehensive review of designated companies.[38]

In February of this year, in response to those calls for change, the FSOC voted to approve "supplemental procedures" to revise its SIFI designation process. The new procedures call for earlier engagement with companies under review, more transparency to the public on the designation process and reasons for designating companies, and a more robust process for annual reviews. While a helpful first step, these new procedures do not go far enough and can be changed at any time without prior notice. ICI believes the changes should be codified in statute to provide greater certainty and predictability to the SIFI designation process.

In this regard, the Committee should be aware of a related issue. In issuing the above-noted supplemental procedures, the FSOC indicated that it would publish "further details explaining how the Stage 1 thresholds are calculated."[39] The so-called Stage 1 thresholds are the six quantitative metrics that the FSOC and its staff use to identify those companies that will be subject to comprehensive

[36] We discuss our specific recommendations in greater detail in Section VI, below.

[37] *See, e.g.*, Letter from Rep. Carolyn B. Maloney (D-NY), Ranking Member, Subcommittee on Capital Markets and Government Sponsored Enterprises to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, dated July 29, 2014; Statement of Chairman Jeb Hensarling before Committee on Financial Services, Hearing on "The Annual Report of the Financial Stability Oversight Council" (June 24, 2014) (stating that, with the exception of the national security agencies dealing in classified information, the "FSOC may very well be the nation's least transparent federal entity"); Letter from Jeb Hensarling (R-TX), Chair, Committee on Financial Services, et. al. to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, et al., dated May 14, 2014 (raising concerns about the SIFI and G-SIFI designation process); Letter from Sen. Mark Warner (D-VA) to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, dated May 9, 2014 (noting that SIFI designation analysis "should follow a rigorous and transparent process, using reliable data, so that regulators and the marketplace can be armed with the best information possible").

[38] *See* Letter from Paul Schott Stevens, President & CEO, ICI to Patrick Pinschmidt, Executive Director, FSOC, dated Dec. 17, 2014.

[39] FSOC, Supplemental Procedures Relating to Nonbank Financial Company Determinations (Feb. 4, 2015), available at http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf, at 5.

review for possible SIFI designation.[40] The FSOC and its staff maintain that these metrics "are designed to be uniform, transparent, and readily calculable by the Council, non-bank financial companies, market participants, and other members of the public."[41] Even with the further details the FSOC staff issued in early June, however, the metrics fall well short of this standard. With respect to the metric focused on derivatives liabilities, for example, the new guidance provides *no* additional details—despite specific industry requests for clarification[42]—and merely restates information from the FSOC's 2012 release adopting these metrics. In our view, if the FSOC and its staff are not willing to provide the information needed to make the Stage 1 thresholds "transparent and readily calculable," they should refrain from mischaracterizing this part of the SIFI designation process.

IV. THERE IS A CLEAR PROSPECT OF HARMFUL CONSEQUENCES FOR REGULATED U.S. FUNDS, THEIR INVESTORS AND THE CAPITAL MARKETS

ICI is greatly concerned about the deficiencies discussed in Section III above because of the potential for the FSB's work to have serious negative consequences for regulated U.S. funds, fund investors and the capital markets. In this section, we highlight how the FSB's work is able to affect U.S. entities and reiterate what the consequences of designation would be for U.S. funds or their managers.

A. Effect of the FSB's Work on U.S. Entities

As mentioned earlier, three U.S. government agencies represented on the FSOC—the Federal Reserve Board, the Treasury Department, and the SEC—also are members of the FSB. The lack of transparency and accountability around the FSB's NBNI G-SIFI consultation process makes it impossible to know precisely what role these agencies have played in this project and what their views are on it.[43] Efforts by members of Congress to gain greater insight into these matters have been largely unavailing.[44]

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[40] We note, however, that FSOC reserves the right to evaluate a company even if it does not meet the Stage 1 metrics.

[41] FSOC Staff Guidance, Methodologies Related to Stage 1 Thresholds (June 8, 2015), available at http://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf, at 1.

[42] *See, e.g.*, Letter from Gus Sauter, Managing Director and Chief Investment Officer, and John Hollyer, Principal and Head of Risk Management and Strategy Analysis, Vanguard, dated Dec. 19, 2011 (recommending that, in calculating net derivative liability under its "Stage 1" analysis, FSOC take into account not just cash collateral but also collateral consisting of cash-equivalents, such as Treasuries and other U.S. government agency securities).

[43] Chair Yellen's recent response to the Lew/White/Yellen Letter (*supra* note 4) shed no additional light. Chair Yellen stated that "as the FSB is made up of participants from many jurisdictions, the particular statements and documents produced by the FSB do not necessarily reflect my views or those of the Federal Reserve." Letter from Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, to Paul Schott Stevens, President and Chief Executive Officer, Investment Company Institute, dated June 11, 2015 ("Yellen Response").

[44] *See, e.g.*, Hearing Transcript, *The Annual Testimony of the Secretary of the Treasury on the State of the International Financial System*, Committee on Financial Services, House of Representatives (May 8, 2014) (exchange between The Honorable Jacob Lew, Secretary, Department of the Treasury, and Chairman Jeb Hensarling (R-TX) *et al.* regarding the FSOC's interaction with the FSB and the FSB's designation of three U.S. insurance companies as G-SIFIs).

It also is troubling that, as mentioned above, a Federal Reserve Board Governor leads the FSB workstream responsible for the proposed G-SIFI assessment methodologies for investment funds and asset managers. This arrangement raises the prospect that the process set in motion by the FSB ultimately could be used to exert multilateral influence on the FSOC to expand the reach of the Federal Reserve itself to regulated U.S. funds and their managers and, by extension, U.S. capital markets.

The FSOC maintains that the FSB's decisions do not determine those of the FSOC.[45] And Federal Reserve Board Chair Yellen recently echoed this view in response to ICI's letter. Chair Yellen indicated that "any recommendations by the FSB with respect to the asset management industry would not be binding on the United States. That responsibility remains with the appropriate domestic regulatory authorities and the Financial Stability Oversight Council."[46] But these assertions provide little comfort as regards the potential for the FSB's decisions to influence the FSOC's. While the FSB's recommendations may not be "binding," they seem certain to have some import for the FSOC. One need only consider the experience of the insurance industry. Surely it is more than just a coincidence that the FSOC has designated for enhanced prudential regulation and Federal Reserve Board supervision all the U.S.-based insurance firms the FSB named as global systemically important insurers.

Indeed, the FSB's proposed process for identifying NBNI G-SIFIs expressly calls for involvement by "national authorities" in each member jurisdiction. Thus, if the FSB were to adopt its current proposal, regulators in the U.S. would be called upon to analyze U.S. funds and asset managers under the applicable assessment methodology and to develop a preliminary list of NBNI G-SIFIs. In addition, under the proposal, national authorities would be permitted to add to their preliminary lists "other NBNI financial entities that are below the materiality thresholds but which they determine should still be added for more detailed assessment."[47] Subsequently, U.S. regulators, together with the FSB, would determine the final list.

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[45] *See, e.g.,* FSOC Nonbank Designations – FAQs (FAQ #11), available at http://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx. FAQ #11 states:

11. If international entities such as the Financial Stability Board (FSB) identify a U.S. firm as systemically important, does that mean that the FSOC will do the same?

No. While the FSB and the FSOC are both focused on strengthening financial stability, their processes are distinct. Decisions reached in the FSB do not determine decisions made by the FSOC. In fact, the FSOC is under no obligation to even consider a firm identified by the FSB for designation.

The FSB's identification of a firm as a global systemically important financial institution does not have legal effect in the United States or any other country. In the United States, the FSOC is the only entity that can designate nonbank financial companies for enhanced prudential standards and Federal Reserve supervision. FSOC designations can be made only pursuant to a super-majority vote of its 10 voting members based solely on the standards and processes set forth in U.S. federal law, after a robust analysis that reflects extensive interaction with the company.

[46] Yellen Response, *supra* note 43.

[47] Second FSB Consultation, *supra* note 22, at 14.

Moreover, participation as a member of the FSB carries with it the expectation that member jurisdictions will implement any agreed upon standards and policy measures.[48] Consistent with this expectation, FSB Chairman Mark Carney recently stated that "full, consistent and prompt implementation" of the standards developed under the FSB "remains essential in order to maintain an open and resilient global financial system."[49] Notwithstanding this instruction, as we advised in the Lew/White/Yellen Letter, we believe that the FSB's proposed asset management methodologies cannot serve as a predicate for any regulatory action in the United States.[50]

B. What is At Stake? The Consequences of Designation

As ICI has cautioned previously, SIFI or G-SIFI designation of regulated funds or their managers would have severe consequences. In both cases (i.e., SIFI and G-SIFI), U.S. law already has established the measures that would apply to any fund or manager designated as systemically important. As prescribed by the Dodd-Frank Act, these measures are designed to moderate bank-like risks and are ill-suited to regulated funds and their managers. Most notably, the requirements include:

- Capital requirements – possibly at the level of the minimum bank capital requirement, which is 8 percent[51]
- Fees/assessments – to defray the Federal Reserve's supervisory costs and to cover the expenses of the FSOC and the U.S. Treasury Department's Office of Financial Research
- Possible resolution assessments – to cover costs associated with the resolution of a distressed financial institution deemed systemically important—for example, fund investors could have to help bail out a "too-big-to-fail" financial institution
- Possible highly prescriptive liquidity requirements – such as a requirement to hold a specified level of cash or cash equivalents
- Federal Reserve prudential supervision – described as "prudential market regulation" of funds and asset managers in accord with banking "system demands" determined by the Federal

[48] *See, e.g.,* Carney Letter, *supra* note 27.

[49] Carney Letter, *supra* note 27, at 1.

[50] Lew/White/Yellen Letter, *supra* note 4, at 3-4.

[51] An unresolved inconsistency between two provisions in the Dodd-Frank Act calls into serious question just how much flexibility the Federal Reserve Board would have to limit the application of capital requirements to any regulated fund designated as a SIFI or G-SIFI. One provision (Section 165(b)(1)(A)(i)) gives the Federal Reserve Board discretion in applying capital standards to nonbank SIFIs, while another (Section 171, also known as the "Collins Amendment") may not. Specifically, the Collins Amendment requires the imposition of minimum leverage capital and risk-based capital standards on any SIFI. The Federal Reserve Board accordingly may be compelled to hold a regulated fund SIFI to the bank minimum capital requirement of 8 percent, although it is unclear whether that precise standard would be applied. *See* 12 C.F.R. 217.10(a)(3) (the capital adequacy rule for U.S. bank holding companies).

Reserve Board, in contrast to the fiduciary obligations of fund managers and fund boards of directors to act in funds' best interests

Based on these requirements, designated funds would face higher costs resulting in lower investment returns for individuals saving for retirement, education and other life goals. The resulting competitive imbalances would distort the fund marketplace, potentially reducing investor choice. Designation also could have far-reaching implications for how a fund's portfolio is managed, depending on how the Federal Reserve exercises its supervisory charge under the Dodd-Frank Act to "prevent or mitigate" the risks presented by large, interconnected financial institutions. As I have previously testified, regulated funds and their managers could be subject to a highly conflicted form of regulation, pitting the interests of banks and the banking system against those of millions of investors.[52]

V. THE FUTURE DIRECTION OF ASSET MANAGEMENT WORK IS UNCERTAIN AND CONTINUES TO RAISE SERIOUS CONCERNS

To mitigate any risks to financial stability that may arise in asset management, ICI has called for regulators to address those risks through industry-wide or activity-based regulation. Likewise, we have said repeatedly that a sector-wide appraisal of activities and practices is the appropriate way in which to evaluate any potential out-sized risks in asset management.

It is encouraging, therefore, to see some movement in this direction both domestically and abroad.

- The FSOC is conducting an activity-based review of the asset management sector, of which its December 2014 notice seeking public comment is a part.

- The SEC—which already has the necessary authority and expertise to oversee the asset management sector—is taking steps to strengthen its oversight of regulated funds and asset managers. Work is underway on a set of targeted reforms in areas including risk management and enhanced collection of fund data.

- The FSB recently inaugurated a separate workstream to review asset management activities on an industry-wide basis.

- Just last month, IOSCO's Board recommended that a review of asset management activities "take precedence" over consideration of the designation of individual funds or asset managers as systemically important.[53] In a subsequent speech, IOSCO Chairman Greg Medcraft said: "I'm not convinced . . . that there is evidence that asset managers put financial stability at risk simply

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[52] Stevens Testimony, *supra* note 6, at 15-18 (discussing in greater detail the highly adverse consequences of inappropriate designations to investors and the capital markets). *See also* Paul Schott Stevens, *Designation's Vast Reach into Investor Portfolios*, ICI Viewpoints (March 24, 2015), available at https://www.ici.org/viewpoints/view_15_designation.

[53] *See* IOSCO media release, *supra* note 24.

because they're large. As yet we do not have concrete evidence that this has been or might be the case."[54]

- Recent press reports indicate that Federal Reserve Board Governor Daniel Tarullo, who leads the FSB workstream on proposed G-SIFI methodologies for investment funds and asset managers, has expressed support for an activities-based approach to the asset management industry.[55]

But despite these positive developments, there is much cause for continuing concern. Notably, neither the FSOC nor the FSB has taken designation of individual regulated funds or their managers off the table. We also are not aware of any FSB response to the IOSCO Board's recent recommendation or Chairman Medcraft's subsequent remarks. Instead, the last official FSB communication touching on the FSB's future course of action was Chairman Carney's April letter. In addition to emphasizing the need for "full, consistent and prompt implementation" of FSB standards, the letter lays out the FSB's work plan for the remainder of 2015, which includes "taking further steps this year to end too-big-to-fail for financial entities other than banks."[56]

Even if policymakers shift their approach from the consideration of individual fund or manager designations to a review of asset management practices and activities, this is not a panacea. For example, we understand that the FSB's SCAV has been tasked with the new asset management workstream mentioned above. Having now looked more closely at that committee's composition (as discussed in Section II above), we are highly skeptical about its ability to conduct a rigorous and balanced review of the asset management sector. We understand that the SCAV's work is internal to the FSB, and thus likely will be conducted without a public consultation.

An activity-based approach to asset management, if led by central bankers, could result in the same poor policy outcomes as designation of individual regulated funds or their managers. The regulatory model that central bankers seem intent on bringing to asset management is a set of highly prescriptive regulations that are straight out of the bank regulators' playbook.[57] This model, we believe, is the "prudential market regulation" that Federal Reserve Board Governor Tarullo envisions as the way to

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[54] *IOSCO and the international reform agenda for financial markets*, Speech by Greg Medcraft, Chairman, IOSCO, to the National Press Club, Washington, DC (22 June 2015) ("Medcraft Speech"), available at http://download.asic.gov.au/media/3273669/speech-to-the-national-press-club-washington-dc-greg-medcraft-published-22-june-2015.pdf, at 6.

[55] John Heltman, *Shift Toward Activities-Based Regulation Continues to Make Headway*, American Banker (June 26, 2015) ("Tarullo said earlier this month that he favored an activities-based approach to the asset management industry, but his Thursday comments expanded on those thoughts.").

[56] Carney Letter, *supra* note 27, at 2.

[57] *See, e.g.*, BIS Annual Report, *supra* note 28. *See also* Medcraft Speech, *supra* note 54 (asserting that refinements to existing tools of capital markets regulators, and not banking tools, should be considered to address any risks in asset management).

address perceived risks posed by asset management activities.[58] Just like the Dodd-Frank policy measures discussed above, such requirements would pit the interests of banks and the banking system against those of fund investors. Ironically, if applied to regulated U.S. funds, these types of prescriptive measures would fundamentally change a highly successful investment product upon which tens of millions of Americans rely to meet their financial goals.

VI. RECOMMENDATIONS

ICI is pleased to offer its recommendations for addressing several of the concerns we discuss above. We believe that this Committee and Congress as a whole have important roles to play.

- On an ongoing basis, the Committee should continue to monitor closely U.S. agencies' participation in the FSB's policy work, particularly as it relates to asset management. As part of its oversight of these agencies, the Committee should seek to ensure that their FSB participation does not conflict with the best interests of U.S. investors and the capital markets.

- In the near term, the Committee should encourage the U.S. officials who participate in the FSB to support the IOSCO Board's recommendation to conduct a full review of asset management activities and products, and urge the FSB to set aside further work on G-SIFI assessment methodologies for investment funds and asset managers. Of utmost importance, IOSCO should lead this review.

- The Committee should use its influence to encourage the reconstitution of the FSB. This reformed FSB should give major sectors of the global financial system—capital markets, banking and insurance—an equal role. In addition, in pursuit of global financial health, the organization's mission should be to advance the dual objectives of mitigating risk to the financial system, while promoting vibrant markets and economic growth.

- With regard to the FSOC, Congress should enact legislation, such as Title III of S.1484, to codify in statute important improvements to the SIFI designation process. In particular, ICI strongly believes that Congress must reform the FSOC's designation process in ways that will advance the Dodd-Frank Act's dual goals of reducing systemic risk while reserving SIFI designation as a tool to be used only in truly exceptional cases. We suggest focusing such reforms on three critical areas:

  - First, the FSOC should provide notice sufficient to inform a company as to the financial stability risks that the FSOC believes the company presents.

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[58] *See Speech at the Office of Financial Research and Financial Stability Oversight Council's 4th Annual Conference on Evaluating Macroprudential Tools: Complementarities and Conflicts*, Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, available at http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.htm.

- Second, the primary financial regulator of a company under evaluation should have a meaningful opportunity, prior to designation, to address any risks the FSOC identifies as systemic. The primary regulator generally will have greater expertise and regulatory flexibility than the FSOC to address such risks.

- Third, a company under evaluation should have an opportunity, prior to designation, to propose changes to its structure or business practices that would address the risks the FSOC has identified. This "de-risking" option, which would require the FSOC's consent, could prove to be a more direct and effective way to achieve the FSOC's goal of risk mitigation.

As for our recommendations concerning the FSOC, ICI is pleased that Chairman Shelby has included reforms of this nature in S. 1484, the Financial Regulatory Improvement Act.[59] If adopted, these types of measures—which have garnered bipartisan support[60]—would give the FSOC additional tools and *more* flexibility to ameliorate systemic risks. We emphasize that, if the FSOC determines that neither action by the primary regulator nor the company's de-risking proposal is sufficient, the FSOC retains the authority to move forward with a SIFI designation. Neither of those two options, moreover, interferes with the FSOC's emergency authority to designate.

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I appreciate the opportunity to share these views with the Committee. ICI looks forward to continued engagement with Congress on these important matters.

[59] Similar legislation has been introduced on a bipartisan basis in the House by Reps. Dennis Ross (R-FL) and John Delaney (D-MD). H.R. 1550, the Financial Stability Oversight Council Improvement Act of 2015, has 10 additional cosponsors.

[60] *See, e.g.*, Remarks by Senator Robert Menendez (D-NJ) at *FSOC Accountability: Nonbank Designations*, Hearing before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (March 25, 2015) ("what is the use of engaging with a company if it is not to both come to a conclusion as to whether it is systemically risky, what activities are systemically risky, and if it wished to avoid the designation because of the consequences that flow from that, give it the opportunity to do so? To me, that is not theoretical. It just makes common sense."); Remarks by Chairman Ander Crenshaw (R-FL) at *Budget Hearing – Department of Treasury*, Hearing before the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. House of Representatives (March 4, 2015) ("I question why FSOC would not create a process to allow companies, or primary regulators, to address identified risks before designation. It seems to me this would save a lot of time and resources for the Council as well as ensure stability within our financial system.").

STATEMENT OF EUGENE SCALIA*
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BEFORE THE
SENATE COMMITTEE ON BANKING, HOUSING, & URBAN AFFAIRS
REGARDING THE ROLE OF THE FINANCIAL STABILITY BOARD
IN THE U.S. REGULATORY FRAMEWORK

July 8, 2015

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to testify today on the role of the Financial Stability Board ("FSB") in the financial regulatory framework of the United States. I speak to you today not as a policy expert on financial institutions or the banking system, but as a lawyer who practices administrative law and has represented clients in connection with activities of the FSB and designation as a systemically important financial institution ("SIFI") by the Financial Stability Oversight Council, or "FSOC." I testify in my individual capacity, and not on behalf of any clients. The views I express are my own.

The FSB was established by the G-20 nations in April 2009 to help rehabilitate and fortify the global financial system in the wake of the 2008 financial crisis.[1] Its membership comprises the financial regulatory agencies of the G-20 nations, including—from the United States—the Department of Treasury, the Federal Reserve Board, and the Securities and Exchange Commission ("SEC").[2] Its functions include coordinating with financial authorities of

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[1] *About the FSB*, Financial Stability Board, http://www.financialstabilityboard.org/about/ (last visited June 29, 2015).

[2] *Members of the FSB*, Financial Stability Board, http://www.financialstabilityboard.org/about/organisation-and-governance/members-of-the-financial-stability-board/ (last visited July 4, 2015); *see also Members of the*

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member nations and other international bodies to develop regulatory policies, assessing potential vulnerabilities within the global financial system, and recommending measures to protect and strengthen the financial system.[3]

These are important functions, and there is a valuable role to be played by an organization such as the FSB. As a nation we participate in a global financial system in which events abroad can substantially affect what happens here—we have an interest in the soundness and integrity of our trading partners' financial systems, just as they do in ours. We also have an interest in the regulatory requirements of different jurisdictions being harmonized on the basis of a reasonable set of principles and prescriptions.

But of course the FSB has limitations. The nations represented on the FSB—and financial institutions within those nations—have interests that may diverge from the interests of the United States and U.S.-based financial institutions. The FSB is not governed by U.S. law or legal processes. The policy prescriptions preferred by some, or even a majority of, FSB members may not necessarily comport with U.S. law or policy. And of course, U.S. officials participating in the FSB cannot commit to actions that depart from requirements of U.S. law, or that are not currently authorized by U.S. law.

In short, it is essential for nations' financial leaders to share information and to seek consensus on matters that require international coordination. But concerns arise if U.S. legal

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Financial Stability Board, http://www.financialstabilityboard.org/wp-content/uploads/plenary1.pdf (last visited July 4, 2015). Currently, Nathan Sheets, Undersecretary for International Affairs, represents the Treasury Department, Daniel K. Tarullo, Governor, represents the Federal Reserve, and Mary Jo White, Chair, represents the SEC. *Id.*

[3] *Id.*

rights and processes take a back seat to decisions that were forged in private meetings with regulators overseas.

That concern has been raised in connection with the designation of systemically important financially institutions, particularly insurance companies. In July 2013, FSB designated nine companies as "global systemically important insurers," or "G-SIIs."[4] The FSB simultaneously identified certain "policy measures" that it said "will apply to G-SIIs," as well as "timelines" "for the further development and application of the policy measures."[5] Among these measures were "enhanced group-wide supervision," through which a "group-wide supervisor" would "have direct powers over holding companies" of the designated insurers, as well as the imposition of "higher loss absorbency requirements," including requirements that the firms hold increased capital.[6]

FSB's process for designating the nine insurers was opaque. The FSB said that it used the assessment methodology developed by the International Association of Insurance Supervisors ("IAIS"),[7] which purports to discern insurers "whose distress or disorderly failure, because of their size, complexity, and interconnectedness, would cause significant disruption to the global financial system and economic activity."[8] The IAIS methodology focuses on five characteristics of firms (including a firm's "size," "interconnectedness," and "non-insurance activities," for instance) and assigns a weight to each characteristic in making the assessment of

[4] FSB, "Global Systemically Important Insurers (G-SIIs) and the Policy Measures that Will Apply to Them" ("FSB's 2013 G-SIIs"), at 1 (July 18, 2013), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_130718.pdf?page_moved=1.

[5] *Id.* at 2.

[6] *Id.*

[7] *Id.* at 1.

[8] IAIS, "Global Systemically Important Insurers: Initial Assessment Methodology," at 3 (July 18, 2013), *available at* https://www.lloyds.com/~/media/files/the%20market/operating%20at%20lloyds/regulation/gpa/final_initial_assessment_methodology_18_july_2013.pdf.

systemic importance—size is five percent of the calculus, for instance, while non-insurance activities are forty-five percent.[9] The IAIS published this assessment methodology the same day that the FSB announced the nine designations that it said resulted from application of the methodology.

In designating these nine G-SII's in 2013—which it subsequently re-designated in November 2014[10]—FSB did not explain how the firms had performed under this assessment methodology, nor how specific activities of each firm were assessed when judging its "non-insurance activities," for example, or how "interconnected" it is. The designated firms were not notified in advance how they had performed on these matrices, they therefore had no opportunity to respond or correct errors, and FSB's G-SII designation was final—there is no court to contest the designation, or law to reverse it. And yet, as noted, in designating the companies the FSB also identified a list of policy measures, and a timetable, that it said "will apply" to the companies. FSB's reference to a "group-wide supervisor" exercising "direct power[ ]" over a G-SII's holding company presumably is a role that could be filled only by a regulator in the company's home country.

Three U.S. companies were among the nine G-SII's identified by the FSB in July 2013: American International Group, Inc. ("AIG"), Prudential Financial, Inc., and MetLife, Inc.[11]

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[9] *Id.* at 12-18.

[10] FSB, "2014 Update of List of Global Systemically Important Insurers (G-SIIs)," at 1 (November 6, 2014), *available at* http://www.financialstabilityboard.org/2014/11/fsb-announces-update-of-list-of-global-systemically-important-insurers-g-siis/.

[11] FSB's 2013 G-SIIs at 2. The list of nine G-SIIs also includes five European insurers and one Chinese company. *See* G-20 Financial Stability Board Names Nine Insurers Systemically Important, The Wall Street Journal (July 18, 2013), *available at* http://www.wsj.com/articles/SB10001424127887323993804578614244083814244 (last visited July 4, 2015).

Those same three companies have now all been designated as systemically important nonbank companies by the Financial Stability Oversight Council in the U.S.[12]

As the Committee is aware, the Dodd-Frank Act sets forth specific criteria for FSOC to consider in determining whether a company is systemically important to U.S. financial stability. There is overlap, but those criteria are not the same as the assessment methodology used by FSB. The Dodd-Frank Act also sets forth specific *processes* to be followed by FSOC in making its SIFI determinations. Under principles of U.S. constitutional law, those processes must apprise the companies under consideration of the legal standard being applied to them, and must give the companies a full and fair opportunity to present their case before decisionmakers who approach the matter without prejudgment and with an open mind.

Leaders of the Department of the Treasury, the Federal Reserve Board, and the Securities and Exchange Commission are members of the FSB Plenary—the decision-making body of the FSB,[13] which designated the three U.S. companies as globally-significant insurers—and of FSOC, which subsequently identified the same companies as systemically important to the U.S.

We have no record of the role that the U.S. FSB members played in the G-SII designation process. However, this dual participation—and the relationship between the FSB and FSOC—presents the potential for two concerns.

First, there is the risk that members participating in the FSB may prejudge questions that will come before them as members of FSOC—and will do so without the affected U.S. companies enjoying the procedural protections afforded by U.S. law. In designating the

[12] *See* FSOC, Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc. ("MetLife Designation") (Dec. 18, 2014); FSOC, Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc. ("Prudential Designation") (Sept. 19, 2013); FSOC, Basis for the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc. ("AIG Designation") (July 8, 2013).

[13] *Supra* n.2.

companies it did, the FSB evidently concluded that the companies' financial distress "would cause significant disruption to the global financial system and economic activity," which is the benchmark under the IAIS methodology that the FSB said it applied.[14] The FSOC designations conducted to date have been based on the conclusion that material financial distress at the subject company "could pose a threat to the financial stability of the United States."[15] The first of these assessments—risk to the global economy—would seem as a matter of logic to encompass the second: threat to the company's home economy. Accordingly, if a decisionmaker has concluded that a U.S. company's distress would be a threat to the global financial system, it is not clear how that decisionmaker would not see the company's distress as a threat to the financial system of the country where it has the majority of its operations.

Under principles of U.S. administrative law, it is essential that members of an agency not "adjudg[e] the facts . . . [or] law of a particular case in advance of hearing it,"[16] and that agencies maintain "a flexible and open-minded attitude" in administrative proceedings.[17] Accordingly, in one court case, an absence of due process was found where an agency decisionmaker had made a speech that indicated he already had reached a decision on a case that was pending before him.[18] Although the person who gave the speech was not the only agency decisionmaker involved in the proceedings, the court sent the case back to the agency because, it said, "Litigants are entitled to

[14] *Supra* n.8 at 3.

[15] Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. § 5323(a)(1).

[16] *Cinderella Career & Finishing Sch., Inc. v. FTC*, 425 F.2d 583, 591-92 (D.C. Cir. 1970).

[17] *Fed. Express Corp. v. Mineta*, 373 F.3d 112, 120 (D.C. Cir. 2004); *see also Castaneda-Castillo v. Gonzales*, 488 F.3d 17, 25 (1st Cir. 2007) (emphasizing importance of an agency's "open mind" and a "fresh look, unclouded by any prior judgment"); *Advocates for Highway and Auto Safety v. Fed. Highway Admin.*, 28 F.3d 1288, 1293 (D.C. Cir. 1994) (discussing need for agency to maintain an open mind in review of comments during rulemaking and holding that "[a] review of the comments submitted and the responses made persuades us that the agency approached the post-promulgation comments with the requisite open mind").

[18] *Cinderella Career*, 425 F.2d at 591-92.

an impartial tribunal whether it consists of one man or twenty and there is no way which we know of whereby the influence of one upon the others can be quantitatively measured."[19] That ruling is consistent with what the Supreme Court has described as a U.S. legal system that "has always endeavored to prevent even the probability of unfairness."[20]

Regulators will naturally bring to their jobs certain preconceptions on matters of policy. But concerns arise when, for example, there has been a prejudgment on a factual matter that will come before an official in his or her adjudicative capacity.

As I have noted, there is no record of the role that the Treasury Department, Federal Reserve, and Chair of the SEC played in the initial designation and subsequent redesignation of the G-SIIs by the FSB. And it is not my suggestion that they brought any bias or prejudgment to those proceedings. But to the extent that one or all joined in the FSB's designation of U.S. companies as G-SIIs, it becomes a legitimate subject of inquiry what effect, if any, that prior participation had in the FSOC proceedings.

Second, and regardless of the role any FSOC member plays in the FSB, there would be cause for concern if the designations by the FSB influenced the decisions of FSOC.

FSOC is governed by U.S. law. The FSB is not. As noted, the Dodd-Frank Act sets forth specific criteria for FSOC to apply. The FSB criteria, to the extent they can be discerned, are different. Perhaps most important, Dodd-Frank establishes *procedures* for FSOC to reach its decisions. Under our Constitution, an essential element of due process is that an affected person (or company) have an opportunity to be heard and make its case at an appropriate time before a

[19] *Id.* at 592; *see also Amos Treat & Co. v. SEC*, 306 F.2d 260, 264 (D.C. Cir. 1962) (observing that "with respect to agency adjudicatory proceedings, due process might be said to mean at least 'fair play'" and "it goes beyond that which is permissible from the standpoint of either litigants or the public" where "one member of the body which made exceedingly important findings of fact had already thrown his weight on the other side").

[20] *Withrow v. Larkin*, 421 U.S. 35, 47 (1975) (quoting *In re Murchison*, 349 U.S. 133, 136 (1955)).

decisionmaker who approaches the matter with an open mind. It would be of serious concern if the FSOC process were not, in fact, the proceeding in which designation decisions were genuinely being made, but instead were functioning as a means by which FSB decisions are implemented by U.S. regulators.

There has been a suggestion that is the case by one of the members of FSOC. Roy S. Woodall, Jr., who holds the seat on the FSOC reserved by statute for "an independent member . . . having insurance expertise,"[21] said in his dissent from FSOC's designation of Prudential that "the international and domestic processes" for SIFI designation "may not be entirely separate and distinct," and that "the declaration of Prudential as a G-SII by the FSB based on the assessment by the U.S. and global insurance regulators, supervisors, and others who are members of the IAIS, has overtaken the Council's own determination process."[22] Mr. Woodall also suggested that FSOC's replication of FSB's designations appeared to be something the FSB expected and needed to occur, since "the FSB pronouncements . . . [could] only be achieved in the U.S. through a subsequent Council designation."[23]

Mr. Woodall expressed similar concerns in dissenting from the MetLife designation late last year. That designation "should come as no surprise to anyone," he wrote, in light of "the chronology of certain circumstances that led to MetLife's designation," including the FSB's earlier identification of MetLife as a G-SII.[24] The only means by which FSB designations can be given force, Mr. Woodall explained, is by home country regulators such as FSOC adopting the

[21] 12 U.S.C. § 5321(b)(1)(J).

[22] Dissent of Roy S. Woodall, Jr., Independent Member with Insurance Expertise, to Prudential Designation ("Woodall Prudential Dissent"), at 9 (Sept. 18, 2013).

[23] *Id.*

[24] MetLife Designation at 301 (Dissent of Roy S. Woodall, Jr., Independent Member Having Insurance Expertise).

designations and "policy measures" adopted by FSB.[25] A "failure of the Council to designate MetLife," he wrote, "would thus appear to amount to a failure of the U.S. to meet international commitments already made within the G-20."[26]

These are serious concerns by someone who personally participated in FSOC's deliberations. We cannot know all that underlies Mr. Woodall's statements, but they are worth further exploration, such as it appears the Committee is undertaking. By way of analogy, if a judge who sat on a three-judge panel of a court of appeals wrote in dissent not merely that her colleagues were wrong, but that some of them had based their decision on considerations other than the applicable law, the facts in the record, and the explanation they gave in their majority opinion, we would regard that as a serious issue. As a technical legal matter, incidentally, an FSOC designation is an "adjudication" under U.S. administrative law because it is a judgment about a single, specific entity—and a judgment of potentially enormous consequence. Principles of judicial decisionmaking are therefore an appropriate point of reference.

Mr. Woodall's description of the relationship between FSB and FSOC finds some support in statements by the FSB itself. Earlier this year, FSB Chairman Mark Carney issued a memorandum to the G-20 regarding member nations' implementation of FSB policies.[27] He stated:

> Full, consistent and prompt implementation is essential to maintaining an open and resilient global financial system. The FSB will support the determined efforts of its members through enhanced monitoring of implementation and its effects across all jurisdictions. We will regularly report our key findings to the G20.[28]

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[25] *Id.* at 302.

[26] *Id.*

[27] Memorandum from Mark Carney to G20 Finance Ministers and Central Bank Governors, at 1 (Feb. 4, 2015), *available at* https://g20.org/wp-content/uploads/2015/04/Financial-Reforms-Finishing-the-Post-Crisis-Agenda-and-Moving-Forward-FSB-Chair-letter-to-G20-February-20151.pdf.

[28] *Id.*

In short, Mr. Carney is saying, FSB expects member nations to implement its "policy measures." It will "monitor" their efforts, and report on them to the G-20 principals. As stated on its website, FSB will use "moral suasion and peer pressure" to achieve its policies at the national level of its members.[29] And after all, what expectation does FSB have *other than that* its members will proceed to use the tools available to them to implement the "policy measures" that FSB adopts? Its Charter itself avows that FSB "will . . . promote member jurisdictions' implementation of agreed commitments," and that members' "commitments," in turn, include "implement[ing] international financial standards."[30] A Standing Committee of the FSB exists to "ensure comprehensive and rigorous monitoring" of its members' "agreed G20 and FSB commitments."[31]

There are others better positioned than I to fully explore the influence of the FSB's designations on FSOC's decisions. I do believe, however, that the explanations FSOC has given for its actions in its designation decisions are unpersuasive on their own terms. They reflect significant lapses of logic and evidence, which raise the question whether those explanations are a full account of what drove FSOC's decisions, or whether instead the FSB's earlier designations were a silent force behind FSOC's decisionmaking. I will give two examples.

The first involves FSOC's reliance on company-specific designations to address systemic risk believed to be posed by insurers, but to lean toward a so-called activities-based approach in the case of asset managers. The activities-based approach addresses systemic risk on an activity-

[29] *About the FSB*, Financial Stability Board, http://www.financialstabilityboard.org/about/ (last visited July 4, 2015).

[30] Charter of the Financial Stability Board, at 2, 4 (June 2012), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_090925d.pdf?page_moved=1 (last visited July 6, 2015).

[31] *Id.* at 7.

by-activity, rather than by designating specific companies. FSOC currently is considering such an approach toward the systemic risk that has been said to be posed by mutual funds and other large asset managers.[32]

Insurance companies—including Prudential and MetLife—have asked that FSOC consider an activities-based approach toward the insurance industry also.[33] FSOC has declined to do so. It gave an explanation for this position in its decision designating MetLife that was essentially circular. When making a company-specific designation decision under Dodd-Frank Section 113, FSOC said, it is required "to take into account a specific set of considerations in making a determination" of the company's systemic importance, and "[c]onducting or considering an industry-wide, activities-based analysis is not one of the statutory considerations."[34] It added that "an industry-wide evaluation of activities is not necessary or appropriate in the case of MetLife," because the "company-specific analysis" it had conducted "supports a determination" that MetLife should be designated on a company-specific basis.[35]

In other words, FSOC's rationale was that it would not consider an activities-based approach for MetLife because it had not considered an activities-based approach. That is a

[32] Press Release, Department of the Treasury, Financial Stability Oversight Council Meeting July 31, 2014, *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031%202014.pdf (last visited July 4, 2015); *see also* John Heltman, *Fed's Tarullo Favors Activities-Based Regulation for Asset Managers*, Am. Banker (June 5, 2015).

[33] *See* Statement of the American Council of Life Insurers and the American Insurance Association Before the Subcommittee on Securities, Insurance & Investment of the Senate Committee on Banking, Housing & Urban Affairs on Examining Insurance Capital Rules and FSOC Process, Robert M. Falzon, Executive Vice President & Chief Financial Officer of Prudential Financial, at 12-14 (Apr. 30, 2015), *available at* http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=24a507d6-8f78-4072-a8e3-b296c3a03bb6. *And see* Capital Markets Summit, U.S. Chamber of Commerce, Steven A. Kandarian, "Life Insurers as SIFIs: A Case of Mistaken Identity?," at 6-7 (Apr. 10, 2013), *available at* https://www.metlife.com/assets/cao/pr/Capital-Markets-Summit-Remarks-FINAL.pdf.

[34] MetLife Designation at 31.

[35] *Id.*

strange and wholly unpersuasive explanation for a regulatory decision of immense consequence to MetLife and the other insurers that were designated.

A second area where FSOC's designation decisions have fallen short concerns FSOC's decision not to consider companies' vulnerability to material financial distress when making designation decisions. In this instance, there is evidence that FSOC may indeed have been influenced by views of the FSB that have no place under Dodd-Frank.

The Dodd-Frank Act enumerates ten specific statutory factors for FSOC to consider when making designation decisions.[36] Three of these plainly relate to a company's vulnerability to material financial distress: the extent of the company's leverage, the extent to which the company is already regulated, and the amount and types of liabilities of the company.[37] FSOC previously acknowledged the importance of considering a company's vulnerability when making designation decisions under Dodd-Frank. In the Final Rule and Interpretative Guidance it adopted to guide the SIFI designation process, it stated that fully half of the six "categories" of considerations it identified in the statute concern "the vulnerability of a nonbank financial company to financial distress."[38] It said it would make this part of its analysis when making designation decisions.[39]

Yet it has not done so. In none of the four decisions designating "non-bank SIFIs" to date has FSOC addressed the company's vulnerability to the conditions of material financial distress that animated its designation. And in the MetLife designation decision—which is the

[36] 12 U.S.C. § 5323(a)(2).

[37] *Id.* § 5323(a)(2)(A), (a)(2)(H)–(J).

[38] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21, 637, 21,641 (Apr. 11, 2012).

[39] *Id.* at 21,641, 21,657-58.

only complete decision that is publicly available[40]—FSOC contended that considering a company's vulnerability would set an "unduly high and falsely precise threshold" for making designation decisions.[41] FSOC has therefore based its designation decisions on assumptions of entirely imaginary and exceptionally severe financial distress at the company in issue.

As noted, this approach conflicts with Dodd-Frank and FSOC's own 2011 Final Rule and Interpretative Guidance. But it does appear to reflect the FSB's view. In setting forth its methodology for identifying global SIFIs, FSB has proposed to "measure the impact that a[non-bank, non-insurance] financial entity's failure can have on the global financial system and wider economy, *rather than the probability that a failure could occur*."[42] This is poor regulatory policy and conflicts with the Dodd-Frank Act, but it has been FSOC's approach also.

I would like to conclude with two observations.

First, the Financial Regulatory Improvement Act of 2015 that has been introduced by the Chairman would make valuable improvements with regard to the FSOC and international bodies such as FSB.[43] Section 403 of the Act—titled "International Insurance Capital Standards Accountability"—would, as its title suggests, give some of the visibility into FSB-type processes that has been lacking, including information on the positions taken by U.S. regulators on policies they may be called upon to address at home. In addition, by requiring consultation with U.S.

[40] For each designation, FSOC has released a "public" summary, in addition to the lengthier decisional document provided to the company under consideration. The MetLife Designation was disclosed in the pending litigation.

[41] MetLife Designation at 27-28.

[42] Financial Stability Board, "Consultative Document (2nd) Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions," at 10 (Mar. 4, 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf (emphasis added).

[43] Financial Regulatory Improvement Act of 2015, S. 1484, 114th Cong. (2015).

insurance regulators, the bill would inform and presumably enhance the contributions that U.S. participants make in forums of that nature.

Section 302 of the Act—regarding the "nonbank determination process"—addresses one of the most vexing aspects of the current FSOC regime: Companies' uncertainty about what they must do to avoid being systemic and subject to supervision by the Federal Reserve Board. A basic element of constitutional due process is that the government provide notice of what the law is, both to constrain its own discretion and power, and to enable members of the public to conduct themselves so as to avoid adverse consequences under the law.[44] Currently in the case of non-bank SIFI designation, though, there is no practical way for a large financial institution to know what it could do to avoid designation or, once designated, how it could shed the SIFI label and the increased regulation and oversight that come with it. The Chairman's bill would make important headway by enabling a company to submit a plan to FSOC with proposed changes to the company's structure and operations, to persuade FSOC that with those changes, the company would not be systemically important. If FSOC found the plan insufficient and believed the company would be systemic even with those changes, it would be required under the bill to explain why and what actions the company *could* take to avoid regulation as a SIFI.[45]

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[44] *See, e.g.*, *Grayned v. City of Rockford*, 408 U.S. 104, 108 (1972) ("if arbitrary and discriminatory enforcement is to be prevented, laws must provide explicit standards for those who apply them," and must give a "person of ordinary intelligence a reasonable opportunity to know" what the law is, so that "he may act accordingly"); *Am. Iron & Steel Inst. v. EPA*, 115 F.3d 979, 994 (D.C. Cir. 1997) (per curiam) ("A standard with which compliance cannot be assessed . . . is no standard at all for purposes of due process."); *Satellite Broad. Co. v. FCC*, 824 F.2d 1, 2-4 (D.C. Cir. 1987) (vacating a decision by the Federal Communications Commission to dismiss as untimely applications to operate radio stations because the agency's rules addressed the filing of applications "in a baffling and inconsistent fashion" and did not provide "adequate notice of the substance of the rule" to the regulated parties).

[45] Financial Regulatory Improvement Act of 2015 § 302(d), (e).

These legislative changes would give more guidance to companies, would shed light on FSOC's reasoning and constrain its actions, and would chart a course for reducing the number of companies that, in FSOC's judgment, threaten U.S. financial stability. All of this is for the good.

Second, and in closing, I have tried to be clear today in acknowledging the important role to be played by an international forum such as FSB. In a global economy, there are clear benefits from regulators sharing information and know-how and coordinating their actions. There are, however, two circumstances I've touched upon today where particular caution is appropriate in such international forums. One is when the rights and obligations of specific, identifiable U.S. companies are at stake. Under our legal system, U.S. companies have a right to notice and an opportunity to be heard before a government official makes a decision specific to the company that could have a significant adverse effect. So, as U.S. officials participate in forums such as the FSB, it is one thing to discuss general principles of regulatory policy, and quite another to frame resolutions naming specific companies as targets for heightened regulation. In the latter circumstance, alarm bells should sound that cause our representatives to take account of U.S. legal and procedural requirements.

U.S. officials participating in a forum such as the FSB must also, of course, be mindful of the letter and intent of U.S. law. Congress and the States make the laws that govern companies within our borders. It follows that when there is a law on the books governing a subject, that should be the basis for our positions in international policy discussions, lest regulators find themselves in the position of retrofitting a commitment made abroad into a U.S. legal framework that calls for something different.[46]

[46] Presumably this is one of the reasons for Section 403 of the Chairman's Financial Regulatory Improvement Act, which requires disclosure and deliberation in the U.S. regarding any proposed international standards about the capital held by insurance companies. *Id.* § 403(c).

* * *

Thank you for the opportunity to testify today. I would be happy to answer any questions of the Members of the Committee.

PREPARED STATEMENT OF ADAM S. POSEN

PRESIDENT, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS[1]

JULY 8, 2015

1. The rationale for international financial regulatory coordination at this time—Generally, the U.S. Government has the lead in international economic negotiations—as the largest and most developed economy, as the incumbent creator of the rules and institutions started after World War II, often as having the most technical expertise on a given subject, and usually as having the model of a property-rights respecting rule of law in its commercial affairs that other economies wish to emulate or import. But even where the U.S. Government is not entirely dominant in international policy agenda setting, there is room for the U.S. economy and citizens to benefit from international coordination. The rest of the world economy exists, whether or not the U.S. Government chooses to engage with other governments in discussion of the rules by which it is partially governed. Economic activities abroad can have significant negative spillovers on U.S. well-being, as well as present opportunities for (mutual) gain to be unlocked. Mostly, though not always, international economic coordination ends up raising standards abroad while constraining harmful behaviors in the United States that we would wish to limit anyway—and in fact, our own Government's legislated intent is often more effectively applied by making it harder for U.S. entities to skirt domestic regulations by moving abroad.

The benefits to the U.S. economy and public from international financial regulatory cooperation are particularly high for a simple reason: unnecessary financial volatility and misbehavior abroad is transmitted to the U.S. economy directly, rapidly, and strongly. As other economies inevitably grow in size and financial depth relative to the U.S. economy, the impacts of their problems on the United States grow. We can see this in the comparison between the real but limited impact of the Latin and Asian financial crises of the 1990s on the United States and the far greater harms felt from the European crisis of recent years and the swings in capital flows and commodity prices driven by Chinese financial instability. This can do us great harm, despite the size, depth, diversity, and general robustness of U.S. financial markets and lending activities making us less vulnerable than other economies to any given shock.

We cannot simply live with the misbehaviors and even unintended weaknesses of other economies' financial systems. We need changes in those other countries to defend ourselves, as well as to help them. Furthermore, the usual concern in international economic governance about a race to the bottom of low standards winning out takes on a particular form in the financial sector: cross-border regulatory arbitrage. Given the mobility of capital and the availability of information technology and connectivity, jurisdictions where regulations are much weaker can become places where activities prohibited in the United States and elsewhere thrive. These activities can produce globally dangerous buildups of financial risk very quickly and easily. While international regulatory coordination cannot rule these out completely, it can make it both much more difficult for such legal loopholes to arise, to be defended, to grow in size and riskiness, and to hide from at least supervisory awareness.

International regulatory coordination, in the manner in which it is currently led by U.S. Government and Federal Reserve representatives, is reducing these risks to U.S. economic and financial stability. Please note that I said reducing, not removing, these risks—please note, also though, that I said reducing not raising. This reduction of foreign financial risks to the United States (including from U.S. entities moving dangerous activities abroad to elude supervision) is happening along four channels at present:

- *Raising minimum standards for the soundness of major banks and banking systems,* including by setting minimums for bank capital, improving risk assessment (*e.g.,* stress testing), creating liquidity/leverage limits, identifying systemically important institutions, making cross-border resolution more feasible, and so on.

[1] I am grateful to the Alfred P. Sloan Foundation for its support of my research on global financial stability, and to my colleagues Morris Goldstein, Simon Johnson, Avinash Persaud, Edwin Truman, and Nicolas Veron for their suggestions for this specific submission of testimony. I remain solely responsible for the views and any errors in this statement, and thus it does not necessarily represent the views of the Peterson Institute, the Sloan Foundation, or any member of their staff or boards. Disclosure of the Institute's funders and transparency policy are available at *http://www.piie.com/content/?ID=138.*

- *Increasing cross-border transparency of financial systems' organization, institutions, financial flows, and buildups of risk.*
- Reducing the possibilities of regulatory arbitrage across major financial centers, both in terms of getting agreement on activities to be restricted and monitored, and of providing a means for 'naming and shaming' noncompliant regimes.
- *Promoting largely U.S.-based versions of best practice for regulators, supervisors, bankers, and nonbank financial institutions in other countries.*

I would be remiss in my duty to this Committee, however, if I did not point out that other countries can legitimately expect better U.S. behavior and practice to emerge from international regulatory coordination as well. Our regulators, supervisors, banks, and other financial institutions did not cover themselves in glory with their practices in the run-up to the financial crisis of 2008–10. At a minimum, having the U.S. financial regulators and supervisors be confronted with international questions and standards should reduce the cognitive capture of that community by a set of blinders, as I have argued played a critical role in causing the U.S. financial crisis.

There are other views which will claim that the current international financial regulatory process is either eroding desirable U.S. regulations by having other countries force compromise on the United States through the process, or is imposing unnecessary additional regulations upon the United States to erode our competitive advantages, or both. I readily acknowledge that there are a few instances of this sort—I believe that the attempt by European Union [EU] regulators to impose Solvency II, their set of insurance requirements, on insurers in the United States and elsewhere is a particularly costly example, as I will explain—but I view that as indeed *instances* of bad regulation, not the overall international process being inherently harmful. Any regulatory process, domestic or foreign, will have debates and make some mistakes. Arguably, the domestic Financial Stability Oversight Council [FSOC] within the United States is if anything primed to be more biased toward lowest common denominator or group think leaving gaps in the U.S. financial regulatory framework than the international Financial Stability Board [FSB]. So, the FSB is a useful check and occasional corrective to the U.S. FSOC process.

Whether it is discussions of Trade Promotion Authority (which I commend the Senate for recently passing), of responses to climate change, of efforts to balance healthy global tax competition with the prevention of tax avoidance by multinational corporations and wealthy individuals, or of the need to prevent cross-border regulatory arbitrage by financial institutions, the U.S. Government has to confront the fact that behaviors and policies abroad affect us here at home. There is sometimes a paranoid tendency by some American politicians and pundits to assume that all international economic deals are about putting one over on the United States, eroding our high standards through subversion of domestic regulation, or eroding our market-based competitiveness by imposing undue additional regulation. This is a profound misunderstanding on both the right and the left of our public debate. The United States advances the economic welfare of its people through constructive international engagement, usually gets its way in such efforts and extends the rules it wants to others, and sometimes even benefits from having constraints imposed from outside pressure that domestic special interests would be able to prevent absent that. Yes, sometimes other governments do pursue narrow interests of their national champions, whether State-owned or simply influential private businesses, through these processes. But American economic negotiators are grown-ups, they can handle it, just as they would when having business negotiations in the private sector. The fact that somebody tries something self-interested does not mean you cannot work with them, you simply call them on that attempt.

2. The demonstrated utility of the Financial Stability Board—Turning from the general issue of international coordination on financial regulation to the current process for pursuing it, what about the FSB? Does it serve U.S. and global interests as currently constituted and operating? I believe that it clearly does, though with some inherent limitations, as well as some areas for improvement that can be fixed. I resolutely dispute any claims that the FSB is run amok, is undermining U.S. domestic financial regulation, or is trying to, let alone succeeding in, forcing our diverse and unique private-sector financial system to converge on others' models. This is not because I am part of some technocratic self-appointed elite, or more crassly simply buddies with the people involved in the FSB process—I have been rather critical on the record of some of the FSB's decisions for lack of ambition and for too much clubbiness in its agenda setting.[2] But I do believe that the FSB as an organization for international coordination is a reasonably good institutional response to the need for effective, legitimate, and well-motivated global financial regulation.[3] Among the positive attributes of the FSB are:

- Its national membership covers all of the world's major financial centers but is still limited enough in number to be able to make decisions.
- It usefully cuts across national and regulatory turf barriers in a way that is needed to confront regulatory arbitrage and address globally connected financial networks.
- It is coordinated with the G20 economic leaders' meetings and processes, which means major agenda items from the FSB get on to the G20 agenda for buy-in.[4]
  - This also creates scrutiny and oversight for the G20 decisions, and a structure for issuing public progress reports for assessment.
- By including central bankers and financial officials, as well as bank supervisors narrowly defined, it avoids some of the narrow thinking and silo mentality that caused cognitive capture in the earlier Basel banking processes and in U.S. supervisory decisions pre-crisis.
- It is a soft-law organization, meaning that agreements it reaches are only binding on member governments to the degree that not complying involves naming and shaming
  - When a regulation issued becomes recognized as worthy, popular and market pressure to adopt a good standard are the main source of compliance, with the FSB simply providing public benchmarks and monitoring.
  - This to me is a virtue in a world of sovereign nation states and the need to change regulations over time.
- It has grown out of leadership efforts by both Democratic and Republican administrations, including the creation of its direct predecessor the Financial Stability Forum, and as such is at its core a U.S.-instigated nonpartisan institution.

The proof is in the pudding, even though it has had little time to cook. The FSB process has produced some useful achievements that are being applied globally as a result of these structural attributes. Banking transparency, standards, and particularly capital requirements have been raised in the major financial institutions of a wide range of countries, including in some critical emerging markets and some financial centers outside of the United States and European Union. Agreement on a set of G–SIFIs, globally systemically important financial institutions, and on capital surcharges for them as partial insurance for the public, has been mutual including all FSB member countries, and done on largely sound replicable criteria. Progress has been made on procedures and compelling conditional funding for safer expedited resolution of such important institutions when they run into trouble.[5]

Having widespread divergence on what different governments believe is adequate bank capital or what banks are systemically important would be a recipe for precisely the kind of race to the bottom that would imperil U.S. financial stability—every country would get looser regulations for its preferred client banks, and some would compete to be the place the world's banks could engage in activities that should not be allowed. This will become increasingly important with large Chinese financial institutions, as we are seeing in today's news. Given China's membership in the FSB and G20, we have a means to bring those potential dangers into the regulatory system beyond Chinese government bailouts and own soft-touch regulation (following the United States and United Kingdom mistakes of the 2000s, sadly).

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[2] See, among others, Adam S. Posen, "Confronting the Reality of Structurally Unprofitable Safe Banking," in *Too Big to Fail III: Structural Reform Proposals: Should We Break Up the Banks?,* Andreas Dombret and Patrick Kenadjian, eds., Boston/Munich: De Gruyter, 2015. *http://tinyurl.com/oxc7wk2.*

[3] For an earlier assessment of the FSB, many of whose recommendations have largely since been adopted, see Edwin M. Truman and Gary Schinasi, "Reform of the Global Financial Architecture," *PIIE Working Paper* 10–14, October 2010, *http://www.piie.com/publications/interstitial.cfm?ResearchID=1674.*

[4] I am grateful to Morris Goldstein for this insight regarding the G20 link.

[5] Which matters if you believe that resolution threats are credible to large/important institutions, and that inability to resolve Lehman Brothers and others was a cause of the financial crisis. I have my doubts this is going to help much in preventing the next crisis. For this hearing, however, the point is that the majority of U.S. officials do believe this is important, and the FSB has delivered in response to their belief some global adoption of measures desired in this regard.

3. Where and why bad regulation is emerging from the FSB process regarding nonbanks—As I mentioned earlier, the FSB can be a good process, producing some good international standards as a result, thus serving U.S. economic interests, and *still* get some things wrong. This is inevitable, as getting things right is difficult, both because there are governments pushing compromises and proposals for the wrong reasons on any given issue, and because some issues are more difficult to tackle than others. Where the FSB at present is getting things wrong, in my opinion, largely has to do with its approaches to coordinating regulation of the nonbank parts of the financial system. Regulating nonbanks is more difficult because some well-organized interest groups that were less weakened or tainted by the financial crisis have some sway, because intellectually the manner and extent of nonbank regulation is less obvious and certainly less well precedented, and because the kinds of national regulators and supervisors involved are much more diverse. I also believe that the FSB has demonstrated a tendency to treat nonbanks as banks because it is something its technocratic members are more familiar with, it allows claims of neutrality across the financial sector, it utilizes off-the-shelf remedies, and it speeds the conclusion of the post-crisis agenda. In other words, treating banks and nonbanks largely the same is the easy way out.

Diversity in financial systems is, however, a virtue. As I have argued for some time, a major reason that the United States and Germany recovered from the financial crisis more rapidly and strongly than other advanced economies was that they had more diversified financial systems, and thus were more robust in continuing to provide financing to nonfinancial business and households.[6] This financial diversity so helpful to the United States comes along at least two dimensions: first, that we have a relatively unconcentrated banking system, despite the existence of megabanks, which includes community banks and various regional lenders; second, that we have a variety of nonbank means of providing finance for investment, including corporate and junk bonds and commercial paper, venture capital and private equity, pension funds and insurance firms, as well as newly emerging forms of direct lending. This makes the U.S. economy far more resilient to financial shocks, even the worst ones we have seen. We do not want any global regulatory process to interfere with this diversity in U.S. finance.

That is not the same, though, as saying any international regulation of nonbanks is a bad thing. If one remembers all the different kinds of financial firms engaged in bad lending and investment decisions, fraudulent behavior, speculation with other people's money, and reliance on implicit government bailout guarantees, during the 2000s in the United States, there is a *prima facie* case which I support for more entities coming under regulation than fewer. What the FSB needs to do, and the U.S. representatives there need to encourage, is serious discussion of *which* parts of the nonbank financial sector need further regulation, and which do not, and *what form* that regulation should take. Simply amping up capital requirements, for holding "safe assets," and calling everything a "shadow bank" that provides funding and is not a bank, misses the point and potentially does harm.

Right now, the biggest mistake the FSB is making in this regard is in the attempt to extend Solvency II, the European Commission's regulation for insurance firms, to global application. This is a bad idea for European insurers on its own lack of merits—as argued by my colleague Avinash Persaud, long-term investors like life insurers with clear payout obligations need a very different approach to their portfolios than do asset managers or banks, and what constitutes safe investment for them is different than for banks.[7] Insurers certainly need regulation and supervision, including clear capitalization to meet their policyholders' expected payouts. But almost every jurisdiction, and certainly the U.S. states, already provides such pure protective supervision. Solvency II tries to add on capital holding requirements of Government bonds and short-term assets akin to what is (rightly) required for banks. This is not only ill-suited for insurers, it is likely to result in a short-fall of private funds for long-term investment like infrastructure in the jurisdictions that adopt this set of requirements—where those investment funds for the long-term are desperately needed.

This bad outcome from the FSB illustrates what happens when the United States goes into international processes with its own house not in order. We have 54 State and other local insurance commissioners, and despite the addition of a Federal over-

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[6] See Adam S. Posen, "Why is Their Recovery Better than Ours?," speech at the National Institute for Economic and Social Research, London, 27 March 2012, available at *http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech560.pdf*.

[7] Avinash D. Persaud, How Not to Regulate Insurance Markets: The Risks and Dangers of Solvency II, *PIIE Policy Brief* 15–5, April 2015, *http://www.piie.com/publications/interstitial.cfm?ResearchID=2777*.

sight, no real one representative to strongly present in the FSB. Meanwhile, the European Union has a coherent Commission point of view on this, which has huge bureaucratic momentum after years of preparation centrally. The insurers in Europe for the most part rightly hate it, but since it seems inevitable to be imposed on them, they have given up fighting Solvency II, and instead back using the FSB to impose it on the United States, Japanese, and other competing insurers. They figure if they will be limited, they want to be sure their global competitors are as well. The United States needs to stand up against this in the FSB. This is the exception that proves the general rule that the FSB process serves U.S. interests, but it reflects an instance of bad regulation, not an overall assault on U.S. financial diversity. And it should be responded to as such within the FSB process.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

PREPARED STATEMENT OF MICHAEL S. BARR

THE ROY F. AND JEAN HUMPHREY PROFFITT PROFESSOR OF LAW
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JULY 8, 2015

In 2008, the United States plunged into a severe financial crisis that shuttered American businesses, and cost millions of households their jobs, their homes and their livelihoods. The crisis was rooted in years of unconstrained excesses and prolonged complacency in major financial capitals around the globe. The crisis demanded a strong regulatory response in the United States and globally as well as fundamental changes in financial institution management and oversight worldwide. The United States has led these reforms, both domestically and internationally.

In the United States, the Dodd-Frank Act created the authority to regulate Wall Street firms that pose a threat to financial stability, without regard to their corporate form, and to bring shadow banking into the daylight; to wind down major firms in the event of a crisis, without feeding a panic or putting taxpayers on the hook; to attack regulatory arbitrage, restrict risky activities through the Volcker Rule and other measures, regulate repo and other short-term funding markets, and beef up banking supervision and increase capital; to require central clearing and exchange trading of standardized derivatives, and capital, margin and transparency throughout the derivatives market; to regulate payments, settlement, clearance and other systemic activities; to improve investor protections; and to establish a new Consumer Financial Protection Bureau to look out for the interests of American households.

The Act established the Financial Stability Oversight Council with authority to designate systemically important firms and financial market utilities for heightened prudential oversight by the Federal Reserve; to recommend that member agencies put in place higher prudential standards when warranted; and to look out for and respond to risks across the financial system. The Council is aided in these tasks by its own staff, the staff of member agencies, and the independent Office of Financial Research, which has a duty to standardize and collect data and to examine risks across the financial system.

One of the major problems in the lead up to the financial crisis was that there was not a single, uniform system of supervision and capital rules for major financial institutions. The Federal financial regulatory system that existed prior to the Dodd-Frank Act developed in the context of the banking system of the 1930s. Major financial firms were regulated according to their formal labels—as banks, thrifts, investment banks, insurance companies, and the like—rather than according to what they actually did. An entity that called itself a "bank," for example, faced tougher regulation, more stringent capital requirements, and more robust supervision than one that called itself an "investment bank." Risk migrated to the less well-regulated parts of the system, and leverage grew to dangerous levels.

The designation of systemically important nonbank financial institutions is a cornerstone of the Dodd-Frank Act. A key goal of reform was to create a system of supervision that ensured that if an institution posed a risk to the financial system, it would be regulated, supervised, and have capital requirements that reflected its risk, regardless of its corporate form. To do this, the Dodd-Frank Act established a process through which the largest, riskiest, and most interconnected financial firms could be designated as systemically important financial institutions and then supervised regulated by the Federal Reserve. The Council has developed detailed interpretive guidance and a hearing process that goes beyond the procedural requirements of the Act, including extensive engagement with the affected firms, to implement the designation process outlined in Dodd-Frank. The approach provides for a sound deliberative process; protection of confidential and proprietary information; and meaningful and timely participation by affected firms. The Council has already designated a number of firms under this authority.

Critics of designation contend that it fosters "too big to fail," but the opposite is true. Regulating systemically important firms reduces the risk that failure of such a firm could destabilize the financial system and harm the real economy. It provides for robust supervision and capital requirements, to reduce the risks of failure, and it provides for a mechanism to wind down such a firm in the event of crisis, without exposing taxpayers or the real economy to the risks of their failure. The FDIC is developing a "single point of entry" model for resolution that would allow it to wind down a complex financial conglomerate through its holding company with "resolution-ready" debt and equity, while permitting solvent subsidiaries to continue to operate. Similar approaches are being developed globally.

Other critics argue that the FSOC should be more beholden to the regulatory agencies that are its members, but again, the opposite is true: Congress wisely provided for its voting members, all of whom are confirmed by the Senate, to participate based on their individual assessments of risks in the financial system, not based on the position of their individual agencies, however comprised.

Members must also individually attest to their assessments in the FSOC's annual reports. The FSOC, moreover, has the duty to call on member agencies to raise their prudential standards when appropriate, and member agencies must respond publicly and report to Congress if they fail to act. If anything, the FSOC's powers should be strengthened, so that fragmentation in the financial regulatory system does not expose the United States to enormous risk, as it did in the past.

Some critics contend that certain types of firms in certain industries or over certain sizes should be categorically walled off from heightened prudential supervision, but such steps will expose the United States to the very risks we faced in the lead up to the last devastating crisis. The failure of firms of diverse types and diverse sizes at many points in even very recent memory—from Lehman and AIG to Long-Term Capital Management—suggest that blindspots in the system should at the very least not be intentionally chosen in advance by the Congress. The way to deal with the diversity of sizes and types of institutions that might be subject to supervision by the Federal Reserve is to develop regulation, oversight and capital requirements that are graduated and tailored to the types of risks that such firms might pose to the financial system, as the agencies have been doing. FSOC and member agencies also have other regulatory tools available with respect to risks in the system for firms not designated for Fed supervision, including increased data collection and transparency, collateral and margin rules for transactions, operational and client safeguards, risk management standards, capital requirements, or other measures.

Some critics complain that the FSOC's work is too tied to global reforms by bodies such as the Financial Stability Board (FSB). But global coordination is essential to making the financial system safe for the United States, as well as the global economy. The United States has led the way on global reforms, including robust capital rules, regulation of derivatives, and effective resolution authorities. These global efforts, including designations by the FSB, are not binding on the United States. Rather, the FSOC, and U.S. regulators, make independent regulatory judgments about domestic implementation based on U.S. law. And U.S. regulators follow the normal notice and comment process when developing financial regulations. The FSB itself has become more transparent over time, adopting notice and comment procedures, for example, but it could do more to put in the place the kind of protections that the FSOC has established domestically.[1]

As with designation, global coordination—and independent regulatory judgment—is essential to capital rules. Strong capital rules are one key to a safer system. There's already double the amount of capital in the major U.S. firms than there was in the lead up to the financial crisis. Globally, regulators are developing more stringent risk-based standards and leverage caps for all financial institutions, and tougher rules for the biggest players. In the United States, regulators have proposed even stronger leverage and capital requirements for the largest U.S. firms, and other countries are putting in place stricter approaches when warranted by their local circumstances.

In my judgment, the local variation based on a strong minimum standard is healthy for the system, taking into account the different relative size of financial sectors and differing local economic circumstances. There's been progress on the quality of capital—focusing on common equity—and on better and more comparable measures of the riskiness of assets, but more could be done to improve transparency of capital requirements across different countries and to make them stronger buffers against both asset implosions and liquidity runs. We need to continue to insist that European capital standards and derivatives regulations are strong—and enforced even-handedly across the board.

The United States has taken a strong lead in pursuing global reforms, galvanizing the G–20, pushing for the creation of the global Financial Stability Board, and pursuing strong global reforms on capital, derivatives, resolution, and other matters.

The G–20 has been driving financial reforms at a global level; the Financial Stability Board pursues agreement among regulators; and technical teams at the Basel Committee on Banking Supervision, the International Organization of Securities

[1] *See* Michael S. Barr, *Who's in Charge of Global Finance?,* Georgetown Journal of International Affairs.

Commission, and the International Association of Insurance Supervisors hash out industry-relevant reforms. While the process of reaching global agreement has at times been quite messy, divisive, and incomplete, the last thing we need is to hamstring global cooperation or U.S. regulation. These mechanisms should be strengthened and improved, not ignored or weakened.

Strong U.S. financial rules are good for the U.S. economy, American households and businesses, and we also need a stronger, harder push to reach global agreement on core reforms. In fact, such an approach is essential in order to reduce the chances of another devastating global financial crisis that crushes the U.S. economy.

The task of financial reform is not over. We need to keep pushing forward if we are to have a financial system that is safer, fairer, and better serves our economy.

PREPARED STATEMENT OF CHRIS BRUMMER, J.D., Ph.D. *

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JULY 8, 2015

What's in it for the United States?: On the Constitutionality and Legitimacy of the FSB (and International Financial Regulation)

The fact that legislators discuss and grapple with FSB policies is in itself a testament to just how far "soft law"—nonbinding, international accords between regulators—has come. When discussing policies, international policymakers routinely reference FSB principles and best practices, and even domestically, in the United States, administrative agencies from the Federal Reserve to the Securities and Exchange Commission grapple with and publicly acknowledge notions of international regulatory "commitments" and "obligations."

That U.S. agencies take the FSB and other international standard setters seriously does not, however, a constitutional crisis make. By definition, international soft law standards do *not* create any formal obligations. They are not treaties under the Vienna Convention on the Law of Treaties or under Article II of the U.S. Constitution. Instead, **both** the FSB's *original* charter *and* its revision (as well as virtually all other international standards) explicitly state: "This Charter is not intended to create any legal rights or obligations."[1]

As informal organizations, the FSB, Basel Committee, IOSCO and other regulatory bodies instead rely on their members to participate in discussions, and after participating, to voluntarily implement those standards at home by crafting them to their local conditions. In the United States, this implementation is done in accordance with the Administrative Procedure Act and other internal agency policies, as well as in keeping with the mission and mandate of the specific regulator involved. A bilateral or multilateral memorandum of understanding on enforcement coordination, for example, is justified and operationalized on the basis of the SEC's core mission of investor protection (which necessarily requires cross-border cooperation in today's globalized financial markets); similarly, articulations on interest rate benchmarks speak to concerns regarding capital allocation in global markets (and again require cross-border cooperation). Even the more recent but controversial rule on asset managers speaks to core concerns among regulatory agencies on the impact of shadow banking on financial and price stability, and capital allocation.

Furthermore, as a tool for achieving the mission of regulatory agencies, international standard setting bodies like the FSB enjoy both functionality and usefulness—and even as informal instruments can exhibit considerable "compliance pull." Markets, for one, often take direction from best practices in an assumption that they provide an indication or roadmap of future regulatory rulemaking. Meanwhile, regulators recognize that in order to influence other countries, they can't lead from behind. Instead, they have to lead by example.

Fortunately for the United States, its ability to impact global standard setting bodies is in many ways unmatched:

- The United States was a founding member of every major international regulatory forum—distinguishing it from China, Russia, Brazil India and even

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[1] *See* Article 16, FSB Charter, *http://www.financialstabilityboard.org/wp-content/uploads/r__090925d.pdf?page__moved=1; see also* Article 23, *http://www.financialstabilityboard.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf* (amended).

Germany and (depending on how one dates the founding of IOSCO) the United Kingdom;

- In most agencies, consensus expectations for decisionmaking give the United States a *de facto* veto authority on most international initiatives;
- The United States hosts the world's largest and most liquid capital markets giving it unparalleled capabilities to impact a number of fields including securities, accounting and auditing;
- Emerging markets have been noticeably subdued on Basel Committee and even FSB, leaving comparatively like-minded countries of the G10 (under U.S. leadership) to dominate discussions on core banking and financial stability matters;
- Although Europe technically has more countries sitting on some bodies (since individual member states can participate), they are often constrained by a necessity to act in unison and EU-level policymaking capabilities are in many sectors still in early stages; and
- The United States boasts the largest (though not best-paid) workforce and thus has a home regulatory "back office" allowing the United States to process and present data and reforms with unparalleled sophistication.

With all this in mind, however, let me be clear: the FSB (and indeed global standard-setting more generally) is no panacea. A number of issues can and do confound the process. In part because of their informality, mandates and missions of international standard setting bodies can (and at times do) overlap. This causes intermittent turf wars (most notably between the FSB and IOSCO—two relatively young standard-setting bodies seeking to establish credibility) that do not always speak well of international diplomacy or financial regulation.

Furthermore, even though the FSB and other standard-setting bodies may be *constitutional,* they do not always boast the kind of popular or policy *legitimacy* some U.S. stakeholders would prefer. This lies in part from the turf wars described above. Dissension between international standard setting bodies, which can be an expression of honest disagreement or the political posturing of competing bureaucracies, by definition leads outsiders to conclude that one party is "wrong," undermining the sense that the substantive output, perhaps of both agencies is of the highest quality. Furthermore, legitimacy can be undermined because of the complicated institutional arrangement supporting the rulemaking, and the at times opaque nature of decisionmaking. Indeed, some standard setting bodies do not always practice notice and comment procedures allowing for the same levels of nongovernmental and stakeholder participation that one expects here in the United States.

In my opinion, however, these challenges, do not merit a wholesale unwinding the work of cross-border standard setting, or the FSB in particular. For one, the turf wars played out internationally also have domestic drivers. The SEC, for example, does not participate in G20 meetings like the Federal Reserve and Treasury do, and is overshadowed by both in the FSB. Thus its best opportunity to articulate and advance its vision internationally is through IOSCO, which it dominates and where neither the Federal Reserve or Treasury have a seat. That policy discord can subsequently arise at the international level, given the varying priorities of prudential and market supervisors, should thus not be surprising.

Second, jettisoning or (erroneously) maligning the international architecture as unconstitutional would undermine, as already spelled out above, an important strategic advantage the United States currently enjoys—the ability (to resuscitate the objectives of the TPP) to "write the rules of the 21st century," with if not an American pen, at least with a good dose of U.S. ink.

Third—and this is a point opponents to international financial regulation often miss—the FSB, and international standard setting bodies more generally, do not only write rules, but they also serve as the basis of more streamlined cross-border financial services. To the extent to which, for example, the FSB is able to articulate shared paths on issues like capital, margin, interest rate policy, and reducing credit rating agency reliance, it is facilitating the interoperable and harmonized provision of cross-border services. Moreover, regulators use the logic and principles embedded in the standards to justify the recognition of market participants (including those in the United States) as equivalent. And when this is done, it is done via the mechanism of soft law (and often explicitly referencing FSB, IOSCO or Basel Committee reforms). From this standpoint, some intellectual consistency is required: if international standard setting bodies are to be applauded for establishing the conditions for more efficient cross-border finance, and effectively lower regulatory burdens, they can't be condemned as illegitimate when they raise them in order to safeguard markets.

Again, I do not wish to downplay the considerable challenges of international regulatory policymaking. Even with the overwhelming influence practiced by the United States, we still have to negotiate with our partners, and occasionally make compromises. And compromise is slow, and won't always get to the best results for the United States. So we have to be agile and tailor our domestic practice in ways that speak to international commitments credibly while also achieving our own prudential and market objectives. Furthermore, turf wars can compromise the effectiveness of international financial regulation, and even undermine the robustness of global reforms. That said, these are procedural and institutional challenges—indeed, challenges that the United States is in an enviable position to address with the right political (and regulatory) will. The ideal Congressional oversight would elevate these concerns to the top of the regulatory agenda, and not promote strategically maladroit initiatives targeting our very tools of economic statecraft.

NAMIC®

NATIONAL ASSOCIATION OF MUTUAL INSURANCE COMPANIES

Statement

of the

National Association of Mutual Insurance Companies

to the

United States Senate

Committee on Banking, Housing and Urban Affairs

Hearing on

The Role of the Financial Stability Board in the U.S.

Regulatory Framework

June 8, 2015

The National Association of Mutual Insurance Companies (NAMIC) is pleased to provide comments to the Senate Committee on Banking, Housing and Urban Affairs on the role of the Financial Stability Board in the U.S. regulatory framework, in particular the framework for property/casualty insurance companies.

NAMIC is the largest property/casualty insurance trade association in the U.S.A., serving regional and local mutual insurance companies on main streets across America as well as many of the country's largest national insurers. NAMIC's 1,300 member companies serve more than 135 million auto, home and business policyholders, and write more than $196 billion in annual premiums.

Introduction

Over the last several years, the Financial Stability Board (FSB) has become an increasingly important and influential regulatory organization for the global financial services sector. Re-established in the wake of the financial crisis, the FSB's core mission is to promote regulatory standards that ensure the stability and soundness of the world's financial system. Pre-crisis, the Financial Stability Forum had a role of monitoring, coordinating, and communicating between regulatory jurisdictions. However, the mandates provided in the FSB's charter go well beyond generally-expressed objectives and require that the FSB assume a direct role in monitoring how various countries implement global rules at home.

NAMIC has significant concerns with many of the activities at the FSB, including the designation process of Global Systemically Important Insurers and its influence on the Financial Stability Oversight Council's designation of Systemically Important Financial Institutions here in the U.S. However, for purposes of these comments, we would like to focus on the FSB's review and guidance of the policy development work of international standard setting bodies, specifically the International Association of Insurance Supervisors (IAIS).

NAMIC believes the current U.S. state-based insurance regulatory system is robust and well-positioned to meet the needs of the nation's insurance marketplace. However, NAMIC has serious concerns about recent international standard-setting efforts – being pushed by the FSB – that have moved beyond development of principle-based standards. Instead, these efforts have increasingly involved initiatives to prescribe particular accounting practices and capital standards, potentially undermining our state-based insurance regulatory system. All NAMIC member companies – those that are domestic-only and those that are internationally active – will feel the impact of the international standards being imported to the U.S. Indeed, the movement toward more formulaic, prescriptive standards seems to be accelerating.

Financial Stability Board Driving Action on New Insurance Capital Requirements

In 2012, the G-20 and FSB were focused on banks as well as identifying Global Systemically Important Financial Institutions (and Global Systemically Important Insurers [G-SIIs]) and developing a new regulatory framework for them. The FSB enlisted the help of the IAIS in identifying G-SIIs for designation and with the crafting of new regulations for them. Then, without warning or clear reasons, in the summer of 2013 the FSB met with IAIS leadership and informed them that, in addition to G-SIIs, other large internationally active insurance groups (IAIGs) should also adhere to a global consolidated capital requirement that was similar to the Basel II and III requirements for banks. The IAIS was ordered to design, field test and adopt such global capital requirements first for G-SIIs by the end of 2014 and then for the IAIGs by 2016. The pace of this edict was unreasonable and unworkable, but the IAIS leadership indicated they had no choice but to comply.

Since the FSB's mandate, the IAIS Executive Committee has made numerous decisions regarding the structure and design of the international capital standard (ICS) for the IAIGs without actually stating the problem the FSB was trying to solve, and without explaining why the decisions were made. The most troublesome of these decisions include: a) the insistence on a highly detailed, prescriptive formula for the ICS that would be applied to all countries; b) the requirement that all countries use the same valuation/balance sheet without regard to the costs and implications; and c) the insistence that the capital resources that companies use to meet the obligation be identical even when the capital instruments available to companies vary across countries.

Since 2013, NAMIC has submitted comments and testified at the IAIS on numerous occasions to encourage IAIS members to listen to a different perspective. We have met with state regulators and federal officials to urge them to make these arguments as well. While there has been some recent success resulting in a delay in the "ultimate" standard, the IAIS is holding firm on many of the decisions it made in 2013.

Despite the goals of the IAIS to achieve a comparable ICS for all IAIGs around the globe, the application of the same capital standard to unique companies that come from very different regulatory environments with very different economic and political objectives will not produce comparable indicators of capital adequacy or solvency. Every country has a unique regulatory system with unique features that influence the solvency of the companies doing business in that regulatory environment. Similarly, every insurance group has unique characteristics that cannot be fully captured in a single one-size-fits-all formula. In their zeal to achieve comparability, the FSB – through the IAIS – will succeed only in generating unnecessary costs to governments and insurers.

The costs to the U.S. will not be insignificant. In fact, our country may be required to make major changes to its supervisory, corporate law, and accounting systems to accommodate the new group capital requirements. Because the new standards being contemplated are largely derived from existing European standards, U.S. insurers will be placed at a competitive disadvantage relative to their European counterparts. NAMIC has asserted that a successful global effort would not create unnecessary competitive asymmetries between companies domiciled in different, but equally well-supervised, jurisdictions. Instead, what is needed is a flexible and dynamic capital assessment that would recognize and improve understanding of diverse, successful approaches to solvency regulation. Such an approach would be principle-based and outcomes-focused. Under this approach, supervisors could achieve the desired goals of policyholder protection and insurer solvency without the costs that would result from implementing new global systems in nearly every country in the world.

Unfortunately, the IAIS does not seem to be heading in this direction. Implementation of the ICS may require adopting different accounting standards and the global capital requirement may favor the local approach of one jurisdiction over another, creating further disproportionate costs between similarly situated companies. The potential market disruptions could be unintended, but very significant. Additionally, it appears that the IAIS is moving forward without a full assessment of the impact on U.S. consumers and insurance markets.

The FSB Structure and Process

The Plenary of the FSB is the sole decision-making body of the board and it operates on the basis of consensus, not actual voting. That, however, is largely all that is known about the decision-making process at the FSB, and there is no formal process for communicating NAMIC members' concerns to the U.S. representatives on the FSB. Further, the Plenary is dominated by central banks and political appointees. Consequently, there is ample reason to doubt that the Board fully understands how its decisions affect insurance markets, or that the critical differences between banking and insurance are fully appreciated. And yet, the decision to craft a new global consolidated capital standard for all IAIGs was made by an organization that has no insurance expertise from the U.S. and little expertise from other countries other than the IAIS representatives that report to them. The U.S. is represented on the FSB by the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission. Interestingly, there are no U.S. state insurance regulators or lawmakers represented on the FSB.

Finally, it is important to note that neither the FSB nor the IAIS are bound by due process and neither formally considers the costs of the changes they are making to international insurance standards relative to the presumed benefits of these changes. With each new or revised standard, costs are added from international regulatory enforcement and compliance with seemingly little regard for the impact of these costs on governments, insurers, and consumers.

Conclusion

NAMIC believes it is important to ensure that federal agencies representing the U.S. on the FSB and at the IAIS are advancing policy positions that represent the interests of U.S. insurance consumers, insurance markets, insurance regulators, and the U.S. economy in general. To that end, the U.S. should insist on an open and transparent policy development process, and the U.S. representatives who engage with international bodies should share a common agenda and a common message. That message should include a strong defense of the U.S. insurance market and existing regulatory structure. It should also promote the interests of U.S. insurers and their policyholders.

Congress has a critically important role to play as these international discussions continue. Through oversight and awareness, along with the possible enactment of legislation to facilitate a needed course correction if necessary, lawmakers can help protect the robustly competitive insurance market in this country. NAMIC applauds the Committee for holding this important hearing.

PCI

Property Casualty Insurers
Association of America
Advocacy. Leadership. Results.

Statement

Of the

Property Casualty Insurers Association of America

Before the

Committee on Banking, Housing, & Urban Affairs

United States Senate

On

"The Role of the Financial Stability Board in the U.S. Regulatory Framework"

July 8, 2015

The Property Casualty Insurers Association of America (PCI) appreciates this opportunity to offer written testimony on "The Role of the Financial Stability Board in the U.S. Regulatory Framework." PCI is composed of nearly 1,000 member companies, representing the broadest cross section of insurers of any national trade association. PCI members write more than $183 billion in annual premium, 35 percent of the nation's property casualty insurance. Member companies write 42 percent of the U.S. automobile insurance market, 27 percent of the homeowners market, 32 percent of the commercial property and liability market and 34 percent of the private workers compensation market.

PCI endorses the testimony offered today by the American Council of Life Insurers (ACLI). We particularly share ACLI's concerns that: (1) the FSB designation of GSIIs has prejudiced the FSOC's designations of SIFIs; (2) the FSB and FSOC designation processes should focus on systemically risky *activities*; and (3) the Federal Reserve Board should complete work on its capital standards for insurers before the U.S. agrees to an international capital standard at the IAIS.

FSB GSII Designations Prejudged FSOC SIFI Designations. In 2013, the FSB designated nine insurers as Global Systemically Important Insurers (GSIIs), including three U.S. insurers: AIG, Prudential and MetLIfe.

The U.S. FSOC also designated the same three companies as Systemically Important Financial Institutions (SIFIs), with the Prudential and MetLife designations following within months of the FSB designations. Significant questions have been raised about the timing of these designations, and in particular, whether the FSB designations effectively pre-judged the FSOC's deliberations. Most notably, the FSOC's independent member having insurance expertise, Roy Woodall, filed strongly worded dissents from two of the FSOC designations in which he pointedly observed that U.S. participation in the GSII designation process at the FSB and IAIS had "overtaken the Council's own determination process." PCI urges the Congress to require that the FSOC designation process be fact-based and independent of the FSB GSII designation process.

Systemic Risk Designations Should Focus on Activities. PCI argued throughout the legislative process that led to the enactment of the Dodd-Frank Act that systemic risk determinations should focus primarily on the nature of the activities being engaged. Size alone is not indicative of systemic risk. We continue to believe that the FSOC and FSB designation processes should be activities-based and that designation decisions should clearly explain how and why the activities engaged in by a company create systemic risk. PCI also believes that designated companies should have an opportunity to cease or scale back any systemically risk activities in order to avoid or reverse a systemic risk designation. As the ACLI has noted, the process for evaluating asset management firms for systemic risk is much more activities-focused and there is no reason why the approach for insurers should be different.

Federal Reserve Should Finalize U.S. Capital Standards Before Finishing Negotiations on International Standards. The Federal Reserve is now developing capital standards for those insurers subject to Federal Reserve supervisory authority. The Federal Reserve received clear direction from the Congress last year in the Insurance Capital Standard Clarification Act that standards for the insurance industry should be appropriate for insurers and not bank-centric. However, that statutory direction could be threatened if an international capital standard is agreed to before the Federal Reserve completes work on capital standards for domestic insurers. PCI therefore joins ACLI in urging that the U.S. get its own standards right at home before finishing negotiations on international standards.

U.S. Insurance Interests Not Represented at the FSB. PCI is concerned that the Financial Stability Board is making many decisions related to international financial services, a number of which directly affect the U.S. insurance industry, but is doing so without any direct participation by U.S. insurance regulators. U.S. participants in the FSB are limited to the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission. There are no U.S. state insurance regulators, and in fact, only one FSC member is focused primarily on insurance – the International Association of Insurance Supervisors (IAIS). Our concern is heightened by the fact that the FSB decision-making process is opaque and lacks the transparency that is typically a feature of policymaking processes in the United States. As a result, there are significant questions about the FSB's understanding of how its decisions affect U.S. insurance markets and deep concerns about the lack of accountability in the opaque decision-making process.

PCI urges Congress to ensure that federal agencies representing the United States at the FSB and the IAIS coordinate closely with U.S. state insurance regulators to ensure that state regulators and federal officials share a common agenda and message, including a strong defense of the existing state-based regulatory structure.

Financial Regulatory Improvement Act. Many of the concerns we have expressed are addressed in the proposed Financial Regulatory Improvement Act of 2015. PCI commends Chairman Shelby and others on the Committee for introducing this important legislation. In particular, we support provisions of the bill that would: (1) increase transparency in the FSOC designation process for SIFIs, including an express requirement that FSOC provide detailed explanations as to why it is considering a company for SIFI designation and a roadmap for "de-designation"; (2) include language from the Policyholder Protection Act that would prohibit the FDIC from using an insurer that is part of a savings and loan holding company as a source of strength for an affiliated financial firm unless the state insurance regulatory has been consulted and there would be no adverse impact on insurance policyholders; (3) and increase transparency and opportunities for stakeholder input in the process of developing international standards (based on bipartisan legislation introduced by Senators Heller and Tester).