THE ARBITRARY AND INCONSISTENT NON-BANK SIFI DESIGNATION PROCESS

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTEENTH CONGRESS

FIRST SESSION

MARCH 28, 2017

Printed for the use of the Committee on Financial Services

Serial No. 115–10

U.S. GOVERNMENT PUBLISHING OFFICE

27–251 PDF WASHINGTON : 2018

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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Tuesday, March 28, 2017

U.S. House of Representatives,
Subcommittee on Oversight
and Investigations,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Ann Wagner [chairwoman of the subcommittee] presiding.

Members present: Representatives Wagner, Tipton, Ross, Messer, Zeldin, Trott, Loudermilk, Kustoff, Tenney, Hollingsworth; Green, Cleaver, Beatty, Gottheimer, and Gonzalez.

Ex officio present: Representatives Hensarling and Waters.

Chairwoman Wagner. The Subcommittee on Oversight and Investigations will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Today's hearing is entitled, "The Arbitrary and Inconsistent Non-Bank SIFI Designation Process."

The Chair now recognizes herself for 4 minutes for an opening statement.

The financial crisis nearly 10 years ago was born as a result of poor government housing policy that encouraged excessive risk-taking at taxpayer expense, as well as an inability of financial regulators to properly identify systemic risk and promulgate appropriate regulations.

As a response to the crisis, the Dodd-Frank Act doubled down on the failed approach and created a new super-regulator with enormous power, the Financial Stability Oversight Council (FSOC), which was tasked with identifying systemic risk.

Additionally, Dodd-Frank enshrined too-big-to-fail. It enshrined its policy in creating a new group of entities called systemically important financial institutions (SIFIs), which are subject to enhanced prudential standards by the Federal Reserve after an FSOC designation. If the financial crisis taught us anything, it was that relying on government regulators in Washington to identify and root out systemic risk will always end in failure.

Instead, government regulators should come up with responsible regulations that enforce market discipline and ensure that institutions are not excessively leveraging themselves at the risk of taxpayers. The CHOICE Act, which this committee is currently drafting, provides such a framework, not for deregulation, but for smarter regulation that will open up our economy, while ending taxpayer-funded bailouts and imposing tougher penalties on those who commit fraud.

For a long time, the actions and deliberations of FSOC were a mystery. Most meetings, nearly two-thirds conducted by FSOC, take place in executive sessions that are closed to the public, even though FSOC's governance documents encourage it to hold public meetings whenever possible. Additionally, FSOC meetings are closed to Members of Congress, as well as to regulators who are not FSOC members.

And finally, there is very little documentation kept regarding meetings in executive session that the FSOC does convene, making it very difficult to determine the rationale behind FSOC decisions, which oftentimes have significant effects on the U.S. economy.

For instance, reports show that the annual consumer cost of designating a non-bank financial institution as a SIFI could range from $5 billion to $8 billion. Yet, FSOC additionally fails to conduct any cost-benefit analysis when designating a firm as a SIFI.

For this reason, the Oversight and Investigations Subcommittee began a review last Congress of the FSOC's designations of non-bank SIFIs by obtaining non-public internal FSOC documents and soliciting testimony from FSOC officials.

After analyzing these documents, we released a staff report last month which found the FSOC's non-bank designation process to be arbitrary and inconsistent. First of all, the FSOC does not follow its own rules and guidance in many ways. The staff report also found that FSOC's analysis of companies has varied among firms eventually designated and firms that FSOC chose not to designate in considering different factors and weighing some factors differently among different companies.

Ultimately, the staff report verifies what we have already known: that Washington simply is unable to accurately identify and define systemic risk. Instead, government bureaucrats have acted very subjectively with very little transparency or accountability in exerting their power to the detriment of U.S. enterprises, their customers, and the economy in general.

I now recognize the gentleman from Texas, the distinguished ranking member of the subcommittee, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Madam Chairwoman. And congratulations again on becoming the Chair of the subcommittee.

Madam Chairwoman, in my opinion, a better title for this hearing would be, "Another repeal bill." We have seen the financial crisis that almost brought this country to its knees, the Great Recession. I think it does merit some reflection so that we can better understand the crisis that caused Dodd-Frank to come into being.

In 2008, financial institutions fell by the wayside. In 2008, Countrywide was bought out. Bear Stearns was bought out. IndyMac failed. Merrill Lynch was bought out. Lehman Brothers went bankrupt. AIG had an $85 billion rescue. Washington Mutual failed. And then on September 29th of 2008, we had the greatest 1-day decline in the stock market in history.

Under the Bush request for a $700 billion bailout, at the time we were voting in the House of Representatives we could see the votes as they were being tallied. And as the votes were being tallied, we could also see the stock market in the cloakroom. And as the votes were being tallied and the bill was going down, the stock market was going down as well. The stock market fell 777 points that day. Again, the greatest 1-day fall in the market ever. That 1-day decline caused billions of dollars to be lost.

I remember how my constituents responded the day before we voted. My constituents wanted us to vote against the $700 billion bailout, as it was called. There were hundreds of calls from people who were opposed to the bailout. Constituents were concerned about taxpayer dollars being used.

After the bailout, the next day the calls were in the hundreds, and they wanted to know why we failed to support the $700 billion bailout. Constituents have the luxury of being here today and there tomorrow. We in Congress have a responsibility to evaluate the evidence and come to reasonable and prudent conclusions. We did pass that $700 billion rescue bill. And that bill caused us to turn this economy around, along with some other things.

But I remember the auto industry, that the "Big Three" were here, and they needed help. Many of my friends across the aisle said, "Let them fail." Let them fail. It was a responsibility of Democrats to stand and protect the auto industry, and we did.

Democrats have been the party of, "Yes, we can." Our friends across the aisle have been the party of, "No, we can't." The latest indication is what happened with health care. The party of repeal voted more than 60 times in one way or another to repeal the Affordable Care Act, had the perfect plan. For 7 years, they have had a perfect plan to replace the Affordable Care Act. But when it was time to produce, when it was time to build as opposed to repeal, they could not produce. They could not replace. They are very good at repealing, but very poor at replacing.

So today, on the heels of the failure to repeal and replace—they could have repealed it to find a replacement—we have yet another opportunity for them to repeal. They want to repeal the Consumer Financial Protection Bureau (CFPB), the bureau that is designed to protect consumers, they would repeal it. They now want to repeal the economic disaster prevention agency. It is called FSOC, but it is there to prevent another AIG. And it did so with G.E.

This bill will do more repealing than replacing. I am against it, and I am going to stand up for Dodd-Frank.

I yield back.

Chairwoman WAGNER. The gentleman yields back.

The Chair now recognizes the Vice Chair of the subcommittee, the gentlemen from Colorado, Mr. Tipton, for 1 minute for an opening statement.

Mr. TIPTON. Thank you, Chairwoman Wagner.

It is incredibly concerning to learn that the counsel and its staff, while evaluating institutions for potential SIFI designation, failed to heed their own guidance, inconsistently applied criteria to firms, and fundamentally misunderstood what could cause financial distress in non-bank institutions.

Further, it is disturbing to read that the designation process was often conducted on an ad hoc basis with no clear guidance for FSOC or its staff and little hard evidence to justify designation decisions. These critiques do not come from the committee alone. Last year, the D.C. circuit court overturned a SIFI designation based in part on the failure of FSOC to conduct a cost-benefit analysis.

A recent GAO report came to similar conclusions, finding that the FSOC did not develop a process for identifying specific criteria to apply to analytical framework in evaluating companies. Yet again, we find regulators are quick to regulate, but slow to analyze. I look forward to learning more in this hearing about ways to reform the designation process to encourage a data-driven approach.

Thank you, and I yield back.

Chairwoman WAGNER. The gentleman yields back.

We now welcome our witnesses. First, Dr. Doug Holtz-Eakin is currently the President of the American Action Forum. He has previously served as Chief Economist of the President's Council of Economic Advisers as well as Director of the Nonpartisan Congressional Budget Office, and as a Commissioner on the Financial Crisis Inquiry Commission.

With that, Dr. Holtz-Eakin, you are now recognized for 5 minutes.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PRESIDENT, AMERICAN ACTION FORUM

Mr. HOLTZ-EAKIN. Thank you, Chairwoman Wagner, Ranking Member Green, and members of the subcommittee. It is a privilege to be here today to discuss the non-bank SIFI designation process.

I want to make three simple points, and then I look forward to your questions.

First, as the staff report makes clear, there are deep weaknesses in the FSOC's designation process. But I would emphasize that even if there was a good process, there is a mistaken emphasis on designating financial institutions as opposed to the activities and instruments that they that they operate.

The second is that the designation process has costs, it has consequential cost for the firms, for their customers and for the economy as a whole, and it is a mistake to ignore these costs in making the designations.

And the third main point is that, thus far, only insurance companies have been designated as non-bank SIFIs, and I would urge the committee to consider removing the FSOC's authority to do so as it appears to be redundant at best. Let me expand on each of those.

First, with regard to the process, as the committee knows, there are three stages in the designation process. Stage one consists of essentially a series of quantitative flags that the FSOC staff checks to see if a firm qualifies. And then it moves to stage two, without the firm knowing it, to undertake an analysis that is based on size, leverage, interconnectedness, liquidity and maturity mismatch, substitutability, and the existing regulatory apparatus surrounding that firm.

As the report makes clear, it is not at all obvious what weights are attached to each of these factors. It is pretty clear that they are applied differently to different firms and that there is anything but a systematic process by which firms are designated.

And then in stage three, it is an in-depth analysis of a firm and, as I emphasized at the outset, the focus on firms is a mistake in the FSOC to begin with and, thus, it repeats this mistake in the final stage of its analysis.

The second main point is that there are costs associated with this, and I would emphasize there some economic costs. In the same industry, you will have non-bank SIFIs designated for a higher standard of regulation and the costs that come with it. That produces an un-level playing field for competition and financial services. It is also true that across the globe, U.S. firms will be at a disadvantage in competing for global markets. These are all important costs to consider.

The Oliver Wyman study that was mentioned by the chairwoman indicates that a single non-bank SIFI designation could cost consumers somewhere between $5 billion and $8 billion. And that is a cost that the courts have indicated that the FSOC should take into consideration, and it has simply failed to do so.

And the last point is, what should be the path forward? First and foremost, I think it is important for the FSOC to move away from a focus on designating firms as systemically important and instead, undertake an activities-based analysis. It has indicated its interest and willingness to do so, but it now has an inconsistent approach across industries. That doesn't make a lot of sense.

And with regard to the non-bank SIFIs that have been designated thus far, as I mentioned, they are all insurance companies. And if you look at the way the designation process is played out, essentially what they have done is taken these insurers and imposed on them a second round of essentially prudential safety and soundness type regulation. Each of these insurers has a consolidated regulator at the State level.

The report indicates that these regulars were not consulted adequately. Going forward, it looks as if the FSOC is essentially imposing simply a second layer of the same kind of regulation. It is not obvious that makes a lot of sense. And we may want to think about removing the FSOC's capacity to designate, at a minimum, insurance companies and perhaps rethinking the designation process as a whole.

So I look forward for the chance to answer your questions, and I thank you for the privilege of being here today.

[The prepared statement of Dr. Holtz-Eakin can be found on page 32 of the appendix.]

Chairwoman WAGNER. I thank the witness.

Our next witness is Dr. Paul Kupiec. Dr. Kupiec is a resident scholar at the American Enterprise Institute. Prior to that, Mr. Kupiec was Director of the Center for Financial Research at the FDIC, as well as Chairman of the Research Task Force of the Basel Committee on Banking Supervision.

Dr. Kupiec, you are now recognized for 5 minutes.

STATEMENT OF PAUL H. KUPIEC, RESIDENT SCHOLAR, AMERICAN ENTERPRISE INSTITUTE

Mr. KUPIEC. Chairwoman Wagner, Ranking Member Green, and distinguished members of this subcommittee, thank you for convening today's hearing.

In my oral remarks, I will summarize my written testimony, and I will use a simple analogy from everyday life. On my commute home, I drive west on K Street. If I see a flash of light as I approach the 22nd Street underpass, I instinctively check my speedometer, remember the 25-mile-an-hour speed limit, and try to guess whether it was my car that triggered the speed camera.

Now imagine that you are a CEO of a large, successful, non-bank financial firm. One day you receive an e-mail from the FSOC saying that your institution is selected for a stage-three FSOC review. Stage-three review, you ask, who even knew the FSOC put us through a stage-two review? Your institution is profitable, well-capitalized, and growing. Your State regulators, and you have regulators in every State where you do business, have given you a clean bill of health. Your staff has no idea why the FSOC picked you.

Keeping now with my speeding ticket analogy, ask yourself, is there a speed limit for the institution? How fast is the firm actually going? How fast does the FSOC think the firm is going? Where can the institution find out answers to these questions? The situation becomes more surreal when you discover that there are no definite answers to any of these questions.

The FSOC has the power to set individual speed limits for each and every non-bank financial institution under its jurisdiction. Moreover, the FSOC does not have to disclose your institution speed limit to your institution, even if you pay your white-shoe law firm to make a formal request. They don't have to tell you.

More troubling, the FSOC is the only agency authorized to measure the speed of non-bank financial institutions. And now you, as a target of a stage-three review, the FSOC scientists are already measuring your institution's speed using an unknown process and without any impartial witnesses present. If this nightmare of jurisprudence reminds you of a "Twilight Zone" episode, it is called, "The Dodd-Frank Act."

I could mention specific troublesome details of the FSOC stage-two and stage-three designation decisions, and I do so in my written testimony. But the bottom line is, the subcommittee's report shows the FSOC has no common methodology or uniform standards or assumptions that are used in individual firm SIFI designations. Each FSOC designation decision is an outcome of an ad hoc process. The lack of standardization means that identical firm characteristics can be and have been evaluated differently in different FSOC designation cases.

An example will bring clarity to this problem. Say that the FSOC staff separately examines two firms with nearly identical characteristics. Let's call these two firms equally tall. They are firm one and firm two. In examining firm one, the FSOC staff decides that firm one is a safe firm because of its height; it can reach the high fruit on trees and it will never starve. The FSOC concludes that firm one is not a SIFI.

In a separate case and time, the FSOC examines firm two and decides that tall firm two is risky because it is at risk of being struck by lightning. FSOC decides the tall firm two is a SIFI. If this designation process sounds unjust, it is. But can't firm two appeal the FSOC's decision? Yes, it can, but remember, only some FSOC SIFI designation decisions are made public. There is no public record of FSOC decisions unless a firm is actually designated.

So, tall firm two has no idea of the processes and arguments the FSOC used to evaluate tall firm one, nor does it even know that the FSOC evaluated tall firm one. Tall firm two lacks the case law it needs to defend itself against an FSOC designation. While I have purposely omitted technical jargon, I have not exaggerated the deep-flawed nature of the Dodd-Frank FSOC designation process.

I myself doubt there is a need for an FSOC SIFI designation process. But even if you would disagree with me on this point, I still doubt you would defend the current FSOC process as a legitimate way to go about making SIFI designations.

The subcommittee has done invaluable work acquiring and analyzing confidential FSOC records that have made transparent the flaws in the FSOC designation process. The process is arbitrary and broken. It should be repealed or, at a minimum, fundamentally reformed.

Thank you very much, and I look forward to your questions.

[The prepared statement of Dr. Kupiec can be found on page 39 of the appendix.]

Chairwoman WAGNER. I thank the witness for his testimony and analogies that I can very much relate to. My apologies for your waiting in the rain to get in, Mr. Kupiec, but we are so glad that you are here.

Our next witness is Professor David Zaring. Professor Zaring is an associate professor of legal studies and business ethics at the Wharton School. Previously, Professor Zaring was with the Washington Lee University School of Law, the New York University School of Law, and he clerked on the U.S. Court of Appeals for the D.C. circuit.

Professor Zaring, you are now recognized for 5 minutes.

STATEMENT OF DAVID ZARING, ASSOCIATE PROFESSOR, LEGAL STUDIES AND BUSINESS ETHICS, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA

Mr. ZARING. Chairwoman Wagner, Ranking Member Green, thank you for inviting me.

At Wharton, I study financial regulation, and I have written an article on the administrative procedure of the Financial Stability Oversight Council with Daniel Schwartz, who is a professor at the University of Minnesota. That article is forthcoming in the University of Chicago Law Review.

And in my testimony on the procedures followed by the FSOC today, I want to focus on three points and make a few additional observations. First, the report prepared by the Republican staff of the Committee on Financial Services subjects the Council to a degree of after-the-fact review that is inconsistent with the flexibility Congress gave the Council in the Dodd-Frank Wall Street Reform Act.

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

The Republican staff report identifies portions of the written memoranda of the Council, where it emphasizes some safety and soundness factors more heavily than it did other factors. It also identifies cases where the Council considered the riskiness of a financial institution as a general matter as indicative of the risk institution would pose when the economy was stressed.

There is nothing arbitrary about emphasizing some factors more than others in such circumstances, nor is it arbitrary to presume that a non-bank, risky in normal conditions, would also be risky when times are difficult.

Second, the report, while a real contribution into how the Council makes decisions, attempts to isolate particular aspects of the Council's analysis and makes arguments about inconsistency based on those aspects. But this sort of picking and choosing is really not consistent with the way that FSOC designations work.

The designation decision is meant to be a holistic one, utilizing a number of different factors in a way that enables the Council to consider a full picture of any particular non-bank's position and of the effect that stress in that non-bank would have on the broader financial markets and greater economy as a whole.

FSOC has its constraints. It can only act given a super majority of its members, it can only designate financial companies as that term is defined in Dodd-Frank, and it must revisit all of its designations annually. These constraints are real and they cabin the ability of the Council to go rogue.

But the factors that Congress told it to consider when it is making any particular determination decision of those institutions that fall within its jurisdiction are, by a necessity and sensibly, broad and open to interpretation.

Third, the Council itself has been given the responsibility for taking a broad view of the safety of the financial system and it is the only part of the Federal Government with the power and the capability to do that. It has chosen to make designations in a manner that makes it possible to revisit those designations. Only the three largest insurance companies in America have been designated as systemically significant, as well as one large financing company.

But it is important that the Council retains its flexibility to adjust its assessments of risk in the future. Second-guessing small portions of large decisions is inconsistent with the necessary flexibility that Congress gave the Council.

Finally, the costs of designation are real, but they are easy to overstate. While G.E. Capital transformed itself in an effort to move away from designation, it is clear that there were business judgment reasons to restructure the company anyway. And it is important to remember that FSOC rescinded the designation of that company. As the CEO of AIG has observed, designation "just simply isn't a binding constraint on our capital returns and our objectives, so we don't spend too much time worrying about it."

For that insurance company, designation has not been a burden, but rather a regulatory requirement that has not imperiled its business or its ability to make plans in the future. FSOC has only designated four companies. It has removed one of those designations. There are two designations that are currently active and one of them is an extremely large insurance company, and the other is

AIG, the company that collapsed so spectacularly during the financial crisis.

There is no indication right now that more designations are contemplated. That does not look like arbitrary exercise of government power. Instead, to me, it looks quite cautious indeed. And it certainly doesn't look entirely subjective.

With that, I thank the subcommittee, and I look forward to your questions.

[The prepared statement of Professor Zaring can be found on page 51 of the appendix.]

Chairwoman WAGNER. Thank you, Professor Zaring.

Our final witness today is Mr. Alex Pollock. Mr. Pollock is a distinguished senior fellow at the R Street Institute. Previously, Mr. Pollock was with the American Enterprise Institute, and was president and CEO of the Federal Home Loan Bank of Chicago.

Mr. Pollock, you are now recognized for 5 minutes.

STATEMENT OF ALEX J. POLLOCK, DISTINGUISHED SENIOR FELLOW, R STREET INSTITUTE

Mr. POLLOCK. Thank you, Madam Chairwoman, Ranking Member Green, Vice Chairman Tipton, members of the subcommittee, and full Financial Services Committee Chairman Hensarling.

To begin with, let me compliment the committee staff for their detailed specific paper on FSOC's non-bank designation process. This embodies what I think is a very good analytical idea, namely to compare the FSOC evaluation memoranda against each other, to measure their consistency. The comparison shows they have been characterized by multiple inconsistencies and anomalies, as we all agree.

The paper says these examples cast doubt on the fairness of FSOC's designation process. They do, but, in my opinion, a more important point than fairness is that these observations cast doubt on the objectivity of the FSOC's work.

As we know, Federal District Judge Rosemary Collyer ruled that FSOC's MetLife action was "arbitrary and capricious," strong words, and that FSOC "hardly adhered to any standard when it came to assessing MetLife's threat to U.S. financial stability." This sound and sensible judicial decision was appealed by the previous Administration.

I believe the current Treasury Department should immediately request the Department of Justice to withdraw the appeal and the Department of Justice should do so as soon as it can.

Just today, the Treasury Department received a letter from 10 members of the Senate Banking Committee, including the chairman, which says, in part, the FSOC's process for designating nonbank SIFIs "lacks transparency and accountability, insufficiently tracks data, and does not have a consistent methodology." So we seem to have the two Chambers tracking together here.

Going back to the FSOC designation, the independent member of FSOC, Roy Woodall, who is a true expert in insurance, voted against the SIFI designation of MetLife, objecting that "the analysis relies on implausible, contrived scenarios." Well, implausible, contrived scenarios are what we don't want.

Ed DeMarco, a distinguished financial regulator, joined Mr. Woodall's earlier dissent on Prudential and also pointed out that key FSOC arguments lacked evidence. We certainly do want evidence.

Was there a substantive discussion among the members of FSOC about these issues? I am told that there was not. But the whole point of FSOC is supposed to be a committee for deliberation and development of insights together in discussion.

I directly asked one former senior FSOC insider from the previous Administration if the meetings of the FSOC members had ever produced a new insight into financial issues. After thinking a minute, he gave me a candid answer: no. The underlying problem, it seems to me, is the structure of the FSOC itself.

So the procedural issue leads us to a bigger structural issue. The shortcomings of designation point us to the question: what about the FSOC itself? We know they are primarily a group of individuals, each from a regulatory agency, each with turf to protect from intrusions by the others and a regulatory record to defend. At the meetings, they bring along helpers and allies. At the FSOC meeting that approved the MetLife SIFI designation, there were, according to its minutes, 46 people sitting around the room. I don't think they had a serious give-and-take, substantive discussion with 46 people.

The composition of the FSOC makes it a necessarily political body. That is why FSOC's evaluations tend to make inconsistent analyses. It is because the decisions made are inherently judgmental with inherently subjective elements.

We might call those "holistic," Professor Zaring.

What that means is FSOC actually acts as a little legislature, and I think that is a bad idea.

Madam Chairwoman, you mentioned Fannie Mae and Freddie Mac, which are obviously systemically important and, without question, systemically extremely risky. But Fannie Mae and Freddie Mac are never studied as possible SIFIs by the FSOC staff in spite of the fact that they obviously are SIFIs. Why not? Because the Secretary of the Treasury controls who gets studied and would not allow the staff to look at Fannie and Freddie, even though they are pure cases of the government shielding creditors and counterparties from losses, not only as a hypothetical, but as a vast fact. Protecting creditors in this fashion is something that the Dodd-Frank Act instructs FSOC to eliminate.

So FSOC needs some immediate actions on its procedural issues, as we have discussed. But it also needs structural reform for the longer term.

Thank you very much for the chance to share these views.

[The prepared statement of Mr. Pollock can be found on page 45 of the appendix.]

Chairwoman WAGNER. I thank all four of our witnesses.

And without objection, the witnesses' full written statements will be made a part of the record. Each member of the subcommittee will now have 5 minutes within which to ask questions.

The Chair now recognizes herself for 5 minutes.

Dodd-Frank, in directing the FSOC to identify systemic risk, tasked a number of prudential financial regulators, such as the Federal Reserve, the FDIC, and the OCC, as members of FSOC.

Mr. Pollock, since you arrived first, I would like to first start off in asking how these financial regulators have fared in the past in identifying risks to the financial stability of the United States?

Mr. POLLOCK. Thank you, Madam Chairwoman. Of course, they haven't done very well. I was just reading two wonderful quotations from the then-Chairman and the current Chairman of the Federal Reserve from the end of 2007 and January 2008, forecasting that there would not be a recession at that point. Of course, as we know, the recession had already started. We have numerous examples of regulators failing to see the disaster that was coming, as other people and other forecasters failed to see it.

Because the financial future, in particular, is inherently uncertain, we certainly can't put faith in any bureaucratic bodies to protect us from that. Personally, I would prefer to put faith in higher capital.

Chairwoman WAGNER. Thank you.

Dr. Holtz-Eakin, I would like to follow up on this as well in asking if there is a simple way to measure systemic risk?

Mr. HOLTZ-EAKIN. There is not; in fact, there is no agreement on exactly how to measure it and what it looks like. If you can't measure something, you can't manage it. And it is far from obvious what the FSOC is trying to do in those circumstances. I think that is a fundamental flaw in the entire idea behind the FSOC.

Chairwoman WAGNER. If you can't measure it, you can't manage it. How then can Congress evaluate whether the FSOC is properly performing its job?

Mr. HOLTZ-EAKIN. The only way to evaluate the FSOC would be to get some transparency about its procedures so that it at least does whatever it is doing the same way every time and to everybody. And all the evidence we have thus far is that it is not doing that.

Chairwoman WAGNER. Another issue, I believe, that impedes Congress from evaluating whether FSOC is performing its job is simply the lack of information and transparency from the Council. From our previous work on this committee, we have known the FSOC to be one of the least transparent Federal entities, providing very little oversight for Congress and the public into the deliberations of Council meetings.

These are quick, and we will switch it up.

Dr. Kupiec, I will start with you. It wasn't until the release of this committee's staff report that we started to actually see the rationale, and in many instances, lack of rationale, for the decisions made by the FSOC. Dr. Kupiec, should the FSOC be made more transparent?

Mr. KUPIEC. I think the subcommittee report makes it very clear that transparency is long overdue. I think from the designations, from the public documents we saw associated with the various designations, there were strong suspicions that the FSOC decides on a designation and kind of makes up a story afterwards to justify it. It is, sort of, an attempt at writing financial fiction.

What I think we have seen with the subcommittee's report where it actually goes through and analyzes the stage-two documentation that was not publicly available or known to anyone is in fact this whole characterization, that it is an after-the-fact story made up to justify a decision or a non-decision to designate I think comes out very clearly in the subcommittee report.

Chairwoman WAGNER. Let's go down the line, starting with Dr. Holtz-Eakin, all four of you, yes or no, should the FSOC publicize its internal process?

Mr. HOLTZ-EAKIN. Yes.

Mr. KUPIEC. Yes.

Mr. ZARING. No.

Mr. POLLOCK. Yes.

Chairwoman WAGNER. Should FSOC allow observers at its meetings, such as participants from member agencies or Congress?

Mr. HOLTZ-EAKIN. Yes.

Mr. KUPIEC. Absolutely.

Mr. ZARING. No.

Mr. POLLOCK. Strongly yes.

Chairwoman WAGNER. Should FSOC keep detailed minutes and transcribe their meetings, like the Fed's Federal Open Market Committee does?

Mr. HOLTZ-EAKIN. Yes.

Mr. KUPIEC. Yes.

Mr. ZARING. No.

Mr. POLLOCK. Yes, it would be a good idea.

Chairwoman WAGNER. I thank you all.

While our committee is considering broader reforms and changes to the structure and powers of FSOC, what are some other actions that Treasury Secretary Mnuchin could make right now at FSOC, to bring more transparency and accountability to its action?

Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. I think that FSOC showed some improvement with its 2015 guidance, and Secretary Mnuchin could pursue greater transparency and greater consistency in its actions.

Chairwoman WAGNER. Dr. Kupiec?

Mr. KUPIEC. I think since systemic risk is such an elusive construct and really can't be identified, in my opinion, that the FSOC ought to move towards specific thresholds and evaluate firms along guidelines that are observable and can be defended or not.

Chairwoman WAGNER. Thank you. My time has expired.

The Chair now recognizes Mr. Cleaver for 5 minutes.

Mr. CLEAVER. Thank you, Madam Chairwoman, and Ranking Member Green.

Mr. Kupiec, I do analogies in my real life quite a bit. And so I was struck by your analogy of the traffic light catching somebody for speeding and getting a ticket for speeding. And then you compared that with the non-bank financial firm suddenly getting a notice of a stage-three evaluation. Did I restate your analogy correctly?

Are you aware that the Council published supplemental procedures with 17 changes and a larger, increased transparency in the designation process? Are you aware that they did that?

Mr. KUPIEC. Yes, I am aware that following testimony in the Financial Services Committee, which is very critical of the FSOC's process, they did publish some changes and try to improve transparency, yes.

Mr. CLEAVER. But no matter why they did it, they did it, right?

Mr. KUPIEC. But they didn't do it out of their own good will. That would matter.

Mr. CLEAVER. Okay, you don't know why they did it. You have no idea. You have absolutely no idea why they did it. All we know is that they did it in 2015. And you said transparency is long overdue, 2015. Now, how do you know that you know why they did it?

Mr. KUPIEC. I testified in the hearings that led up to the—maybe I am mistaken, but that would be my judgment, that—

Mr. CLEAVER. Okay, and that is fine. That is judgment, and I like judgment, except if it has "they" on the end of it. But the point I am trying to make is that you are calling for transparency, and we have had transparency. And that is just a little confusing. Have you looked at the website?

Mr. KUPIEC. Excuse me?

Mr. CLEAVER. Have you looked at the FSOC website?

Mr. KUPIEC. Yes, sir. I have read the designation decisions.

Mr. CLEAVER. Yes, and you also know—

Mr. KUPIEC. And the court court cases, the MetLife court case.

Mr. CLEAVER. And you know they detailed the criteria they use in stage one—

Mr. KUPIEC. Yes, in fact I was involved in the stage-one designation process when I was at the FDIC as the head of the economics group there.

Mr. CLEAVER. But you know that is on the website, don't you?

Mr. KUPIEC. Yes.

Mr. CLEAVER. Okay. I don't understand the "pants on fire," which was your testimony. Then you are now admitting that they have a transparent—Professor Zaring, can you confirm that FSOC announced that they will notify a company within 30 days of activating a review in stage two?

Mr. ZARING. That is right. They have this elaborate three-stage process, and if they take a company into the third stage of that process, the company has every opportunity and so far, as far as I know, has taken every opportunity to interact with the Council in either fighting or responding to an inquiry by the Council that suggests that the stage-three review is beginning. That includes meeting with Council members, turning over documents to the Council.

The Council vote is public, of course, after which comment and a hearing can be or—the tentative decision is public, of course, after which the designated institution can provide comments. There is an opportunity for a public hearing. I think there is a great deal of process attached to this designation decision.

Mr. CLEAVER. And then stage two, Professor Zaring, do the companies have the opportunity to present information to the Council?

Mr. ZARING. They do after a stage three. In stage two, the Council tries to figure out which companies to ramp up to this adversarial determination.

Mr. CLEAVER. I am trying to figure out this lack of transparency, just that people are going into bunkers to do business. I don't understand this.

Mr. ZARING. I agree. To me, the Council is providing the very few institutions that it has designated with a strong amount of process.

Mr. CLEAVER. Thank you very kindly. I yield back.

Chairwoman WAGNER. The gentleman yields back.

The Chair now recognizes the gentleman from Colorado, Mr. Tipton, the Vice Chair of the subcommittee, for 5 minutes.

Mr. TIPTON. Thank you, Chairwoman Wagner.

Dr. Kupiec, when the FSOC is conducting an assessment on an institution's potential for creating systemic risk, does the Council consider the existing supervisory process regulating that entity?

Mr. KUPIEC. They are supposed to consider the supervision and regulation in place, but I would say the designation decisions that have been made thus far do not take account of those in any way.

Mr. TIPTON. Thank you. How were the current non-bank SIFI firms supervised then prior to their designation?

Mr. KUPIEC. AIG was actually supervised by a primary Federal regulator, the Office of Thrift Supervision, actually, and State insurance commissioners in all the States that AIG does business. And the other insurance companies, all their insurance subsidiaries are supervised by the State insurance regulators. And some of the designated SIFIs, at one time, had bank subsidiaries which were supervised by both State regulators and a Federal regulator. It varies case by case.

Mr. TIPTON. Now, have these regulators raised issues about financial health or safety of the current SIFI non-bank institutions prior, during, or after their designation?

Mr. KUPIEC. The short answer is no, I am not aware of that. AIG, of course, did get in trouble in the financial crisis, but I am not aware that it was under any kind of warning signs from the Office of Thrift Supervision. I think they basically weren't really looking at AIG. They were the ones responsible for the Financial Products Group in London, which was actually the part of the firm that wasn't supervised by a State insurance regulator. And that is the part that caused the troubles.

Mr. TIPTON. So just to be clear, the whole series of regulators are lined out, going through, they have raised no concern about the health, the safety of the institutions that were in place going forward. But now with the FSOC going in, we are seeing them choosing to designate?

Mr. KUPIEC. Yes, and the designations for the insurance companies, the way the FSOC makes it, is very unusual in that it treats the products of insurance companies as if they were bank deposit-like liabilities that could be withdrawn, that people would line up and withdraw the residual value of their life insurance policies or whatever. And they are not bank deposit-like products, and there is really no evidence that there have been any institution-wide runs on all the various subsidiaries at any time in the past.

So the story is a very fictional story that the FSOC uses to make the designation.

Mr. TIPTON. Now, did the FSOC do any sort of cost-benefit analysis as part of the SIFI designation process?

Mr. KUPIEC. None that I am aware of and none that they specifically state in public documents. And their opinion is that they don't have to, is their opinion in the legal case, that they are not required to make any cost-benefit analysis.

Mr. TIPTON. In your opinion, does this undermine the credibility of the FSOC's conclusions, the fundamental aspects of the assessment process are flawed, and the impact of its SIFI designation was not extensively studied prior to the beginning of the designations?

Mr. KUPIEC. I don't think the FSOC or anybody has the capacity to scientifically that identify one firm is a SIFI and another firm isn't a SIFI. I do not think the science of statistics or economics or finance is sufficiently advanced that you can definitively separate out firms into those that are a source of systemic risk and those that aren't until perhaps after they blow up.

But ahead of time, I don't have any confidence that regulators have that ability, or any academic or any person anywhere at this point in the science of risk measurement.

Mr. TIPTON. Thank you.

Mr. Pollock, I gather you agree with Mr. Woodall's conclusions in regards to designation of MetLife and Prudential. Why is that really important? Is it important to be able to have somebody who actually has experience in an industry playing a role in these designations?

Mr. POLLOCK. Congressman, I think to have somebody who actually is an expert in the industry is extremely important. And Mr. Woodall's dissents, in my opinion, were very articulate and substantive.

Mr. TIPTON. Once a firm is designated as a SIFI, they are overseen by the Federal Reserve Board. How much experience does the Federal Reserve have in insurance regulation?

Mr. POLLOCK. Very little, and it certainly by no means could be considered an expert.

Mr. TIPTON. Thank you.

And, Madam Chairwoman, my time has expired.

Chairwoman WAGNER. The gentleman yields back.

The Chair now recognizes the gentleman from Texas, Mr. Gonzalez, for 5 minutes.

Mr. GONZALES. I will be yielding the balance of my time to Representative Al Green.

Mr. GREEN. Thank you for yielding, and thank you for being such an outstanding member of the committee. We greatly appreciate your service.

Let's start with Mr. Holtz-Eakin. Sir, you talked about the cost of designating a bill as a SIFI. And I think that is worthy of consideration. But what about the cost of not designating an entity as a SIFI? AIG was not designated as a SIFI and AIG cost the country a good deal of stress, an $85 billion rescue effort, and it was paid back by the way. Don't you think that the cost of not doing it is important, as well?

Mr. HOLTZ-EAKIN. If we could, as a matter of science—

Mr. GREEN. Let's examine that, if we could. Because we can't do it perfectly, we should not do it at all, seems to be your thought processes. But it seems to me that FSOC is working. FSOC, by the way, is the economic disaster prevention agency. It is in business to look over the economy and to spot these AIGs.

By the way, Mr. Kupiec, how was AIG regulated?

Mr. KUPIEC. AIG was an international insurance company—

Mr. GREEN. Okay, it was an insurance company. You seem to have some concern about insurance companies being regulated. AIG is the ultimate example of why we have to regulate some of the insurance companies, some of them, not all of them, some of them. Let me move on.

Mr. KUPIEC. AIG was regulated.

Mr. GREEN. Excuse me, let me move on. I am going to my next witness, if I may, please.

Mr. Zaring, is this economic disaster prevention commission, if you will, is it working?

Mr. ZARING. So far, since the passage of Dodd-Frank, we haven't had a financial crisis, despite the fact that around the world there has been plenty of financial turmoil. There is every reason to believe that financial institutions, especially non-banks, are more solvent and have better protections in place for a crisis. And I think a lot of that has to do with the fact that they know that FSOC is watching.

So FSOC is being very cautious about its designations, but because it has the power to reach out and get risky behavior by financial institutions, it has had a salutary effect on those institutions as a whole.

Mr. GREEN. And can you give an example of not only designation, but also de-designation? Because FSOC has the ability to designate and it has the ability to allow a company to take the necessary steps to eliminate risk and de-designate. Can you respond, please?

Mr. ZARING. That is right. In the case of G.E. Capital, the firm was designated, and it was engaged in lots of marketplaces, which meant that a lot of its financing was very runnable. Financing and insurance companies also do practices like securities lending, and get into markets where the financial assets and stake in those markets are runnable as well.

So G.E. Capital transformed itself from an institution that relied on these runnable assets for financing into a much more stable institution that did not. And the Council responded by revoking the designation. It has an annual responsibility to review every designation for revocation, and there is every indication that FSOC takes that responsibility very seriously.

Mr. GREEN. As a matter fact, looking at G.E. Capital, they were into consumer credit. They had a consumer credit arm. They had a commercial lending business. They had a real estate assets business. They had online deposits. They had an asset management arm. They had hotel financing. They had restaurant financing. They had transportation financing. They had health care financing. They were all over the place.

Mr. ZARING. Right, and I might add that it didn't seem to me that G.E. Capital was well-supervised by any regulator, given all these various and potentially risky businesses it was in. FSOC provided a backstop that I think was an important source of stability in the way that it supervised G.E. Capital and persuaded it to change its business in, I think, ways that were good for the American economy.

Mr. GREEN. Does that cause you to hearken back to AIG and how it was regulated and supervised?

Mr. ZARING. Big companies like AIG can get involved in new and creative markets with levels of risk that they don't really understand. FSOC is a barrier against that kind of thing.

Mr. GREEN. Thank you. I yield back.

Chairwoman WAGNER. The gentleman yields back.

The Chair now recognizes the gentleman from Tennessee, Mr. Kustoff, for 5 minutes.

Mr. KUSTOFF. Thank you, Madam Chairwoman.

Dr. Holtz-Eakin, thank you for being here this morning, and thank you for your past public service.

As we have seen with the implementation of Dodd-Frank and the creation of FSOC, it has been authorized to notice and implement final rules to determine whether a non-bank company will pose a threat to the financial stability of our country.

Undeniably, this authority has allowed for FSOC to impose guidance on what it considers its own definition for what actually constitutes a threat to financial stability, a definition, in my opinion, which is inconsistent in their rulemaking and, more specifically, their designation of systematically important financial institutions.

These independent agencies are created by Congress and staffed with presidential employees. As such, we expect these individuals to create rules and regulations objectively and independently. Do you believe that the FSOC is capable of acting as an independent regulatory agency?

Mr. HOLTZ-EAKIN. It could be a better regulator in the sense of having processes that were more systematic, that were uniform, that were transparent, and where you could have objective criteria that they sought to meet. I do not think that the science exists to fulfill its basic mission which is to identify systemic risk and reduce it.

As you know, I served on the Financial Crisis Inquiry Commission. I think all the time in the narrative of that crisis and in the events as they unfolded, had there been an FSOC, would it have known how to stop it? And the answer is no, it would not have.

It is the activities that went on, the interconnectedness of those activities, not just among firms, but across the globe that is the most striking feature of the crisis. That took place in many different regulatory environments. None of them were smart enough to foresee the forces that combined to produce the financial crisis. And FSOC would not have been smart enough either.

Mr. KUSTOFF. As a follow-up, if I could, last year Chairman Hensarling introduced the Financial CHOICE Act which would eliminate the FSOC's ability to designate SIFIs. What additional reforms would you recommend to this committee that would remedy the FSOC's unchecked authority to make these designations?

Mr. HOLTZ-EAKIN. I think there are several levels of reforms. First, is one that we have mentioned several times about the process by which it operates: making it more transparent; more uniform; with a clear exit ramp from SIFI status; and making sure that the burden doesn't fall on firms that are too small.

The second would be limiting its scope to designate non-bank SIFIs. I, for example, think that in many cases, all we are getting out of the regulation of these insurance companies is a second layer of what the consolidated State regulars are doing anyway. And they are ignoring that, so I don't see why we should do that.

And then the third thing, level of reform, I think, would be to really pull back on its ability to do this at all. It has been given a mission that it can't fulfill. It has enormous authorities and can impose large costs on the economy. That strikes me as a very bad regulatory arrangement and ought to be scaled back entirely.

Mr. KUSTOFF. Thank you very much. I yield back.

Chairwoman WAGNER. The gentleman yields back.

The Chair now recognizes the gentleman from New Jersey, Mr. Gottheimer, for 5 minutes.

Mr. GOTTHEIMER. Thank you. I yield my time to Mr. Cleaver, Madam Chairwoman. Thank you.

Mr. CLEAVER. Thank you very much.

I want to kind of keep going in the direction I was going. When the financial crisis hit—when Treasury Secretary Hank Paulson, Sheila Bair from the FDIC, Ben Bernanke from the Fed, and Chris Cox from the SEC were here—I was in here that day, it was late in the day. I was sitting right over there next to that empty seat on the end when they came in—half of the Members were gone already—to tell us what was happening to the economy. I was in here.

I get the impression that there are those of you on the panel who would suggest we should have just walked out and said, I hope things turn out on Monday. We were warned that if we didn't start acting, that the U.S. economy, by the time the Asian markets opened after the weekend, that the world economy could very well fall into shambles.

Mr. Holtz-Eakin, are you guys saying we should have said, well, whatever happens is fine, we want the free market to just kind of do what it does and see you later; and walk out and catch our planes? Because I was in here, and I guess sometimes I get disturbed when people say, "You guys should have done this, and you should have done that." I was here, and I know the tension that was going on. I saw what was happening firsthand.

And so I am just curious, if you had been sitting in here, what would you have said to Hank Paulson, who said that President Bush asked him to come over? Would you have said, well, go back and tell him, let's let the free market just kind of roll?

Mr. HOLTZ-EAKIN. I have been on record as saying it would have been irresponsible for the Congress to do nothing and we saw that in the aftermath of the first failed TARP vote significant economic damage. I am not—

Mr. CLEAVER. I watched that as well. I watched it in real time going down on the TV in the cloakroom.

Mr. HOLTZ-EAKIN. That is different from saying I think the response was the most effective response possible, which I don't think the TARP turned out to be. I do think it is important to recognize that the Federal Reserve was the single-most effective response to the financial crisis. It essentially followed the oldest central bank's playbook and was remarkably creative in lending against any reasonable collateral and flooding markets with liquidity.

That has always been the recipe in a financial crisis. They did it again, and the speed with which financial markets recovered is a tribute, I think, primarily to that response.

Mr. CLEAVER. Since that legislation was passed, how many nonbanks have been designated as SIFIs?

Mr. HOLTZ-EAKIN. There have been a total of four.

Mr. CLEAVER. Like one, two, three, four?

Mr. HOLTZ-EAKIN. Yes.

Mr. CLEAVER. Yes. This is just amazing.

Mr. Zaring, can you explain why—we are talking about this traffic light, getting a ticket for speeding. What is—

Mr. ZARING. I agree with you, there is no sense that the Council is going rogue here, with only 4 designations in 6 years of existence. And then, of course, it rescinded one of those designations.

And the reason I don't think a traffic light camera is an apposite is precisely for the reason that Dr. Holtz-Eakin suggested. This Financial Stability Oversight Council occupies a precautionary role in American regulation, because we do not know where the next financial crisis will emerge from.

But we do know that the downside risk, as you have just stated, Congressman Cleaver, is extremely high and extremely serious. It makes sense to create an institution that can take precautionary approaches to the possibility of that extreme downside risk coming in some way that we don't precisely know will occur.

And that is what FSOC does. The fact that financial crises are not reducible to some sort of arcane or particular mechanical measure, it seems to me, is a good reason to have a regulator to take the broad view that FSOC has.

Mr. CLEAVER. Thank you.

Mr. Kupiec, if you re-thought your analogy, would you rather have a flashing yellow light?

Mr. KUPIEC. No, sir, I think my analogy is completely apt, and I would say that the FSOC has done nothing on regulation. They have designated four firms. The Federal Reserve Board has not promulgated any regulation specially for insurance companies. And I fail to see how anybody would argue that just merely designating four firms has made the world safer against a financial crisis.

As far as I can tell, they have done nothing. The costs caused G.E. Capital to jettison what had been a very profitable line of business over many years. I don't see why destroying a profitable, well-run firm and making it split apart is a success. I would disagree with all those things that were said.

Chairwoman WAGNER. The gentleman's time has expired.

The Chair now recognizes the gentlelady from New York, Ms. Tenney, for 5 minutes.

Ms. TENNEY. Thank you, Chairwoman Wagner.

And I thank the panel for being here today on this very important issue.

You have heard from my colleagues about the inconsistent, arbitrary designation of SIFIs. And for the record, I just want to say that a systemically important financial institutions because it just sounds so vague and bureaucratic. And I think that instead of saying SIFI and FSOC, I think we need to let the public know just exactly the nature of the vagueness, but the costs associated and increased burdens that are involved.

I would like to touch on a couple of off-ramp strategies specifically for the non-banks, systemically important financial institutions, I have to get it all out there.

Dr. Holtz-Eakin, in your testimony you pointed out that FSOC/ Financial Oversight Stability Council, another vague title, only designated insurance companies as non-bank SIFIs and you believe they provide no additional financial stability.

FSOC has made it their mission to identify threats to America's financial stability. But when they are blindly designating companies based solely upon inconsistent and arbitrary standards, that is a clear indication of poor structure and management in the non-bank SIFI destination process. Again, more vagueness.

I think you make a fair argument by calling for the removal of FSOC's authority to regulate those non-bank financial institutions because these companies are already being heavily regulated at the State level. And I can speak for that as a former State assembly member who actually voted "no" on the consolidation of the banking and insurance agencies into one financial services agency in the State of New York, which has just caused more regulation and just evidence of the incredible oversight and regulation that we already have in New York State.

But let me add that FSOC has been criticized for failing to provide clear standards, again, we are back at vagueness, for de-designation and for failing to provide affected companies with a clear path or exit ramp of actions the company could take to take to change its business to get the designation removed.

So let me address my first question to Dr. Kupiec. If there is no clear standard for designation, how can there be a clear standard for de-designation? Or to put the question another way, does the fact that FSOC cannot clearly state what will lead to de-designation mean that the entire designation process is arbitrary?

Mr. KUPIEC. I think that is an accurate statement. To the best of my knowledge, the FSOC does not give the designated firms clear guidance on what they would have to do to not be a SIFI. The designation documents themselves paint a very arbitrary and fictional story about how the FSOC gets into trouble.

There is no way that you can, based on those stories and narratives, decide how you would change your business to escape that narrative. So I think it is very, very true that there is no off-ramp, no specific off-ramp. G.E. negotiated one somehow over time, took a very drastic step by getting out of the financial services industry entirely. The FSOC couldn't regulate it anymore. It fell below the 85 percent threshold.

So it wasn't like the FSOC did something, G.E. did it. They got out of the financial services business period. And the FSOC fell below the 85 percent threshold. And the FSOC couldn't designate it anymore. So I wouldn't say that was a great day in the FSOC history where they de-designated a firm. The firm did it themselves and it was very costly and painful.

Ms. TENNEY. Thank you.

Let me follow that up. So would you then say that the—do you trust that FSOC has been fair in evaluating the de-designation process?

Mr. KUPIEC. No.

Ms. TENNEY. Evaluating companies in the de-designation process.

Mr. KUPIEC. I think the subcommittee report does a very big service to the public by making public the decision process for the stage two non-designation decisions which you couldn't know without the committee getting ahold of those documents, and even with the very heavily redacted discussion of it we can tell that the FSOC makes up a story and an ad hoc analysis for each firm on any given day. And then they are never consistent and there is no set standard that they follow.

Ms. TENNEY. Thank you.

Dr. Hultz-Eakin, do you agree that we would have to have a complete overhaul of the SIFI process or designating process?

Mr. HOLTZ-EAKIN. I very much do.

Ms. TENNEY. Okay.

Mr. HOLTZ-EAKIN. From the sort of arbitrariness of the analysis from firm to firm, from the ignoring of the experts in the insurance business during the designation of insurance companies, and from, I want to emphasize, the point that Dr. Pollock made at the outset, which is, how can you not at least look at Fannie Mae and Freddie Mac, which are the living, breathing definition of dangerous financial institutions and have proven it through time?

Chairwoman WAGNER. The gentlelady's time has expired.

Ms. TENNEY. Thank you very much. I appreciate it.

Chairwoman WAGNER. The Chair now recognizes the ranking member of the full Financial Services Committee, the gentlelady from California, Ms. Waters, for 5 minutes.

Ms. WATERS. Thank you very much, Madam Chairwoman.

And I thank the panelists for being here today.

One of the main arguments that opponents of the FSOC make is that it simply has too much power, and Congress, through Dodd-Frank, has given the agency unlimited authority to determine which non-bank institutions are systemically important. However, directly included in Dodd-Frank are 10 specific factors that the FSOC must consider prior to designating a firm as systemically important.

Can you discuss—and this is for Professor Zaring—these factors and how they serve as a check on FSOC's ability to declare any institution a SIFI?

Mr. ZARING. That is right. The factors that Congress gave it give it some flexibility, but also some instruction as to how it is supposed to make particular designation decisions. And, of course, FSOC can only designate companies that qualify as financial companies. It can only designate them upon a super-majority vote. And it can only designate them after going through this three-stage process at which the companies have time to respond.

FSOC has to find that a firm could pose a threat to the financial stability of the United States, either in the event of material financial distress or due to the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities. Those factors and the other ones that it has considered are guidance to FSOC as to what it should consider. And I don't think it means that FSOC is arbitrarily applying that guidance if they emphasize some factors over other factors when it comes to figuring out whether a particular institution poses a great deal of downside risk.

Ms. WATERS. So this discussion about being arbitrary with unlimited authority just does not ring true, based on the fact that there are these 10 specific factors that you just helped to explain.

Now, doesn't the fact that the FSOC has only designated four non-banks as SIFIs since 2010 confirm that the FSOC is not arbitrarily imposing SIFI designations on all non-bank financial firms, but instead acting responsibly to protect taxpayers and our financial system from another devastating financial crisis, Mr. Zaring?

Mr. ZARING. I agree, Congresswoman. I very much agree with that. FSOC has not designated any more than four institutions. It has only designated four institutions. And those designations, once again, made a great deal of sense. They were the three largest insurance companies in the United States, including AIG, which was the insurance company that collapsed during the financial crisis necessitating a massive and painful bailout. And if that is not systemically risky, then I am not sure what is.

And then the final company that was designated was G.E. And as we have discussed earlier, G.E. was poorly regulated by any other regulator, was engaged in many different markets, had a real risk of runnable financing that creates systemic risk; at the very least, we know that. And so it was accordingly designated and changed its business accordingly.

So I think that FSOC is being cautious in its designation power use. It is being clear about the kinds of things it is worried about. It only hasn't tried to create some sort of a standard which informs some non-bank financial institutions that they will never be designated, thereby encouraging them to take on systemic risk after they get a free pass.

Ms. WATERS. This may not be a fair question, but why is it opponents of FSOC have forgotten the lessons of AIG? Can you speculate on that?

Mr. ZARING. To me, it is a real concern. AIG had a AAA credit rating. And it is not that their regulators were the only people to miss its riskiness, so were its investors, its managers, and the broader capital markets as a whole. So the idea that we can rely on the free market, to the extent that one exists in financial services to begin with, to uncover risks like AIG, I think is naive.

What AIG did, in addition to its runnable securities-lending business, was get involved in a new industry or a new business, writing credit default swaps where it didn't understand the risks posed in that business. That is the kind of thing that a regulator is supposed to be able to step in and caution a firm that it should pay attention to. And I think that forgetting the lessons of AIG is unwise to the extreme.

Ms. WATERS. Thank you very much.

And I yield back the balance of my time.

Chairwoman WAGNER. The gentlelady yields back.

The Chair now recognizes the gentleman from Michigan, Mr. Trott, for 5 minutes.

Mr. TROTT. Thank you, Chairwoman Wagner.

And I thank the panel for being here.

Professor Zaring, so what happened in the MetLife case? You have been singing the praises of FSOC all morning and what happened there? Is it just some rogue judge who doesn't understand, or what happened there?

Mr. ZARING. I disagree with the judge's decision in that case. And I think in that case, the judge made a decision to require FSOC to conduct a cost-benefit analysis that is plainly not required by the language of the statute and that doesn't really make sense for FSOC as a whole. And here is why. I will be brief, I know you have more questions.

But the costs of designation, and that is something that is pretty easy to calculate, but the benefit of designation is the goal is to avoid a financial crisis or a calamity. It is really difficult to quantify that, though it is a real benefit. So FSOC does apply a cost-benefit analysis, but it doesn't apply a quantified one in the way that the judge seemed to prefer, and I disagree with that imposition.

Mr. TROTT. You have testified this morning that you are really not in favor of any kind of transparency, that you don't feel they need to disclose their decision-making criteria, and you are fine with FSOC exercising broad discretion and authority basically shrouded in secrecy. So let me ask you this question, have you ever run a business?

Mr. ZARING. I have not.

Mr. TROTT. Have you ever been accountable to shareholders? You were in the Justice Department, and you have been in academia, but you have never run a large corporation, correct?

Mr. ZARING. That is for sure.

Mr. TROTT. How would these corporations expect to proceed? And the hypocrisy of this whole thing is illustrated from the deposition testimony of Patrick Pinschmidt, who is the executive director. And they are asking about the different criteria that he looks at in terms of designating a SIFI. And in his answer, he says, "Again, I am sort of doing this on the fly, here. The paragraph above acknowledges that obviously, if something bad were to happen to this particular company, that would probably be factors that would impact all other companies in the same industry."

Boy, that is just clear as mud, isn't it? That is his answer on his criteria when he looks at an industry.

Mr. ZARING. All I will say is corporations and government agencies don't have to disclose their internal deliberations. The key question is, what is the decision you make, and is there a basis for the decision that is made? FSOC provides that to any designated institution.

It is definitely the case that the members of FSOC, because of their expertise and because of the factors that have been given it from Congress, can come to their own conclusions about what counts as too risky and appropriate for designation and not risky enough.

Mr. TROTT. And those conclusions, you don't believe, can be arbitrary, right? They are always well-reasoned and there is no chance of any kind of arbitrary outcome that provides for a disparate impact on companies within the same industry.

Mr. ZARING. I think the best way to measure the arbitrariness of any designation decision is to look at the basis for the decision that FSOC supplies and in the four cases where it has made a designation, that basis hasn't looked at all arbitrary to me.

Mr. TROTT. Can you understand some of our concern here? And let me know if you disagree with any of the following premises. We are dealing with bureaucrats who yearn to be relevant because that is how they keep a job. We are dealing with unelected bureaucrats. We are dealing with bureaucrats who really have no budget. We are dealing with the Department of Justice that has no litigation budget when they decide to fight. And it is also hard to fight the government.

So can you sort of understand? And maybe you don't accept any of those statements, but if you accept any of them, can you sort of understand why this designation process gives us pause?

Mr. ZARING. I worry about bureaucrats not making sensible decisions, but that is why I think that they have to be in a position to explain those decisions. And I think that FSOC has done that in this case.

Mr. TROTT. Speaking of explaining their decisions, in our report we said that since they don't follow their own rules and guidance in most multiple ways, Dr. Kupiec, the concern is that they treat the companies in the same industry differently. Do you think that is a risk of the way they are currently preceding?

Mr. KUPIEC. I think the evidence that the subcommittee found in terms of second-stage designations exactly goes to that point, where they found that collateral, in some cases, was treated as a positive, as a risk mitigant. And in other cases, collateral was the worst thing that could ever happen, it was going to cause the end of the world.

So, yes, they looked at the same phenomenon for two different firms and came to exactly opposite conclusions. I think this is my story of the two tall firms.

Mr. TROTT. When I was in business, all I wanted to know was, tell me what the rules are and treat everyone the same and let us go get about our business and see if we can make money. And those two factors don't seem to be in play.

Mr. Pollock, one quick question, my time is running out. Professor Zaring is not concerned about the cost of compliance. Can you just speak briefly to the effect that has on the stock price and reputational risk and cost of compliance and the overall effect on the economy?

Mr. POLLOCK. I think, Congressman, you are right about all of those. Clearly, the cost of compliance is substantial and affects value. We are looking here at these arbitrary decisions and I would just like to repeat, the biggest arbitrary decision of the FSOC was not to look at the biggest, most obvious SIFIs in the country, which are Fannie Mae and Freddie Mac. They get a free pass. It is unbelievable. It is, in my opinion, a purely political decision of the previous Administration.

Chairwoman WAGNER. The gentleman's time has expired.

Mr. TROTT. Thank you.

Chairwoman WAGNER. The Chair now recognizes the gentleman from Indiana, Mr. Hollingsworth, for 5 minutes.

Mr. HOLLINGSWORTH. Good morning. Thanks so much for all of you being here.

Mr. Pollock, you continue to bring up something that disturbs me as well. When I think about systemic risk, I think about those things that are risks to the entire system itself. And what I keep coming back to is the world's largest debtor, the world's largest balance sheet are all held by institutions of this government. And I want to make sure that we are not creating adverse incentives and creating more systemic risk by government policy itself.

Can you talk a little about maybe instead of, as my colleagues continue to say, that it is lack of regulation that created the financial crisis, instead maybe it is this distortion that is caused by government getting involved in markets. And now here we are talking about even more distortion and even unclear, unaccountable distortion.

Mr. POLLOCK. Congressman, I think that is absolutely right. There is no doubt that a very important part of the crisis was what the government did itself in the way of promoting credit, expanding credit, driving up housing prices and, in general, inflating the bubble. Many parts of the government were involved in that, but, of course, in particular, Fannie Mae and Freddie Mac, pushing on credit and pushing up house prices.

I say in my testimony that there are two overwhelming factors in systemic risk. One is highly leveraged real estate and the other is the moral hazard created by government credit policy and government implicit or explicit guarantees. Fannie Mae and Freddie Mac are that to the max, but somehow they are not SIFIs.

Mr. HOLLINGSWORTH. Right. Do you think that we have taken adequate steps thus far to remove some of those misaligned incentives or other challenges that are created in the market through the efforts that have been undertaken in the last 7 or 8 years?

Mr. POLLOCK. No, Congressman, I don't. As a matter of fact, one of the biggest problems with FSOC's being even able to think about systemic risk is it has to think about systemic risk created by the government.

Mr. HOLLINGSWORTH. Right.

Mr. POLLOCK. If you want a body to think about the massive systemic risk created by the government itself, you need a different body than FSOC.

Mr. HOLLINGSWORTH. An independent body?

Mr. POLLOCK. Yes.

Mr. HOLLINGSWORTH. Something that would be able to look at all the participants, not just the private participants and the issues created there?

Mr. POLLOCK. Yes, I think so.

Mr. HOLLINGSWORTH. Yes.

And then the second thing I wanted to talk about a little bit is some of the costs around this gray-area regulation. And maybe this goes to Dr. Holtz-Eakin.

I used to deal with a lot of contractors. And I knew one thing for sure, when I handed out a scope of work that was incomplete or unclear in any way, I knew I was going to get a wider bid because they would protect themselves. They wanted to stay further away from the line. The more exact the rules of the game were, the further they could go in getting to that line.

And so it is not just the immediate costs of compliance, but it is the cost of not knowing and wanting to stay further back and wanting to curtail business activities that might or might not be viewed by FSOC as problematic.

Can you talk a little bit about, in your view, how not only the idea of FSOC being there, but the lack of clarity around it is creating this gray area that companies are being forced to operate in and how that might incur more costs than we even know?

Mr. HOLTZ-EAKIN. I think that is a real issue. One of the things we do at the American Action Forum is we actually add up the self-reported compliance costs that agencies put to regulations. And so over the past 8 years, it was $800 billion. That is what they estimate it to cost businesses to comply.

Mr. HOLLINGSWORTH. Yes.

Mr. HOLTZ-EAKIN. And as you point out, that is the easy part. You actually know what you have to do there, fill out paperwork and things. It is the business decisions that are affected that are the genuine economic costs, whether they are capital expansions you don't undertake because you don't want to grow and get too big and become a target, you don't hire, whatever it may be, those are genuine losses. And once the designations are made, you now have different firms being treated differently in the same industry and you don't have a single set of rules and you don't have a fair competition.

Mr. HOLLINGSWORTH. Yes. One of the big things that I have consistently pushed is, by more and more regulation, especially more and more regulation from a variety of regulators, we continue to herd companies in the financial services sector into one corner. We continue to push companies that do and have the same portfolios and same exposures because that is what we want them to have.

But we should be darn sure if we are doing that, that they are the exposures we want them to have because systematic risk is really about dominoes toppling over. And the more these firms look like each other because regulators have forced them to look like each other, the more easily issues migrate from one firm to another.

So I would just like maybe you, Dr. Holtz-Eakin, and Mr. Pollock, to comment on that.

Mr. HOLTZ-EAKIN. It is a huge irony because the basic lesson of finance is to diversify.

Mr. HOLLINGSWORTH. Correct.

Mr. HOLTZ-EAKIN. And that is a very undiversified view of the universe.

Mr. HOLLINGSWORTH. Yes.

Mr. Pollock?

Mr. POLLOCK. I think that is a great example of systemic risk created by government regulation, Congressman. An excellent example.

Mr. HOLLINGSWORTH. Right. And so my concern, again, is, as we herd these into a corner, we are going to find that the risk really comes from something we didn't expect, and then we have perfectly lined up all the dominoes ensuring that one is transmitted to the other, whether that is through mark to market accounting because they all hold the same portfolio securities, et cetera.

So thank you for your time this morning.

I yield back to the Chair.

Chairwoman WAGNER. The gentleman yields back.

The Chair now recognizes the distinguished ranking member of the subcommittee, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Madam Chairwoman.

Let's start with Mr. Zaring. Mr. Zaring, let's talk about this cost of compliance and juxtapose it to the cost of not finding another AIG. Could you give us some intelligence on this, please?

Mr. ZARING. The costs of compliance with financial regulation to make financial institutions safe and sound are real, but the benefits are much more real, in my view. And what FSOC is doing with its limited designation so far is, in my view, looking around at firms where, if there was a collapse, their collapse would likely break down the rest of the financial sector in potentially unpredictable ways, and making sure that those institutions are adequately regulated.

It is hard to know just how much of a benefit an avoided financial crisis is, but I think we can all presume that benefit is extremely high, very large, and very difficult to quantify.

Mr. GREEN. If FSOC, which is the economic disaster prevention agency, had had the opportunity to examine AIG with the cost-benefit analysis, would it be such that it would have been beneficial to find out what AIG was doing and see it as systemically important?

Mr. ZARING. One of the advantages of FSOC is that it brings together every financial regulator in the government, including the newly created Federal Insurance Office and an insurance representative.

The ability of all of those regulators to take a look, not just at some aspect of AIG, its thrift business or some other financial activities in a particular place, but all aspects of the business, make it more likely that the regulators would have realized that AIG was writing credit default swaps in a relatively unhedged manner.

And we don't know what would have happened. But we do know that AIG was a business failure and was never scrutinized holistically by regulators in the way that FSOC promises to do.

Mr. GREEN. You make a good point, and I would like for you to elaborate on it for just a moment, because there is a contention that there are other prudential regulators that would find these flaws in the system.

But it didn't happen with AIG and it didn't happen with Bear Stearns. It didn't happen with Countrywide. It didn't happen with a whole host of financial industry entities. Would you elaborate, please?

Mr. ZARING. That is right. And one of the things that a designation is supposed to do is increase capital, which is one way of making sure that these institutions are prepared for a shock, even a shock that comes from somewhere surprising.

But for the AIG story, the idea that the Office of Thrift Supervision in overseeing its, I think, New York's chartered savings and loan, which was a very small part of what AIG did, was supposed to catch what was going on in London is, I think, naive.

But on the other hand, if you get a team of rivals and a group of regulators together in a room, to the extent that they are rivals, you make catching that kind of new and creative financial businesses all the more likely.

Mr. GREEN. Let's talk about proprietary information. Does that have something to do with releasing information with reference to an evaluation?

Mr. ZARING. I don't think that the institutions that the Council has considered and carefully considered would want all of the information that they provide the Council in discussing and indeed sometimes contesting their designations to be released to the public and to their competitors and to the financial marketplace, more generally.

Some of the things that FSOC does that some of the witnesses here seem to believe are sort of secret are the kinds of secrets that businesses want the government to keep. And I think it is responsible for FSOC to keep those secrets for the businesses they are reviewing.

Mr. GREEN. Speaking of keeping secrets, there is a desire on behalf of some to have Congresspersons in the room when these deliberations are taking place. Is that going to be beneficial to secrecy, and how do you think that will impact the process?

Mr. ZARING. No, I don't think agencies or businesses benefit from having their deliberations, internal deliberations before a decision is rendered, being open for nitpicking or after the fact. It is, at worst, Monday-morning quarterbacking. What you should do is evaluate the decision and expect that decision to be carefully articulated.

Mr. GREEN. I yield back.

Chairwoman WAGNER. The gentleman yields back.

The Chair now recognizes the gentleman from Florida, Mr. Ross, for 5 minutes.

Mr. ROSS. I thank the chairwoman.

Interesting, of the four non-bank financial institutions, three, of course, were insurance companies and we have discussed today through your testimony that although there may not be that great at transparency and there might not be the best, well, rules in place in order to assess the vulnerability, there are experts. FSOC has experts.

And yet, in the assessment of the SIFI designations, there are two experts, one a voting member in the insurance industry or arena, and two a nonvoting member, both of whom were ignored by the designations with regard to whether these insurance companies should be considered a SIFI.

Now, Dr. Holtz-Eakin, was there any discussion in this FSOC's determination as to whether these insurance companies were not properly regulated by their State insurance regulators?

Mr. HOLTZ-EAKIN. No, they didn't take that adequately into consideration.

Mr. ROSS. And do we not have the best form of regulation, by way of our State regulators, of any other system in the world?

Mr. HOLTZ-EAKIN. The insurance system has proven to be very well-regulated and it is also true that these same institutions are regulated in other countries where they do business. There is an enormous amount of regulatory oversight already prior to designation.

Mr. ROSS. And I guess my point is, is this not, this action by the FSOC of designating these three insurance companies, is it not an indictment of the State-regulated base form of insurance regulation that we have in this country?

Mr. HOLTZ-EAKIN. It is a mystery to me what the Federal Reserve believes it will know that a consolidated regulator in New Jersey, for example, doesn't already know about the operations in these insurance companies.

Mr. ROSS. And wouldn't you say that if we are going to go this route and allow for FSOC to ignore its experts and indict a State-based system of insurance regulation that we are essentially setting up possibly a two-tiered system, one of which that once you are designated, you are going to have increased regulation, and would that not impact the free market of insurance sale?

Mr. HOLTZ-EAKIN. I have mentioned this several times. I am very worried about the fact that we are going to end up with an uneven playing field in financial services markets if we continue down this path.

Mr. ROSS. And who is going to get hurt the most?

Mr. HOLTZ-EAKIN. The consumer.

Mr. ROSS. The consumers are. And so, has there ever been a run on an insurance company in the history of the United States?

Mr. HOLTZ-EAKIN. No. One of the mysteries of this designation has been ignoring the history of successful regulation of insurance companies and also the use of scenarios which are completely unrealistic for that insurance business.

Mr. ROSS. Dr. Kupiec, risk-based capital is used to assess the systemically important nature of an insurance company. Would you agree that there is no reason to deviate from the State-based system that we have today, where we have never seen a run on an insurance company, where a whole different method of assessment and analysis of your risk is used as opposed to financial institutions?

Mr. KUPIEC. I don't think insurance merits a SIFI designation. I think AIG was a special case.

Mr. ROSS. It was a special case. There wasn't even a regulator then at the time.

Mr. KUPIEC. And I think—

Mr. ROSS. So let me ask you this, Dr. Kupiec, because you hit on it with General Electric. Now, we have discussed also the designation. And it is like going to the doctor, you are sick, but we are not going to tell you why you are sick or how you got sick or how you can get better, but we will let you know when you are dead. It's the same way with SIFI designation.

We tell you you are now designated, but we don't tell you how to get off. Where is the exit ramp? And it appears to me that the only exit ramp that we have been able to see in this regard has been the total sell-off like they did with G.E. Capital. Is that a fundamentally good method of having an off-ramp, not only for the business, but also the consumer?

Mr. KUPIEC. No, I think if you think about my analogy, you are a well-run, growing company, this becomes a penalty for well-run, growing companies, that you might become the object of an FSOC stage-three review. You have no idea why. You get good marks from all your—

Mr. ROSS. You get no answers. You don't know why you are there, but you know that you are being investigated and you have an obligation to your shareholders as well as your consumers. And so what you do? You divest yourself from that particular operation. That is the off-ramp.

Mr. KUPIEC. One firm did that. Whether the insurance companies, which are—G.E. Capital was part of G.E., which has non-financial parts to it. Whether an insurance company can actually divest its way out of this is maybe a bridge too far.

Mr. ROSS. At least one went to court and was successful. And I think one insurance company went to court and was successful, MetLife. And I think that what we have to do is we have to be able to allow for not only the review, but also the ability to be de-designated, the ability to have the off-ramp.

And I see my time is up, so I yield back.

Chairwoman WAGNER. The gentleman yields back.

I would like to thank our witnesses again for their testimony today.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is now adjourned.

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

APPENDIX

March 28, 2017

The Arbitrary and Inconsistent Non-Bank SIFI Designation Process

United States House of Representatives

Committee on Financial Services

Oversight and Investigations Subcommittee

Douglas Holtz-Eakin, President*

American Action Forum

March 28, 2017

*I thank Meghan Milloy for her assistance. The views expressed here are my own and not those of the American Action Forum.

Chairman Wagner, Ranking Member Green, and members of the Subcommittee, thank you for the opportunity to appear today and share my views on the Financial Stability Oversight Council's (FSOC) non-bank designation process. And thank you for your work on the report released earlier this month. I've found it useful in highlighting and explaining both the procedural and substantive problems with FSOC.

FSOC's mission is to identify, monitor, and address threats to America's financial stability. Yet, the current process by which non-bank financial companies are designated as systemically important financial institutions (SIFIs) and the heightened oversight and regulation they fall subject to thereafter, is inherently flawed and risks losing the confidence of the public and policymakers and burdening the economy without any notable benefits. In my testimony, I wish to make three main points:

- FSOC's process, inconsistent or not, has prioritized designation and regulation of institutions, often arbitrarily, over the identification of activities that pose systemic threats and has done so in a fundamentally flawed manner. I applaud the Subcommittee for making a critical investigation into this process and all its implications.

- Designating a non-bank financial institution as a SIFI is consequential for both the institutions and the institutions' customers. Those consequences include, but are not limited to, decreased international competitiveness for American companies in the international market and increased costs with decreased benefits for consumers.

- Thus far only insurance companies have been designated as non-bank SIFIs. A good argument can be made for removing FSOC's authority to regulate those non-bank financial companies, as these companies are already being regulated at the state level. The increased burdens from FSOC's oversight are unnecessary and provide no additional financial stability.

Let me expand on each in turn.

FSOC's designation process was authorized by Dodd-Frank. Title I, Subtitle A, of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) established FSOC, outlined the Council's powers, and introduced factors that must be considered when designating NBFCs as SIFIs. Because banking companies with over $50 billion in assets are automatically considered SIFIs in the Dodd-Frank Act, key issues involving designation revolve around non-banks.

Specifically, Section 113 of the Dodd-Frank Act gives FSOC the authority by two-thirds vote (including the chairperson) to bring a NBFC under increased supervision and regulation by the Federal Reserve Board (FRB) if the Council determines that "material financial distress at the U.S. non-bank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. non-bank financial company, could pose a threat to the financial stability of the United States."[1] In making that determination, the Dodd-

[1] 12 U.S.C. § 5323 (a)(1).

Frank Act lists ten criteria for FSOC to consider along with "any other risk-related factors that the Council deems appropriate."[2] Given that, FSOC has broad authority statutorily when evaluating companies for SIFI designation. In April 2012, FSOC released a final rule and interpretive guidance on the process it uses to designate SIFIs.[3] The Council recently voted to supplement that process during its February 2015 meeting following an internal review and input from the public and stakeholders.[4]

The three-stage evaluation process FSOC developed is intended to narrow the pool of companies potentially subject to designation by applying specific thresholds based on 11 criteria included in Section 113 of the Dodd-Frank Act. The 11 criteria have been incorporated into six overarching framework categories that FSOC considers: (1) size, (2) interconnectedness, (3) leverage, (4) substitutability, (5) liquidity risk and maturity mismatch and (6) existing regulatory scrutiny.

Table 1 highlights how thresholds in these categories are applied and how scrutiny increases as a company advances through each stage. However, in practice, it is not clear the weight given to certain factors over others or what makes a designation more likely.

TABLE 1. FSOC DESIGNATION PROCESS
STAGE 1: APPLY QUANTITATIVE THRESHOLDS A NBFC moves on to Stage 2 if it has: (1) $50 billion in total consolidated assets, and (2) One of the following: • $30 billion in gross notational credit default swaps outstanding for which a NBFC is the reference entity; • $3.5 billion of derivative liabilities; • $20 billion in total debt outstanding; • 15 to 1 leverage ratio of total consolidated assets (excluding separate accounts) to total equity; or • 10 percent short-term debt ratio of total debt outstanding with a maturity of less than 12 months of total consolidated assets (excluding separate accounts). Note: FSOC reserves the right to "evaluate any NBFC based on other firm-specific qualitative or quantitative factors, irrespective of whether such company meets the thresholds."[5]
STAGE 2: QUANTITATIVE & QUALITATIVE ANALYSIS In further detail, FSOC applies its six-category framework: • Size • Leverage • Interconnectedness • Liquidity Risk & Maturity Mismatch • Substitutability • Existing Regulatory Scrutiny The Council evaluates the risk profile and characteristics of each NBFC using industry- and company-specific factors, with company information being gathered from existing regulators and public sources as well as information submitted voluntarily by companies under consideration.
STAGE 3: IN-DEPTH ANALYSIS OF COMPANY With previously amassed information, FSOC performs an in-depth analysis of the company based on the six-category framework. Through OFR, FSOC further collects confidential data obtained from the firm to incorporate in its analysis.

[2] 12 U.S.C. § 5323 (a)(2)(K).

[3] "Authority To Require Supervision and Regulation of Certain Non-bank Financial Companies; Final Rule and Interpretive Guidance," 77 Federal Register 70 (April 11, 2012) pp. 21637-21662; https://federalregister.gov/a/2012-8627.

[4] FSOC, "Supplemental Procedures Relating to Non-bank Financial Company Determinations," (February 4, 2015); http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental Procedures Related to Non-bank Financial Company Determinations – February 2015.pdf.

[5] "Authority To Require Supervision and Regulation of Certain Non-bank Financial Companies; Final Rule and Interpretative Guidance," 77 Federal Register 70 (April 11, 2012) pg. 21661; https://federalregister.gov/a/2012-8627.

Table 2 includes a summary of all changes adopted in 2015, many of which attempt to address the need for increased transparency and communication. Items shaded in gray are substantially similar to reforms previously highlighted in past work by the American Action Forum.[678]

TABLE 2. SUMMARY OF FSOC'S SUPPLEMENTAL PROCEDURES ADOPTED IN FEBRUARY 2015
CATEGORY 1: ENGAGEMENT WITH COMPANIES UNDER CONSIDERATION BY FSOC (IN STAGES 2 & 3)
• Company to be notified in Stage 2 when it comes under active review
• Company in Stage 2 has the opportunity to submit relevant information to the Council and meet with FSOC staff
• When requested, FSOC staff should provide a company under consideration with a list of the public sources of information from which FSOC derives its decision
• Company notified in writing if it is not advanced to Stage 3 (though FSOC reserves the reconsider the company again in the future)
• Staff would meet with a companies' representatives at the start of Stage 3 to explain the evaluation process, framework for analysis, and specific activities and operations viewed by FSOC staff as the primary focus of their Stage 2 evaluation
• FSOC will explain the purpose of requested information in Stage 3 in relation to the risks being analyzed
• Companies can continue to submit material they deem relevant and request meetings with FSOC staff during Stage 3
• FSOC intends to grant hearing requests from companies subject to a proposed designation
• FSOC will engage with a company's primary financial regulatory, including notifying the regulator when a company comes under active review in Stage 2 and beginning the consultation process before any vote to advance a company to Stage 3
CATEGORY 2: THE ANNUAL REEVALUATION OF DESIGNATED COMPANIES
• Designated company is given the opportunity to meet with FSOC staff prior to annual reevaluation of its designation, discuss scope and process of review, and present them with any relevant information that could change the need for a systemically important determination
• FSOC will issue an explanation of its decision (addressing the company's objections) to maintain a systemically important designation if a company contests following its annual reevaluation, and inform the company, its primary regulator, and the primary regulator of its significant subsidiaries
• FSOC will provide a company subject to determination the opportunity for an oral hearing once every five years to contest its designation
CATEGORY 3: TRANSPARENCY TO THE BROADER PUBLIC REGARDING THE DESIGNATION PROCESS
• If a company publicly announces it is in active review in Stage 2 or 3, FSOC will confirm it upon request
• FSOC will include more public information on the bases of its designations
• FSOC will publish more information during its annual report including the number of nonbanks FSOC voted to move or not move on to Stage 3, became subject to a proposed or final determination, and the aggregate number of companies subject to a final determination
• FSOC will publish further detail on how the Stage 1 thresholds are calculated

Even if FSOC were following the rules and designating NBFCs fairly, consistently and with good reason (which the Committee's report suggests in not always the case), the process FSOC has developed to designate NBFCs as SIFIs can disrupt markets and impose unnecessary regulatory burdens and costs that outweigh its benefits to the economy. So despite slight improvements made two years ago, FSOC's process is still fatally flawed (as I have testified

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[6] Satya Thallam, "Reform Principles for FSOC Designation Process," (November 11, 2014) http://americanactionforum.org/research/reform-principles-for-fsoc-designation-process.
[7] Scott Harrington, "Systemic Risk and Regulation: The Misguided Case of Insurance SIFIs," (September 20, 2016) https://www.americanactionforum.org/research/systemic-risk-regulation-misguided-case-insurance-sifis/.
[8] Meghan Milloy, "Congress: FSOC is 'Arbitrary and Inconsistent'," (March 23, 2017) https://www.americanactionforum.org/insight/congress-fsoc-arbitrary-inconsistent/.

before the House Committee on Financial Services previously).[9] The fact that FSOC is using its considerable power with little to no uniformity and reason to designate NBFCs, putting them and their customers at risk of serious financial consequence, is reason to doubt whether FSOC should be able to designate NBCFs at all. It is important to take a look at exactly what those consequences entail.

AAF has noted that FSOC's regulatory designation "imposes direct costs and risk on the designated institutions. The magnitude of the costs is uncertain, especially given that the specific rules and capital requirements have largely yet to be determined, but it cannot be presumed negligible." More worrisome is the fact that FSOC's "two-tiered system will alter competitive dynamics in the insurance sector...Other things being equal, the increased costs of enhanced supervision will reduce their ability to compete effectively, plausibly shifting some amount of business and risk to entities not subject to the additional level of regulation, and destabilizing rather than stabilizing the market. Large banks who compete with each other are all under the same regulatory umbrellas." Such is not the case with FSOC-designated SIFIs.[10]

The arbitrary and inconsistent designations should also raise questions of regulatory scale, scope, and overreach. At a very basic level, it should be obvious that FSOC's decisions to regulate insurers, capricious or not, disregard the role that state regulators already play in overseeing insurance companies. As Scott Harrington wrote in a paper for AAF,[11] "[FSOC] largely ignores the historical solvency record, pays little attention to the history of improvements in solvency regulation, and dismisses states' ability to issue stays on policyholder withdrawals because doing so 'could' undermine financial stability during an unspecified crisis. The treatment reflects the notion that the lack of a true consolidated regulator at the state level trumps any argument for the effectiveness of state regulation, including changes in response to the crisis."

Similarly, given FSOC's failure to perform a basic cost benefit analysis, it failed to consider even the costs of its macroprudential regulation to consumers of those companies' products. In a 2013 report[12], Oliver Wyman explains how FSOC's heightened capital requirements on insurance companies result in increased costs to consumers. The report shows that designated insurers will reduce their capacity or exit the market entirely, leaving the remaining insurers to increase their prices. And in markets with higher barriers to entry with a high market share by the designated insurers, the ability for the undesignated insurers is even greater, leaving consumers with significantly increased costs for the same or fewer

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[9] Douglas Holtz-Eakin, "FSOC Accountability: Non-bank Designations," (March 25, 2015) http://americanactionforum.aaf.rededge.com/uploads/files/insights/sbc_testimony_on_fsoc_final.pdf.
[10] id. at Note 8.
[11] id. at Note 7.
[12] Oliver Wyman, "The Consumer Impact of Higher Capital Requirements on Insurance Products," (April 10, 2013) http://www.responsibleregulation.com/wpcontent/uploads/2013/05/Pricing-impact-study-Oliver-Wyman-April-10-2013.pdf.

benefits. Specifically, the report shows that the annual consumer cost of designating a NBFC as a SIFI could range from $5 billion to $8 billion.

Recommendations and Conclusion

The first obvious fix for FSOC is greater transparency and accountability. FSOC simply cannot continue to arbitrarily designate companies without consequence. Aside from that, the alternative and better approach to developing enhanced supervision to mitigate systemic risk is not to designate specific companies as systemically risky. Rather it is to focus on the underlying activities in different sectors that could lead to systemic risk. If there is sufficient evidence to show that an activity is creating systemic risk without adequate regulatory constraints, then this approach would lead to the development of new regulations governing the activities throughout a sector or across multiple sectors. It would allow bodies like FSOC to focus on underlying risk with systemic potential and would address all entities participating in that particular activity. It would consider systemic risk without an unnecessary attention to potential distress at a single company, thereby better reflecting the potential accumulation of risk across entities. If an activities-based approach had been in effect during the mid-2000s, it's conceivable that the financial crisis would have been substantially less severe or even inexistent.

Policy debate over systemic risk in asset management has considered the same underlying story for insurance – that some shock could lead to liquidity problems, runs, and liquidations with systemic consequences.[13][14] The Financial Stability Board has moved to an activities-based approach for asset managers, and the FSOC should be doing so as well.[15]

In closing, to quote Scott Harrington, who has written extensively on this issue, "Although the domestic and international insurance SIFI trains have left the station, the U.S. train is currently down to two cars, and there is a long way to go in terms of developing and implementing insurance specific standards for enhanced supervision under Section 113. There is no compelling evidence that any life insurer poses a threat to the financial stability of the United States, and the Section 113 regime is flawed in concept and execution. A better approach would be to return to the station and change destinations. If the United States were to shift towards an activities-based approach for insurers, it might have positive spillover effects globally."[16] At a minimum, FSOC must conduct its business

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[13] FSOC, "Financial Stability Oversight Council Update on Review of Asset Management Products and Activities" (2016) https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf

[14] Office of Financial Research, "Asset Management and Financial Stability" (September 2013) https://www.financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf

[15] Financial Stability Board, "Consultative Document – Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities," (June 22, 2016) http://www.fsb.org/wp-content/uploads/FSB-Asset-Management-Consultative-Document.pdf

[16] id. at Note 7.

in a way that is analytically sounder and better grounded in date and regulatory history, with a clear path away from SIFI designation for non-banks.

Thank you, and I look forward to answering your questions.

AMERICAN ENTERPRISE INSTITUTE

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

Is there a uniform standard for FSOC designation?

Paul H. Kupiec
Resident Scholar

March 28, 2017

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Testimony of Alex J. Pollock
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To the Subcommittee on Oversight and Investigations
Committee on Financial Services
United States House of Representatives

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

March 28, 2017

A Flawed Process Generated by a Flawed Structure

Madam Chairman, Ranking Member Green, and Members of the Subcommittee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. I spent 35 years in banking, including twelve years a President and CEO of the Federal Home Loan Bank of Chicago, and then eleven years as a fellow of the American Enterprise Institute, before joining R Street last year. I have both experienced and studied numerous financial crises and financial cycles, including the political contributions to creating them and the political reactions afterward, and my work includes the issues of banking systems, central banking, risk and uncertainty in finance, housing finance and government-sponsored credit, and extensive study of financial history.

To begin with, let me compliment the committee staff for their detailed, specific paper on the FSOC's non-bank designation process. The paper embodies a very good analytical idea: it "compares the FSOC's evaluation memoranda [of various companies] against one another to measure the consistency of the FSOC's analysis." This comparison, as documented in the paper, results in the conclusions that the treatment of different companies is not consistent, that FSOC did not follow its own formal guidance, and in summary, that the evaluations upon which companies either were or were not designated as systemically risky (as "SIFIs") "have been characterized by multiple inconsistencies and anomalies on key issues."

The paper says that "These examples cast doubt on the fairness of the FSOC's designation process." They do, but in my opinion, the more important point than fairness, is that the observations cast doubt on the *objectivity* of the FSOC's work. Were these evaluations impartial analyses looking for disinterested conclusions, or were they rationalizations for conclusions already reached in political fashion?

As we all know, federal District Judge Rosemary Collyer, in her decision on the lawsuit MetLife brought against FSOC, found for MetLife and ruled that FSOC's action was "arbitrary and capricious." I want to focus on one of the reasons stressed by the Judge: the assumptions FSOC made to arrive at its proposed designation.

Considering hypothetical losses resulting from MetLife, Judge Collyer's Opinion pointedly observes that "FSOC *assumed* that any such losses would affect the market in a manner that 'would be sufficiently severe to inflict significant damage on the broader economy.' ...These kinds of *assumptions* pervade the analysis; every possible effect of MetLIfe's imminent insolvency was *summarily deemed* grave enough to damage the economy" [my italics]. "But," the Judge continued, "FSOC never projected *what* the losses would be, *which* financial institutions would have to actively manage their balance sheets, or *how* the market would destabilize as a result" [original italics]. Further, "FSOC was content...to stop short of projecting what could actually happen if MetLife were to suffer material financial distress." FSOC's work appears pretty pathetic in this light, doesn't it. FSOC "hardly adhered to any standard when it came to assessing MetLife's threat to U.S. financial stability," the Judge found.

This sound and sensible judicial decision was appealed by the previous administration. I believe the current Treasury Department should immediately request the Department of Justice to withdraw the appeal, and that the Department of Justice should do so as soon as possible.

Recall that the point of designation of insurance companies as SIFIs is to give significant regulatory jurisdiction over them to the Federal Reserve Board, an institution with little or no experience in insurance regulation and which certainly cannot be considered expert in it. The Independent Member of FSOC Having Insurance Expertise, Roy Woodall, who indubitably is a true expert in the insurance business and its regulation, voted against the SIFI designation of MetLife. Coming again to FSOC's assumptions, he objected: "The analysis relies on *implausible, contrived scenarios*" [my italics], which moreover, include "failures to appreciate fundamental aspects of insurance and annuity products."

Mr. Woodall continued that "the central foundation for this designation" is the assumption of "a sudden and unforeseen insolvency of unprecedented scale [and] of unexplained causation." He reasonably added, "I simply cannot agree with such a premise." Can anybody?

Voting against the earlier designation of Prudential Financial as a SIFI, Mr. Woodall similarly pointed out that "Key aspects of [FSOC's] analysis are not supported by the record or actual experience," that it presumes "an unfathomable and inexplicable simultaneous insolvency and liquidation of all insurance companies" among its "misplaced assumptions."

Ed DeMarco, a distinguished financial regulator who was at the time the Acting Director of the Federal Housing Finance Agency and thus the Conservator of Fannie Mae and Freddie Mac, joined the dissent on Prudential and also observed the lack of evidence presented in the FSOC's evaluation. FSOC proceeded "despite the acknowledgment that no institution has as disproportionally large exposure to Prudential"; it "does not fully take account of the stability of Prudential's liabilities"; it assumes that "withdrawals at Prudential could lead to runs at other insurance companies without providing supporting evidence." Once again, FSOC was operating on assumptions.

Of course, Messrs. Woodall and DeMarco were in the minority. But did the majority address their serious and substantial objections? Was there a meaningful, substantive exchange among the members of FSOC about the conceptual issues and the relevant evidence, as would be appropriate, before voting the proposal in? I am told that there was not.

Why not? The whole point of the existence of FSOC is supposed to be the combined substantive deliberation and development of insights by this committee of the heads of financial regulatory agencies. But it doesn't seem to happen. So the designation process does not work well not only at the staff level, but also at the level of the FSOC as a corporate body.

I directly asked one former, senior FSOC insider from the previous administration if the meetings of the FSOC members had ever provided a new insight into financial issues. After thinking a moment, he gave me a candid answer: "No."

Why is this? The Milken Institute, in a recent paper, proposed idealistically that although FSOC is currently nothing like this, "policy makers should convert the FSOC into a truly cooperative working group of regulators focused on risks." To anyone familiar with the ways of Washington, this will seem an unlikely outcome.

The underlying problem, it seems to me, is the structure of FSOC itself. The shortcomings of the designation process reflect the underlying problems with the fundamental design. To begin with, FSOC is primarily a group of individuals each representing a regulatory agency, with turf to protect from intrusions by the others, and a regulatory record to defend from criticism, as principal bureaucratic concerns.

It is a big group, with 15 official members, but in addition they all bring along helpers and allies. At the FSOC meeting of December 18, 2014 which approved the MetLife SIFI designation, there were according to its minutes, 46 people present. It's pretty hard, indeed impossible, to imagine a real, open, give-and-take, "truly cooperative" discussion with 46 people.

Moreover, FSOC is chaired by the Secretary of the Treasury, a necessarily very political, powerful senior government actor with major partisan and institutional interests always in play. No company can be taken up for systemic risk study by the SIFI staff without the approval of the Secretary. Does this suggest a disinterested analytical process?

The Federal Reserve is a special case in the structural design of FSOC, because it stands to expand its power every time FSOC makes a SIFI designation. Does the Federal Reserve like power? Would it like to acquire a big new jurisdiction? Of course, and it is a party at interest in every SIFI discussion. I think it is not unreasonable to suggest that given the Fed's major conflict of interest, it should recuse itself from any SIFI votes.

With this context, it is easier to see why the FSOC's SIFI evaluations had to rely on big assumptions and tended to make inconsistent analyses of different companies. It was because the decisions being made were inherently judgmental, with inherently subjective elements, made amidst competing interests—that is to say, unavoidably political.

The shortcomings of the FSOC evaluations appear at least consistent with the theory that the evaluations were meant to rationalize decisions already made. Where might the pressure for such decisions have come from?

One publicly debated possibility is that commitments were already made in the setting of the international Financial Stability Board, in which two of the FSOC members, it is sometimes suspected, made deals with foreign central bankers and regulators about which companies were "Global Systemically Important Insurers." There is dispute about whether the FSB discussions were really agreements, and whether they were thought to be binding. But there is no dispute that the international discussions and the naming of "Global SIIs" preceded the Prudential and MetLife designations of the FSOC. Roy Woodall reflected, "While the FSB's action should have no influence, I have come to be concerned that the international and domestic processes may not be entirely separate." A related question is whether the Treasury and Federal Reserve FSOC members felt personally committed by their international discussions. If they did, it seems that they should have disclosed that and recused themselves from the FSOC decisions. Did they feel committed to follow the FSB? Only they know.

During their research for the study of the FSOC designations process, the committee staff asked the Executive Director of the FSOC, Patrick Pinschmidt, what "significant damage on the broader economy" meant in their assessments. Mr. Pinschmidt replied, "It's up to each voting member of the Council to decide for him or herself what constitutes a significant threshold." That sounds like depending on subjective judgments to me.

I agree that it is a naturally good idea for financial regulatory agencies to get together and share information, ideas and experiences (to the extent that they will really share). But what is a committee of heads of regulatory agencies, who are acting as individuals and not even on behalf of the relevant boards or commissions, doing making political decisions? If Congress wants to have the Federal Reserve Board regulate big insurance companies, it can make it so in statute, using whatever subjective judgments it wants. In my view, FSOC is a distinctly inappropriate body to act as a little legislature.

The staff paper of FSOC's evaluations of possible SIFIs, those recommended for designation and those not, details the inconsistencies in treatment. But these differences pale beside the huge discrepancy of those companies chosen for evaluation and those companies not evaluated at all, because the previous Treasury Secretary did not approve their being studied. So the FSOC staff did not even analyze them because of some higher, prior, political judgment. I think this could fairly be characterized as desperately wanting to "see no evil" when it comes to the systemic financial risk of some entities.

The most egregious cases are Fannie Mae and Freddie Mac, which are obviously systemically important and without question systemically very risky. To document that is simple, starting with their combined $5 trillion in credit risk, virtually zero capital, and ubiquitous interconnectedness throughout the country and world. Two of the biggest causes of systemic risk are leveraged real estate and the moral hazard created by the government—Fannie and Freddie are both of these combined and to the max.

The Dodd-Frank Act gives a key assignment to FSOC: "To promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties that the Government will shield them from losses in the event of failure." Fannie and Freddie are pure cases of "the Government shielding creditors and counterparties from losses," not only as a hypothetical, but as a vast *fact*. They operate entirely on the government's credit. They represent the very essence of the problem that FSOC was supposedly created to address. But FSOC doesn't even study them—instead, the staff was ordered not to study them.

That is an inconsistency raised to the nth power-- in my view, a bankruptcy of FSOC's intellectual credibility as run by the previous administration.

A recent article claims that "the next financial crisis that rocks America...will be driven by pension funds that cannot pay what they promised." Whether or not it triggers the next crisis, there is no doubt that this is a looming huge risk.

In the very center of this risk is an insurance company absent from FSOC's evaluation as a SIFI: the Pension Benefit Guaranty Corporation. The PBGC is not only on the hook as guarantor of unpayable pensions nationwide, but is already insolvent itself, with according to its own books, a deficit net worth of $76 billion. Might PBGC represent a systemic risk? Yes. Do the creditors of the PBGC think "the Government will shield them from losses"? Yes. Does the FSOC staff evaluate the PBGC? Nope.

In sum, it appears that the flawed process of FSOC's SIFI designations is generated by the flawed structure of FSOC itself.

In my opinion, structural reform of FSOC is needed as part of larger the Dodd-Frank reform legislation. But here are a few recommendations for improvements which could be implemented by the new administration in the short run:

-FSOC should have regular meetings of principals only with substantive discussions of major issues and explorations of disagreements. No helpers, no staff.

-The Secretary of the Treasury should immediately instruct the FSOC staff to undertake systemic risk evaluations of Fannie Mae and Freddie Mac.

-The Secretary of the Treasury should immediately instruct the FSOC staff to undertake a systemic risk evaluation of the Pension Benefit Guarantee Corporation.

-The Treasury Department should immediately request the Department of Justice to withdraw the government's appeal in the MetLife v. FSOC suit and the Department of Justice should immediately do so.

-The FSOC staff should be encouraged to come up with new ideas on evolving risks for discussion among the FSOC principals.

-Any SIFI evaluation should strictly follow the rules and guidance approved by FSOC, with analysis performed in a strictly consistent manner.

-Assumptions about macro reactions and assumptions of implausible and contrived scenarios should be clearly identified as judgments and guesses.

-International discussions and actual decisions of FSOC should be kept strictly separate. Any international agreements, even if informal, made by FSOC members, should be fully disclosed.

Again, my appreciation to the committee staff for their productive study of the inconsistent FSOC designations process and the very important issues it raises.

And thank you very much for the chance to share these views.

TESTIMONY OF DAVID ZARING

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

to the

United States House of Representatives

Committee on Financial Services

Oversight and Investigations Subcommittee

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

March 28, 2017

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

I. Overview

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[3] Dodd-Frank Act § 113(a)(2)(K).

[4] Dodd-Frank Act § 113.

[5] Dodd-Frank Act § 113.

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

[7] Id. § 113(d).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

[8] Dodd-Frank Act § 113.

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

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

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

III. The Council's Role In Financial Regulation

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

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

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

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

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

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

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

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

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

//ACLI
Financial Security...for Life.

Statement for the Record

Subcommittee on Oversight & Investigation
House Committee on Financial Services
U.S. House of Representatives

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

March 28, 2017

Chairman Wagner, Ranking Member Green, the American Council of Life Insurers (ACLI) is pleased to submit this statement for the hearing record expressing the views of member life insurance companies regarding the non-bank Systemically Important Financial Institution (SIFI) designation process. We agree with the Committee's majority staff report that the non-bank SIFI designation process has been arbitrary, inconsistent, and highly problematic. The insurer designations have led to duplicative supervision and regulation of insurers, produced excessive and unnecessary regulatory costs and burdens, and harmed competition in the insurance market without actually reducing systemic risk. We strongly support provisions in Chairman Jeb Hensarling's Financial CHOICE Act from the previous Congress (H.R. 5983) that would reform the authorities of the Financial Stability Oversight Council (FSOC) to repeal its ability to designate life insurance companies as SIFIs.

The American Council of Life Insurers is a Washington, D.C.-based trade association with approximately 290 member companies operating in the United States and abroad. ACLI advocates in state, federal, and international forums for public policy that supports the industry marketplace and the 75 million American families that rely on life insurers' products for financial and retirement security. ACLI members offer life insurance, annuities, retirement plans, long-term care and disability income insurance, and reinsurance, representing 94 percent of industry assets, 93 percent of life insurance premiums, and 97 percent of annuity considerations in the United States. Learn more at www.acli.com.

The FSOC Designation Process is Fatally Flawed

As clearly identified in the Committee's majority staff report, the FSOC process for systemic designations of non-banks has been materially unfair and uneven. The experience of life insurance companies that have been designated by FSOC confirms the findings of the staff

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report. In the view of ACLI, the FSOC process has not met basic standards of accountability, transparency, and good governance.

A significant issue with the FSOC process has been the extremely inconsistent use of its broad authorities as applied to different sectors of the financial services industry. This problem is best illustrated by the very different approaches taken towards the insurance industry, which has been subject to designation of individual firms, as compared to the asset management industry. In the case of asset managers, FSOC has focused on recommendations for new or heightened standards for specific practices that may pose significant risk rather than singling out firms for designation.

Even in the insurance sector itself, there is no evidence of a uniform, consistent or transparent methodology being applied to each individual company under review. Life insurance companies that have gone through the designation process have not received adequate information or explanation of FSOC analysis and decisions. Documents provided by FSOC to insurance companies provide little insight into the basis for designation decisions. These documents typically offer only conclusory statements, predictions, and speculations that are unsupported by factual and economic analysis. FSOC has not provided companies with enough information that would allow them to take positive steps to avoid designation, or be de-designated through appropriate action.

One of the most significant problems with the FSOC process for non-bank systemic designations of insurers has been its failure to appropriately consider the role of existing primary financial regulators leading to a lack of understanding and recognition of the strong insurance regulatory framework in place through the state-based system. The state-based insurance regime has a long and successful track record of insurance regulation.

One of the explicit statutory requirements the FSOC must consider is the "degree to which the company is already regulated by one or more primary financial regulatory agencies." Contrary to this statutory requirement, the FSOC has not appropriately considered in its designation of insurers the authority and tools available under the state-based insurance regime, including numerous and substantial reforms policymakers have implemented since the financial crisis.

FSOC Lacks State Insurance Regulator Voting Representation

The lack of consideration given to primary financial regulators of insurance has been exacerbated by the lack of insurance expertise and representation on the panel. Of the 10 FSOC voting members, at least seven are primarily banking industry regulators. When either the FSOC Independent Member with Insurance Expertise or the nonvoting state insurance regulator offered dissenting views, they were disregarded and overruled. FSOC also dismissed concerns registered by the then primary insurance regulator in New York state, Benjamin Lawsky, Superintendent of the New York Department of Financial Services, in a letter to Treasury Secretary Jacob Lew in July of 2014.

Clearly, the designations of insurers were largely dependent on banking expertise, not insurance expertise. FSOC's decisions with regard to insurers were bank-centric and not grounded in an accurate understanding of the business of insurance. Life insurers are fundamentally different from banks. FSOC's reliance on an inappropriate and unrealistic bank-like "run" scenario on insurance products as the trigger of an insurer's financial distress or cause of systemic risk illustrates its bank-centric mindset for considering insurance firm designations.

The structure of FSOC should be changed to add state insurance regulators as voting members. Right now, no state insurance commissioner is a voting FSOC member. The history of FSOC, now dominated by bank regulators, shows that it discounts the opinions of the single insurance expert voting member, resulting in erroneous and harmful decisions for insurance markets. Structural change must also ensure that any FSOC recommendations that would affect insurers must be developed with direct input from state insurance regulators, and that any implementation of such recommendations is solely within the province and authority of those regulators.

FSOC Has Misused Its Existing Authority

FSOC's narrow focus on a few individual entities in certain sectors has diverted attention and resources away from its more important role as a broad-sighted macro-prudential overseer of the economy that can identify potential systemic risk in a timely fashion. The enormous resources and time devoted by FSOC to duplicative oversight of a few individual insurance companies has significantly depleted the attention that could be focused on insufficiently regulated or unregulated sectors of the financial economy, where the next crisis is much more likely to arise. For any such entity that by virtue of its activities poses a threat to the financial stability of the United States, FSOC should act as an early warning system and ensure that adequate regulation can be put in place.

FSOC's primary responsibility should be assessing macro-prudential risks to U.S. financial stability. It should be made clear that its principal role is making advisory recommendations to primary financial regulatory agencies, which for insurance are the state commissioners, on applying new or heightened safeguards for financial activities that could increase risks to the U.S. financial markets.

There is no evidence that the current structure and approach of FSOC has facilitated the reduction of systemic risk, nor has it effectively demonstrated that life insurance activities present a systemic risk. The resulting erroneous FSOC systemic designations of insurance companies have imposed unnecessary costs on insurers and distorted the competitive landscape in the insurance industry.

Life Insurers Do Not Represent a Systemic Risk

There is no compelling evidence that any life insurer represents a systemic risk to the financial services system. The exact opposite is true. Life insurers have historically been a source of stability in the U.S. financial system, providing families with financial protection and providing businesses with long-term capital for economic growth and job creation. Life insurance companies hold assets for the long-term to match up with product guarantees that are made for the long-term. The average maturity of the bonds purchased by life insurance companies is more than 18.5 years on a dollar weighted basis.

Life insurers are not subject to a "run on the bank" as depository institutions are. The long-term nature of our products and promises discourage such behavior. Policyholders cannot accelerate benefits or periodic payments. Indeed, during the greatest stress-test in more than 70 years - the financial crisis of 2008 - extraordinary redemptions from life insurance or annuity policies did not occur. Given the improbability of this occurrence, insurers would not be forced into a mass liquidation of assets.

Insurance companies have experienced prudential regulators that have greatly increased the tools available to oversee and effectively regulate the industry. In the last decade, state insurance holding company laws and group supervision practices have been strengthened and expanded to enable state regulators to be vigilant in identifying and aggressive in addressing issues of concern that might jeopardize the corporation as a whole. For example, insurance companies or groups are now required to submit their own risk and solvency assessments to state insurance regulators, who routinely review them with the group's management in cooperation with other regulators. Prudential oversight of insurance companies through the state-based system continues to be demonstrably strong and effective as it evolves to meet ongoing challenges.

ACLI Supports Provisions in the Financial CHOICE Act to Eliminate Non-Bank Designation Authority

ACLI would like to reiterate its strong support for provisions in the Financial CHOICE Act that address the clear failures of the existing FSOC non-bank designation authority. Elimination of the non-bank designation authority for life insurance companies is an essential reform that will refocus systemic oversight on insufficiently or unregulated sectors or those that actually present systemic risk, while maintaining its authority for identifying and assessing macro-prudential risks to U.S. financial stability. By rebalancing the FSOC approach, and removing the impact of arbitrary and misdirected FSOC designations, insurance regulators, insurance markets, and insurance consumers can expect better outcomes.

Conclusion

The American Council of Life Insurers (ACLI) thanks the Committee for convening this important hearing and for its comprehensive oversight over the non-bank systemic designation process. We strongly support the Committee's efforts to examine the failures of FSOC to conduct a fair, transparent, and accountable process. We look forward to working with the Committee to eliminate FSOC designation authority of life insurance companies.

PCI

Property Casualty Insurers
Association of America
Advocacy. Leadership. Results.

Testimony

Property Casualty Insurers Association of America (PCI)

The Arbitrary and Inconsistent Non-Bank SIFI Designation Process

House Committee on Financial Services

March 28, 2017

444 North Capitol Street NW, Suite 801, Washington, DC 20001 Telephone 202-639-0490 Facsimile 202-639-0494 www.pciaa.net

The Property Casualty Insurers Association of America (PCI) is pleased to offer testimony on the Arbitrary and Inconsistent Non-Bank SIFI Designation Process. PCI is composed of nearly 1,000 member companies, representing the broadest cross section of insurers of any national trade association. PCI members write $202 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, 33 percent of the commercial property and liability market and 34 percent of the private workers compensation market.

Congress created the Financial Stability Oversight Council (FSOC) to identify and reduce systemic risk. FSOC has selectively targeted large state regulated insurers for designations to vastly expand federal regulatory involvement in insurance in violation of its own rules and due process. PCI strongly supports proposals adopted by the House Financial Service Committee to terminate FSOC's authority to designate nonbanks as systemically important financial institutions (SIFIs). Instead of imposing ill-targeted federal bank regulations on large insurers to duplicate state insurance supervision, FSOC should work with state insurance regulators and other financial regulators to identify and mitigate and reduce systemically risk activities.

Flaws in the Non-Bank Designation Process

FSOC Rationale for Designations Unclear and Inconsistent. The non-bank systemic risk designation decisions handed down by FSOC have failed to state clearly the rationale for the decision based on activities in which the firms engage. For example, a Federal District Court ruling overturning a nonbank designation found that the FSOC's Final Determination "hardly adhered to any standard when it came to assessing [the] threat to U.S. financial stability."[1] Not only does this call the integrity of the designation decision into question, but it has left all companies in the dark about what activities the FSOC considers systemically risky and thus provides no clear direction to companies on how to reduce systemic risk. *Thus, FSOC has failed to achieve the primary objective of Dodd-Frank, which was to identify and reduce systemic risk.*

A report released in February by the Committee's majority staff concluded that FSOC's non-bank designation process is "arbitrary and inconsistent," and that FSOC failed to follow its own rules and guidance. The report concluded that "FSOC is not fulfilling its statutory mandate of actually analyzing where companies are systemically risky."[2]

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[1] *MetLife v. Financial Stability Oversight Council*, 177 F.Supp.3d, 219 at 237 (2016).
[2] Report Prepared by the Republican Staff of the Committee on Financial Services, U.S. House of Representatives, *The Arbitrary and Inconsistent FSOC Nonbank Designation Process* (February 28, 2017).

The Government Accountability Office (GAO), in a report released on November 20, 2014, identified several of the flaws in the FSOC's process.[3] Specifically, the GAO noted that "FSOC's public documents have not always fully disclosed the rationale for its determination decisions" and that "the lack of full transparency has resulted in questions about the process and may hinder accountability and public and market confidence in the process."[4] GAO also criticized FSOC for "using only one of two statutory determination standards (a company's financial distress, not its activities)" and noted that "FSOC may not be able to comprehensively ensure that it had identified and designated all companies that may pose a threat to U.S. financial stability."[5]

PCI believes there is ample evidence in the Federal court decision, the Committee Staff Report, the GAO report, and elsewhere to support the conclusion that the current nonbank systemic risk designation process has not worked to identify systemic risk correctly and consistently or to eliminate it where FSOC believes it exists.

FSOC Insurance Experts Disregarded. When FSOC designated two insurers as systemically important, the Independent Member Having Insurance Expertise, Roy Woodall, filed strong dissents arguing that the FSOC had failed to appreciate differences between the banking and insurance industries and saw systemic risk in the insurance industry that does not exist. For example, in his dissent from an insurer designation, Mr. Woodall said the FSOC's analysis "relies on implausible, contrived scenarios as well as failure to appreciate fundamental aspects of insurance and annuity products, and, importantly, State insurance regulation and the framework of the McCarran Ferguson Act."[6] These views were echoed by FSOC's non-voting State Insurance Commissioner Representative, Adam Hamm, who noted his statement disagreeing with an insurer designation that the FSOC "fails to fully consider the range of mechanisms insurance regulators use to identify and address problems. . ." He noted that, in addition to preventing solvency concerns, these tools "also minimize the impact of any material financial distress on policyholders, other counterparties and the system." He said in disregarding the full scope of state insurance regulatory authorities, FSOC had misapplied Section 113 of the Dodd-Frank Act, which requires that "the Council appropriately take into account the degree to which the company is already regulated when making a determination that a

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[3] Government Accountability Office, Financial Stability Oversight Council: Further Actions Could Improve the Nonbank Designation Process, GAO Highlights Page, (November, 2014).
[4] *Id.*
[5] *Id.*
[6] Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc., Views of the Council's Independent Member Having Insurance Expertise.

company could pose a threat to the financial stability of the United States."[7] PCI agrees with Mr. Hamm's views.

It is alarming that non-insurance regulators on the FSOC would so cavalierly ignore the advice of the insurance experts Congress provided to it in considering questions of systemic risk. What is even more alarming is that, following these designations, the FSOC failed to provide clear direction on how these insurers could reduce the perceived risk.

A primary purpose of the Dodd-Frank Act was to mitigate systemic risk to avoid a repeat of the 2008 financial crisis. It should follow that the Financial Stability Oversight Council (FSOC) would place a high priority on providing sufficiently detailed and credible information to companies it designates. This information would allow a company's management to make decisions to reduce the company's exposure to systemic risk and to be delisted as a systemically important financial institution. FSOC's refusal to do this suggests that its members may be more interested in preserving the enhanced supervisory authority they obtain as a result of a systemic risk designation than in reducing systemic risks posed to the economy. As Mr. Woodall said in his dissent from an insurer designation, "[w]hile the Council's approach to designation triggers supervisory jurisdiction by the Board of Governors of the Federal Reserve System . . . it does little else to promote real financial system reform." This is not at all consistent with the goal of Congress in enacting Dodd-Frank.

Inappropriate Pre-Designations with Foreign Governments. There is substantial evidence that, before FSOC considered designation of some companies, members of the FSOC agreed with foreign regulators participating in deliberations of the Financial Stability Board (FSB) that certain of these firms would be designated as Global Systemically Important Institutions (G-SIIs). Thus, a subset of members of the FSOC who participated at the FSB committed the United States to a position before the full FSOC (including FSOC's chair) had even considered the question. Mr. Woodall was highly critical of this in his dissent from an insurer designation, stating "[a]n FSB meeting with only a few Council members' agencies participating should not decide that certain firms are systemically important; or conversely, that any firms are not systemically important, before the Council as a whole has decided those questions." He urged his fellow FSOC members "to not again allow the FSB to 'front-run' or pressure decisions that must be made first by the Council as a whole." He further charged that to do otherwise is "to undermine confidence in the Council itself; to be

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[7] Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Inc., Views of Adam Hamm, the State Insurance Commissioner Representative.

inconsistent with the intent of Congress; and to be patently unfair to those nonbank financial companies under review that must be afforded due process and fair dealing under U.S. law and procedures."[8] PCI agrees with Mr. Woodall's assessment. Ceding systemic risk designation authority to foreign governments is not in the best interests of the United States, and there is no hint of any such intent in Dodd-Frank.

Insurance is Not Systemically Risky. There was widespread recognition during the legislative process that led up to the passage of Dodd-Frank that traditional insurance activities simply are not systemically risky. Property casualty insurers, in particular, have low leverage, are not interconnected with other financial firms, do not pose a "run-on-the-bank" threat, are highly competitive with low market concentration, have low failure rates, and have their own effective and self-financed resolution system. These points were reiterated by Mr. Woodall in his dissents from the designations of several insurance companies. They have also been noted by U.S. and foreign insurance regulators. The International Association of Insurance Supervisors (IAIS) said in a 2011 report that "traditional insurance is unlikely to become a source of systemic risk."[9] In addition, Dr. Mary Weiss, a Distinguished Scholar with the Center for Insurance Policy and Research at the National Association of Insurance Commissioners found in a 2010 report that "insurers are not instigators or the cause of systemic risk" and that "they do not require systemic risk regulation – any direct systemic risk regulation of insurers is unlikely to stem future systemic risk crises."[10] Nevertheless, the FSOC designated insurance companies as systemically risky and then refused to provide a coherent rationale for the decision or any meaningful direction on how to eliminate the perceived risk.

[8] Basis for the Financial Stability Oversight Council's Final Determination Regarding MetLife, Views of the Independent Member Having Insurance Expertise.
[9] International Association of Insurance Supervisors, *Insurance and Financial Stability*, pg. 6, (November, 2011)
[10] Mary A. Weiss, Ph.D, Distinguished Scholar, Center for Insurance Policy and Research of the National Association of Insurance Commissioners, *Systemic Risk and the Insurance Sector*, (February 23, 2010).

Conclusion

By failing to achieve the primary goal assigned to it by Congress, FSOC has failed to protect taxpayers form the risk of future financial crises while imposing unwarranted burdens and costs on companies that do not, in fact, pose systemic risk. Not only does this create additional costs for consumers, but it also fails to protect them from the negative economic implications of the next crisis. Because the FSOC has not utilized its nonbank systemic risk designation authority wisely and, in particular, has declined to focus its activities on reducing perceived systemic risk, the FSOC's authority to designate nonbanks as systemically important should be eliminated. Federal and state financial regulators could still consider whether nonbank financial institutions pose systemic risk, but should not be burdened with the FSOC's current conflict of interest under which providing clear rationales on how to identify and eliminate systemic risk requires them to relinquish their enhanced supervisory authority.

THE WALL STREET JOURNAL.

https://www.wsj.com/articles/does-too-big-to-fail-mean-too-big-for-the-rule-of-law-1490828724

COMMENTARY

Does 'Too Big to Fail' Mean Too Big for the Rule of Law?

Blame Congress for the arbitrary nature of the 'systemically important' label under Dodd-Frank.

PHOTO: GETTY IMAGES/ISTOCKPHOTO

By ADAM J. WHITE
March 29, 2017 7:05 p.m. ET

When President Obama signed the Dodd-Frank Act in 2010, he said it would cure the problem of too-big-to-fail banks by setting "new rules to make clear that no firm is somehow protected" from failure. "In the end," he said, "our financial system only works—our market is only free—when there are clear rules and basic safeguards that prevent abuse, that check excess, that ensure that it is more profitable to play by the rules than to game the system."

Seven years later, those reforms have achieved far less than he promised. That's especially true of the framework for designating insurance companies and other non-banks as "systemically important financial institutions," or SIFIs.

The Financial Stability Oversight Council has put the SIFI label on four companies so far, but its approach has proved wildly arbitrary. After a two-year investigation into the FSOC's operations, the House Financial Services Committee last month released a staff report highlighting the problems. The report says that the FSOC has failed to honor its own procedural rules and apply its standards and methodologies consistently.

“The FSOC treats certain companies differently than other companies,” the report says. “The reason for this disparate treatment is unclear. It could be because the FSOC has no internal procedural controls . . . or it could be the case that the FSOC deliberately circumvented its procedures and expected that this deviation would never be discovered.”

This confirms what a federal district court found last year after the insurance company MetLife sued over its SIFI designation. Judge Rosemary Collyer struck down that designation, concluding that the FSOC “hardly adhered to any standard when it came to assessing MetLife’s threat to U.S. financial stability.” Federal regulators didn’t analyze whether MetLife actually posed a substantial systemic risk. Instead they simply assumed the worst at every turn. The FSOC has appealed and the case remains pending. But during oral argument in October at the U.S. Court of Appeals for the District of Columbia Circuit, the judges expressed similar concerns.

Moreover, the House committee’s new report reiterates the criticism leveled at the FSOC by its own “independent member with insurance expertise,” S. Roy Woodall. When the FSOC labeled MetLife and the insurer Prudential as SIFIs, Mr. Woodall voted against the designations. He wrote in a dissent that the majority’s approach “would inevitably lead to a conclusion that any nonbank financial company above a certain size is a threat—contradicting pronouncements that ‘size alone’ is not the test for determination.” In other words, the FSOC’s designation of some large companies but not others is arbitrary.

To be fair to the FSOC, its blunt approach is not exclusively the fault of the regulators. Much blame lies with Congress, which created and empowered it in the first place.

As former Treasury Secretary Timothy Geithner once explained, it is impossible to set effective, purely objective criteria for evaluating systemic risk: “What size and mix of business do you classify as systemic? . . . It depends too much on the state of the world at the time. You won’t be able to make a judgment about what’s systemic and what’s not until you know the nature of the shock” the economy is undergoing.

The recipient of that warning was the special inspector general for the Troubled Asset Relief Program, who drew an ominous conclusion. “If the Secretary is correct,” he wrote in a 2011 report, “then systemic risk judgments in future crises will again be subject to concerns about consistency and fairness, not to mention accuracy.” This was prescient, as Mr. Woodall, Judge Collyer and now the House Financial Services Committee have confirmed.

Given the problems inherent with the FSOC’s designations, Congress should consider whether the overarching policy is misguided and excessively ambitious—an example of Hayek’s “fatal conceit.” At the very least, lawmakers should end Dodd-Frank’s approach of granting open-ended power to regulatory agencies, hoping that the administrative state will solve the problem.

Congress did not meaningfully define the standards for the FSOC to use in discerning “systemic importance.” Instead lawmakers authorized nearly a dozen broad considerations, ending with the catchall of “any other risk-related factors that the Council deems appropriate.” Such grants of limitless discretion not only invite arbitrary bureaucratic action, they also stretch the bounds of constitutional government.

If Congress believes in reducing systemic risk through regulation, then it should do the hard work of legislating the precise, substantive standards that it believes will best guard the financial system. If the FSOC has expertise, then it can advise lawmakers in writing the law.

But the FSOC should not make up the law, let alone make up the law as it goes along. As President Obama said, we need "clear rules and basic safeguards that prevent abuse"—not least abuse by the regulators themselves.

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Appeared in the Mar. 30, 2017, print edition.