S. HRG. 116–23

FINANCIAL STABILITY OVERSIGHT COUNCIL NONBANK DESIGNATION

HEARING

BEFORE THE

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

ONE HUNDRED SIXTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING VIEWS ON THE FSOC NONBANK DESIGNATION PROCESS, INCLUDING THE STRENGTHS AND WEAKNESSES OF THE DESIGNATION PROCESS; COMMENTS ON THE RECOMMENDATIONS MADE BY TREASURY IN ITS NOVEMBER 2017 REPORT ON FSOC DESIGNATIONS; AND RECEIVE RECOMMENDATIONS ON LEGISLATIVE OR ADMINISTRATIVE ACTIONS THAT COULD BE TAKEN TO CHANGE THE DESIGNATION PROCESS

MARCH 14, 2019

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: https://www.govinfo.gov/

U.S. GOVERNMENT PUBLISHING OFFICE

36–538 PDF WASHINGTON : 2019

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

MIKE CRAPO, Idaho, *Chairman*

RICHARD C. SHELBY, Alabama	SHERROD BROWN, Ohio
PATRICK J. TOOMEY, Pennsylvania	JACK REED, Rhode Island
TIM SCOTT, South Carolina	ROBERT MENENDEZ, New Jersey
BEN SASSE, Nebraska	JON TESTER, Montana
TOM COTTON, Arkansas	MARK R. WARNER, Virginia
MIKE ROUNDS, South Dakota	ELIZABETH WARREN, Massachusetts
DAVID PERDUE, Georgia	BRIAN SCHATZ, Hawaii
THOM TILLIS, North Carolina	CHRIS VAN HOLLEN, Maryland
JOHN KENNEDY, Louisiana	CATHERINE CORTEZ MASTO, Nevada
MARTHA MCSALLY, Arizona	DOUG JONES, Alabama
JERRY MORAN, Kansas	TINA SMITH, Minnesota
KEVIN CRAMER, North Dakota	KYRSTEN SINEMA, Arizona

GREGG RICHARD, *Staff Director*

JOE CARAPIET, *Chief Counsel*
BRANDON BEALL, *Professional Staff Member*

LAURA SWANSON, *Democratic Deputy Staff Director*
ELISHA TUKU, *Democratic Chief Counsel*
COREY FRAYER, *Democratic Professional Staff Member*

CAMERON RICKER, *Chief Clerk*
SHELVIN SIMMONS, *IT Director*
CHARLES J. MOFFAT, *Hearing Clerk*
JIM CROWELL, *Editor*

C O N T E N T S

THURSDAY, MARCH 14, 2019

WITNESSES

Additional Material Supplied for the Record

FINANCIAL STABILITY OVERSIGHT COUNCIL NONBANK DESIGNATION

THURSDAY, MARCH 14, 2019

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

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. This hearing will come to order.

Today we welcome to the Committee three witnesses to testify on the Financial Stability Oversight Council, or FSOC, relating to nonbank designation processes: Dr. Douglas Holtz-Eakin, president of the American Action Forum; Mr. Paul Schott Stevens, who is president and CEO of the Investment Company Institute; and Professor Jeremy Kress, assistant professor of business law at the University of Michigan's Ross School of Business.

Each of these witnesses is knowledgeable about FSOC's designation process and policy, drawing from their experiences in industry, Government, and academia.

The Dodd–Frank Act established FSOC to identify and respond to potential threats to U.S. financial stability.

Dodd–Frank authorizes FSOC to subject nonbank financial companies to supervision by the Federal Reserve and prudential standards, if it deems a nonbank to pose such a threat.

In the years after Dodd–Frank was enacted, FSOC evaluated individual companies for designation as systemically important and ultimately designated four nonbank financial companies: AIG, MetLife, Prudential, and GE Capital.

At the outset, the process for nonbank designation was immeasurable and unclear, which was not only contrary to the long-established principles of our regulatory framework, but also led to legal uncertainty that undermined the very objective of FSOC.

Several years ago, I requested a comprehensive study by the GAO on the nonbank designation process.

The report concluded that FSOC's process lacks transparency and accountability, insufficiently tracks data, and does not have a consistent methodology for determinations.

In recent years, FSOC voted to rescind three of those designations, while another's designation was overturned in court.

FSOC's decisions have costly implications for designated companies, which inevitably translates into higher costs for consumers and to the overall economy.

It is important that FSOC's designation process be clear, robust, and focused on addressing real underlying risks.

The process should also take into account how the existing regulatory structure already addresses any potential risks before taking the drastic step of designating an individual company.

In 2012, FSOC issued interpretive guidance that outlined its designation process, which begins with identifying individual companies over $50 billion in total assets for further scrutiny based on a set of five other quantitative thresholds and then gradually using more granular and company-specific information along the way.

In November of 2017, Treasury issued a report entitled, "Financial Stability Oversight Council Designations", which provided recommendations to improve FSOC's designation process.

One of Treasury's key recommendations was for FSOC to prioritize an activities-based approach to designation and work with relevant regulators to address any risks posed prior to considering designating a nonbank financial company.

Among the other important recommendations made by Treasury for the nonbank designation process were: to only designate a nonbank financial company if the expected benefits to financial stability outweigh the costs of the designation; and provide a clear "off-ramp" for designated nonbank financial companies, including by identifying key risks that led to the designation and enhancing the transparency of FSOC's annual review process.

At its meeting on March 6, FSOC proposed to replace its current interpretive guidance on the nonbank designation process with new interpretive guidance that would make several substantive changes.

Some of those changes include: prioritizing an activities-based approach to designation that would focus on identifying and addressing the underlying sources of risk and would only contemplate designating individual companies if a risk could not be addressed through an activities-based approach; conducting a cost-benefit analysis prior to designating a nonbank; eliminating the first of its three-stage process that focuses on applying quantitative thresholds to identify individual companies for further evaluation, and the six-category framework used to analyze individual companies; and instituting several procedural changes to improve FSOC's engagement with companies and regulators, and clarifying off-ramp opportunities for companies through risk mitigation efforts prior to or after designation.

After FSOC issued the proposed guidance, Comptroller Otting expressed support for the proposal, saying, "The proposal ensures FSOC continues to serve its primary function in a transparent, efficient, and effective manner."

The proposed guidance is a step in the right direction to improve FSOC's effectiveness, transparency, and analyses.

Senators Rounds, Jones, Tillis, and Sinema have also introduced the Financial Stability Oversight Council Improvement Act, which would require FSOC to first determine that a different action would not address risks posed to financial stability prior to a vote on an initial nonbank designation.

During this hearing, I look forward to discussing how an activities-based approach will more effectively address potential risks to U.S. financial stability; the appropriate framework for evaluating activities; and additional opportunities for improvements to the process.

I again thank each witness for joining the Committee this morning.

Senator Brown.

OPENING STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman, for holding this hearing. Welcome to the three witnesses, including Ohioan Professor Kress. Nice to see you.

Let us remember why FSOC matters. When Wall Street takes big risks, they do it with Americans' money.

The financial system affects who gets loans. It affects whether people have enough money to retire or pay medical bills or send their children to college. When banks and other big financial firms take risks and they do not pay off, it is never the executives, it is never the CEOs who are left with nothing. It is never the executive and the CEOs who have to explain to kids, to their own children at the kitchen table what has happened. It is ordinary families who lose their jobs, who lose their homes, who lose their life savings.

When too many financial institutions take too many risks at once, we all pay the price.

Right now the risks to the financial system have increased, which means the risks are greater for families buying homes and saving for retirement and paying off student loans. The biggest Wall Street banks have gotten even bigger and bigger and more interconnected. The shadow banking system has grown; the shadow banking system is taking on more risk. The business cycle is extended and growth is slowing. The global economy faces uncertainty from Brexit and growing debt levels in China.

And things look even worse when you look past Wall Street and look at ordinary families: Student loan debt has hit record levels. Seven million Americans are more than 3 months behind on their car payments—think about that. Seven million Americans are more than 3 months behind on their car payments. That is the highest in 19 years. For too many Americans who have not felt the benefits of economic recovery, decades of income and wealth inequality have made it harder. Yet this Committee, yet this Congress, yet this President seem not to care—in fact, are making it worse.

This Administration is all too happy to look the other way as long as the risks affect families' bank accounts, not bank profits.

That is what led to the crisis a decade ago.

FSOC was created after large, interconnected firms—firms like Lehman, Bear Stearns, and AIG—wreaked havoc on the economy.

These firms did not have strong rules in place to ensure they had enough liquidity or loss-absorbing capital in case of an economic shock. There was no single regulator monitoring the entire country and the entire company for systemic risks.

It was so important to address this problem that the authors of Dodd–Frank created FSOC as Title I in the bill.

Today FSOC appears to be closed for business. It recently rescinded the last remaining SIFI designation of the Obama administration. Prudential, the giant insurance company that grew larger and more complex after it was designated as systemically important, is apparently no longer in need of stronger safeguards and no longer a risk to financial stability.

Just last week, FSOC issued proposed interpretive guidance to make it more difficult to designate nonbank financial firms. It shifts the burden back on the primary regulators to identify and solve systemic risks before FSOC can take any action.

These are the same primary regulators that failed to identify the risks that led to the worst financial crisis since the Great Depression.

Even more concerning is this approach gives unregulated shadow banks a free pass.

If you still do not believe that this Administration is a threat to financial stability, look at how FSOC's staff has been literally cut in half. FSOC member agencies have fewer meetings; they spend less time considering financial stability risks. Treasury has cut a third of the staff of the Office of Financial Research, which is supposed to support the work of FSOC.

The Financial Stability Oversight Council has all but given up its role as the agency tasked with identifying and constraining excessive risk in the financial system.

Wall Street continues to push legislation that would further weaken FSOC and make it impossible for future Administrations to designate nonbank financial firms.

We need to overcome this collective amnesia in this Committee and in this Congress. We should be strengthening FSOC; we should give it more authority to address risks; we should make sure it has the staff and resources to protect Americans' savings and homes from financial crisis. Instead the collective amnesia of this Administration, Wall Street, and the Senate will once again leave hardworking Americans and taxpayers holding the bag.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Brown.

We will proceed with the testimony now, and we will begin with you, Mr. Holtz-Eakin.

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

Mr. HOLTZ-EAKIN. Chairman Crapo, Ranking Member Brown, and Members of the Committee, it is a privilege to be here today to discuss the Financial Stability Oversight Council.

It has a less than glorious track record in the business of nonbank SIFI designations, and this is probably not surprising given that it was given an almost impossible job as a systemic risk regulator. We cannot measure systemic risk, and if you cannot measure something, you probably cannot regulate it very well.

As a result, the FSOC took the very strong authorities it was given in Dodd–Frank for designations and used those as its chief mechanism. Unfortunately, there were vague criteria for designation, and the processes by which designations were made turned out to be even less transparent than that. And so we had a series of designations that were not, I think, very well thought out and have been unwound. But that does not mean they did not have real consequences.

AIG reported, for example, that it was relieved of about $150 million in costs by its de-designation, and in thinking about some designations that did not happen, asset managers, our research indicated that this could have profound impacts on their cost structures, and those would be passed forward onto customers, lowering the rate of return to retirement saving by something like 25 percent.

So FSOC's activities are very important, and this is a great moment for the Committee to hold this hearing because at this point there are no nonbank SIFIs, and it is a good time to think about the criteria for designation and the processes by which they would be done.

The key things in that regard I think have become pretty clear. The first is to move toward an activities-based designation and not to rely on entities. In effect, what happened with the FSOC is it simply gave a second prudential regulator to these nonbank entities, and having two prudential regulators is not better than having one that does its job. And moving to an activities-based designation would also remove the bias against simply picking large organizations. You would have to identify the activity that is producing the systemic risk, and that is an important step for the FSOC to take.

The second thing that it would focus on is a disciplined benefit-cost analysis prior to designation. Benefit-cost analysis is not a panacea in the public policy process, but it forces a discipline on regulators to think through clearly those costs which will be incurred—and those are typically relatively easy to measure—and then to try to put the scale of the benefits, which in this case would be foregone financial problems, in perspective. That is something that is important to try to do because it often becomes clear that the costs are quite large and the benefits would have to be comparably large. And that discipline is something we need to do.

Then, finally, it should be transparent and predictable, providing some way for remediation prior to designation and a clear off-ramp if someone has been designated. Those have been missing in the past.

My take on the interpretive guidance that the FSOC just released is this is a good step in the right direction. It is not permanent. It could be changed again in the future. But it does, in fact, do four things that I think are important: turn to an activities basis and stipulate that an entity cannot be designated if it can be dealt with by dealing with its activities; doing a benefit-cost analysis, as the Chairman mentioned; assessing the likelihood that a firm will get into financial trouble. The operating procedure in the past has been, well, what if this firm got in trouble? What if it fell apart? That is a very different calculation than what is the probability that something will happen. A benefit-cost analysis would roll that right into it, and that is a very good thing.

And then, finally, the information being provided to firms and primary regulators as to what is making the institution a risk to the financial system so that it can take steps to mitigate predesignation or to provide a clear chance for an off-ramp after designation.

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

Chairman CRAPO. Thank you.

Mr. Stevens.

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, INVESTMENT COMPANY INSTITUTE

Mr. STEVENS. Thank you, Chairman Crapo, Members of the Committee. I am pleased to be before you once again today to testify.

The registered funds that are ICI's members are major participants in U.S. and global financial markets, and they do so on behalf of more than 100 million American investors and millions more overseas. The stability of the financial system is, therefore, a matter of utmost concern to the institute and its members as we help our investors achieve their most important financial goals.

To that end, ICI was an early supporter of proposals to form a council of regulators to share information and coordinate their activities. We believe that this convening authority can be FSOC's greatest strength.

Ten years after the financial crisis, the financial system clearly is more robust and resilient, so the time is right to review the effectiveness of postcrisis reforms and to make tailored adjustments.

I will make four points in my remarks today.

First, designation of nonbank financial companies as a SIFI, a systemically important financial institution, is a blunt regulatory tool that should be reserved for extraordinary circumstances. FSOC's primary goal should be to reduce systemic risk, and there can be more effective, less burdensome, or more expedient ways to do so. FSOC itself in 2014 decided that a review of products and activities would be the first step in considering potential risks in the asset management industry.

ICI welcomed this change in approach. We have long stressed that registered funds and fund advisers do not warrant designation as SIFIs. Thanks to their structure and regulation, registered funds simply do not pose risks to the financial system at large. Designation would bring banklike regulation that would be highly ill-suited to funds and their managers and would significantly harm fund investors.

More generally, designation of specific firms can create significant market distortions, including increased moral hazard and reduced competition and reduced consumer choice. We believe there is and should be a very high bar for singling out individual companies as SIFIs.

My second point is that SIFI designation should be reformed to address widely recognized shortcomings. Officials from both the current and prior Administrations have recognized the need to allow greater engagement with a company being considered for designation, a greater role for the company's primary financial regulator, more analytical rigor and attention to actual experience, and greater transparency to markets and the public.

My third point is that policymakers are moving in the right direction. The Treasury Department's November 2017 report on FSOC offered a series of constructive recommendations for the designation process. Just last week, FSOC itself proposed to implement these recommendations. It has proposed prioritizing an activities-based approach to addressing systemic risk, while reserving SIFI designation as a last resort whenever necessary. We welcomed FSOC's request for public comments on these proposed amendments to its guidance.

Despite these welcome developments, my fourth point is that Congress still must act to confirm in statute that SIFI designation is indeed intended as a tool of last resort and should be used only in extraordinary circumstances. Four members of this Committee—Senators Rounds, Jones, Tillis, and Sinema—have introduced bipartisan legislation to achieve this goal. S. 603, the Financial Stability Oversight Council Improvement Act of 2019, would require the Council to consider whether other steps could mitigate any potential risks posed by a nonbank financial company before voting to designate that company. These steps could include a different action by FSOC; action by the company's primary regulator, including industrywide regulation of products or activities; or de-risking actions by the company itself.

The legislation, in our view, would help ensure that the Council considers the full range of options available to mitigate risks and makes an informed decision rather than simply reaching for the hammer of designation in the first instance. The result would be an FSOC that is more effective in meetings its primary goal: reducing risk to the financial system. ICI urges the Committee to consider S. 603 and report it favorably to the full Senate.

Mr. Chairman, Ranking Member Brown, thank you for your attention. I will be happy to address the Committee's questions.

Chairman CRAPO. Thank you.

Professor Kress.

STATEMENT OF JEREMY C. KRESS, ASSISTANT PROFESSOR OF BUSINESS LAW, UNIVERSITY OF MICHIGAN ROSS SCHOOL OF BUSINESS

Mr. KRESS. Chairman Crapo, Ranking Member Brown, Members of the Committee, I am honored to appear before you to discuss the Financial Stability Oversight Council's nonbank systemically important financial institution designations. Nonbank SIFI designations are an essential policy tool for regulating systemic risk. I am, therefore, concerned that recent efforts to de-emphasize nonbank SIFI designations—or eliminate them altogether—would expose the financial system to many of the same dangers it experienced in 2008.

I will make three points in my testimony today.

First, nonbank SIFI designations are crucial for preventing catastrophic nonbank failures like the collapses of Bear Stearns, Lehman Brothers, and AIG. Nonbank SIFI designations protect the financial system by deterring nonbanks from becoming systemically important and by applying heightened safeguards to firms that nonetheless become excessively large, complex, or interconnected. By contrast, nonbanks' baseline regulatory regimes are generally not well suited to accomplish these goals.

Second, criticisms of nonbank SIFI designations are unpersuasive. For example, despite critics' complaints, nonbank SIFI designations do not impose bank-centric rules on nonbanks. To the contrary, the Federal Reserve has gone to great lengths to recognize the distinct regulatory issues associated with nonbank financial companies and to tailor its approach accordingly. Moreover, to the extent that heightened regulations create an uneven playing field for designated nonbank SIFIs, this differential is a feature, not a bug. Enhanced safeguards for nonbank SIFIs ensure that companies have incentive to avoid becoming or remaining systemically important.

Third, proposals to replace nonbank SIFI designations with an activities-based approach are deeply misguided. Activities-based regulation, on its own, will not prevent systemic collapses like those we experienced in 2008. It is unrealistic to expect that regulators will identify and appropriately regulate all such activities ex ante, especially given financial companies' strong incentives to restructure or rename activities to avoid regulation. By contrast, policymakers are much more likely to consistently and accurately identify nonbank financial companies whose distress could threaten financial stability.

A purely or predominantly activities-based approach to nonbank systemic risk will fail for yet another reason: the U.S. regulatory framework is not configured to implement effective activities-based regulation. The U.S. regulatory system is riddled with gaps in areas like insurance, hedge funds, and FinTech. Because FSOC lacks authority to implement activities-based rules directly, this pervasive jurisdictional fragmentation would undermine efforts to enact and enforce uniform, consistent activities-based rules throughout the financial system.

To be sure, if configured appropriately, activities-based regulation could address some sources of nonbank systemic risk. But as currently configured, the U.S. regulatory framework is simply not conducive to effective activities-based nonbank regulation.

Proponents of an activities-based approach to nonbank systemic risk contend that activities-based rules would merely supplement, rather than displace, nonbank SIFI designations. But make no mistake. The procedural barriers to nonbank SIFI designations that FSOC proposed last week would make it exceedingly difficult for the Council to designate new nonbank SIFIs and for any such designation to survive judicial review. Moreover, the Council's apparent enthusiasm for activities-based nonbank regulation rings hollow given that the FSOC has not used its existing statutory authority to propose a single activities-based rule in more than 2 years under Secretary Mnuchin's leadership.

In sum, I am deeply concerned about recent initiatives to roll back nonbank systemic risk regulation. Efforts to marginalize the Council by diminishing its legal authority, politicizing its work, and reducing its budget collectively increase risks to the financial system and ultimately threaten the real economy.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you very much.

I want to start out with you, Dr. Holtz-Eakin, and just sort of an overall question. You address in your testimony the fact that the nonbank SIFI designations come with a cost.

Mr. HOLTZ-EAKIN. Yeah.

Chairman CRAPO. Could you describe that cost? And, you know, there has been a lot of talk about who is the beneficiary of addressing the regulatory burden that is imposed by this system. What is that cost? And who bears it?

Mr. HOLTZ-EAKIN. Well, there are two main costs that designation brings. The first is sheer compliance costs, which would be borne by the institution itself—the hiring of compliance personnel, the additional reporting requirements, compliance with stress tests and the like, all of which can be quite costly. Those costs never end up residing just in the institution. They will be passed on in some way, either to the customers in the form of higher prices, if it is an insurance company, for example, higher premiums on insurance, or in lower returns to the owners of the firm, the shareholders. But those costs are real, and they have proven to be quite significant.

The second cost is really the requirement to hold more capital and to restrict the innovation in the scale and scope of the business practice. You have got now a new regulator who has decided they know how you can run your business. If you start trying to do something new, you are going to have to get their permission to do that, and you will not have the capital necessary to deploy it perhaps, and so you lose some of the sort of natural institutional vitality in the process.

Chairman CRAPO. And, ultimately, that impacts consumers and the economy.

Mr. HOLTZ-EAKIN. Yes. All of these costs are borne by U.S. citizens who use financial sector products.

Chairman CRAPO. All right. Thank you.

Mr. Stevens—and I want to get to Professor Kress' comments on this as well—but do you agree with Professor Kress' point that focusing on an activities-based or a risk-based approach to regulation is just unrealistic to expect to be workable?

Mr. STEVENS. You know, I took particular note of the assertion in the testimony. I represent the mutual fund industry. We had a statute passed in 1940 by the Congress that has governed our industry from its birth, the modern fund industry. It is an activities- and product-based form of regulation that has been supervised by the SEC very successfully for many years now, and it gave rise to, I think, the 20th century's most prominent new formal financial intermediation. It actually was the formal financial intermediation which weathered the great financial crisis most effectively.

So the idea that our regulation does not know how to deal with activities and practices and make them safe and sound and stable for the future is something that is simply unrecognizable from the point of view of our industry.

Chairman CRAPO. All right. Thank you.

Professor Kress, if I understood you correctly, you were making—one of the points that you were making is that our regulatory system as it currently exists does not provide the appropriate, I guess

I would say, seamless approach across the regulatory world to dealing with activities. Is that correct?

Mr. KRESS. That is correct.

Chairman CRAPO. How would you suggest that we—well, would you agree that it would be good for us, to improve our overall regulation system, to do that?

Mr. KRESS. Certainly. I acknowledge that activities-based regulation can combat some sources of systemic risk. In order for activities-based regulation to work, though, the regulatory system has to be set up for it to succeed.

Chairman CRAPO. Right. So how would we do that?

Mr. KRESS. I am concerned with gaps and overlaps in our system. When Congress mandates activities-based regulation, as it did with investment companies, it can work. A successful provision of the Dodd–Frank Act was mandatory derivatives clearing. That is an example of a congressionally mandated activities-based rule. But when it is left to the discretion of regulators who are fractured and overlapped, I am concerned about the consistency and uniformity with which activities-based rules will be implemented.

Chairman CRAPO. So should Congress take away that discretion?

Mr. KRESS. I do not think so, but if you wanted to empower FSOC to write activities-based rules directly, rather than simply make recommendations for the fragmented primary regulators, I think that would strengthen FSOC's activities-based approach to nonbank systemic risk.

Chairman CRAPO. All right. Thank you. I only have 20 seconds left, and I would like to get both Dr. Holtz-Eakin's and Mr. Stevens' response to that. So could you really quickly say do you agree with the notion of giving FSOC regulatory authority over activities-based—the authority to issue rulemaking over activities-based—activities?

Mr. HOLTZ-EAKIN. I would not start there. I would start with the framework that is in the interpretive guidance and is also in the proposed legislation, which is identify activities which could be systemically dangerous and put the burden on the primary regulator of insulating that firm from the danger of that activity.

Chairman CRAPO. All right. Mr. Stevens, real quickly, please.

Mr. STEVENS. FSOC has lots of different members with vastly different forms of expertise. The idea that they could come together as a council and begin writing regulation for discrete parts of the financial system to me is implausible.

Chairman CRAPO. All right. Thank you.

Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Professor Kress, FSOC was created to address risks to our economy posed by nonbank financial firms, like Lehman and Bear Stearns and AIG, as you know, whose risky bets contributed to the last financial crisis. Briefly, tell me why it is important that FSOC have the ability to designate nonbank financial companies as systemically important.

Mr. KRESS. Precrisis, there was a longstanding assumption that banks were the only types of financial companies that could pose systemic risk. As you noted, during the crisis that was proved untrue. Investment banks, insurance companies, other nonbanks precipitated the economic collapse.

We still have nonbank systemic risk regulation that, at its baseline, addresses risks unrelated to financial stability, like consumer protection and investor protection. It is not directly targeted to limiting those nonbanks' systemic risk. So FSOC designations are important because they are the only way to ensure that large, complex, interconnected nonbanks are subject to enterprisewide safeguards, like consolidated capital and risk management requirements that are designed to limit the risks that those companies pose to the financial system and the broader economy.

Senator BROWN. Thanks. In the Obama years, there were four nonbank financial companies designated as systemically important, including AIG. It received a $182 billion Government bailout during the crisis. Today, as you know, there are zero.

What kinds of insights into the workings of large nonbank financial companies is FSOC losing for lack of designation? And are other regulators stepping in?

Mr. KRESS. I am concerned that FSOC is losing substantial insight into the activities, risk exposures, and risk management of large systemically important nonbanks. Because of the gaps and fragments in our regulatory framework, there are in some cases—like in insurance holding company regulation—maybe no regulatory authority has jurisdiction to step in and take FSOC's place.

Senator BROWN. OK. That is important.

Last week, FSOC proposed to replace its existing nonbank designations process with a new activities-based approach that you were talking back and forth on, signaling the Council only designate a firm as a last resort. A couple of questions. How much time and difficulty would this add to the designation process?

Mr. KRESS. One of the parts of FSOC's proposed guidance that I think is so problematic is its proposal to designate nonbank SIFIs only in an emergency situation. SIFI designations are not an emergency response tool. SIFI designations are supposed to be prophylactic safeguards to prevent a nonbank from becoming—from transmitting——

Senator BROWN. Sorry to interrupt, but that suggests an earlier designation so they would have time to implement safeguards?

Mr. KRESS. Absolutely.

Senator BROWN. If the process described had been in place before the last crisis, what would have prevented or mitigated the damage to the financial system back a decade ago?

Mr. KRESS. A purely activities-based approach would not have prevented the financial crisis, and we know that because an activities-based approach did not prevent the financial crisis. We had a precursor to FSOC called the "President's Working Group on Financial Markets", which was compromised of many of the top regulators in the United States. The PWG had many of FSOC's activities-based authorities to identify and make recommendations for regulating systemically risky activities.

If you were to go back and look at what the President's Working Group was doing in 2004, 2005, 2006, when risks were building in the mortgage market, PWG was focused on mutual funds and hedge funds and terrorism risk insurance, activities that were largely unrelated to the causes of the crisis.

The President's Working Group eventually proposed enhanced rules for mortgages and securitizations and derivatives in March of 2008, one week before Bear Stearns failed. I strongly believe that asking regulators to predict ex ante what activities will cause systemic failures is a fool's errand.

Senator BROWN. Thank you, Professor Kress.

Mr. Chairman, I think that from this discussion it is pretty clear that FSOC's proposed activities-based process is really just another effort to weaken the rules for Wall Street and let the largest institutions avoid requirements put in place to prevent another taxpayer-funded bailout. We have seen just in the last 2 weeks more and more weakening of regulation. We have heard several Members of this Committee talk about the collective amnesia of this Committee, of the majority in this Committee, and of the Trump regulators, and Senator McConnell and others in this institution, and the price that—increasingly it looks like a price that we pay for this is something that we just do not want to happen.

Thank you.

Chairman CRAPO. Thank you.

Senator Rounds.

Senator ROUNDS. Thank you, Mr. Chairman.

Let me begin by just thanking the Chairman, Chairman Crapo, for calling this important hearing. Also, as Chairman Crapo indicated earlier, I am one of the sponsors of the FSOC Improvement Act, and I did this in conjunction with my colleagues Senators Jones, Tillis, and Sinema.

Part of our job in the Senate is to provide oversight of Federal laws and regulations in order to make certain that they are in the best interest of the American people. While we may not all agree on whether Dodd–Frank was the right approach to banking regulation—and I personally do not—we can all agree that there is room to review and improve it.

One of the foremost examples of this is Barney Frank's admission nearly 2½ years ago that the level of supervisory thresholds in Dodd–Frank was, and I quote, "a mistake." Revisiting the nonbank SIFI designation process is a healthy conversation to be having, and it is the Senate's responsibility to be doing more of this type of oversight.

The bipartisan legislation that I proposed simply suggests that FSOC consider nondesignation alternatives, like working with a company's primary regulator before voting on designation. It does nothing to detract from FSOC's emergency designation authority.

I would also like to point out that much more robust legislation passed the House last Congress with more than two-thirds of the chamber's support. A majority of Democrats on the House Financial Services Committee cosponsored that more robust approach. So it is my hope that the Senate Banking Committee can come together on this issue this year. With that, I would like to direct my first question to Mr. Stevens.

Mr. Stevens, one of my primary motivations for sponsoring the FSOC Improvement Act was the impact of an unjustified SIFI designation on mom-and-pop retail investors, people that go to work every single day. Your organization has pointed out that nearly three in four Americans save and invest in public markets through a 401(k) or similar retirement plan. That means every penny in fees counts for the long-term outlook of Main Street's retirement savings. A small increase in unnecessary fees through an unjustified SIFI designation could amount to tens or hundreds of thousands of dollars in lifetime savings for the average American.

From your perspective, why would it be important to think about how to make FSOC work more efficiently? And how does our legislation help?

Mr. STEVENS. Thank you for your question, Senator. Thank you also for the legislation that you have introduced.

Professor Kress has said that the Federal Reserve has articulated these highly flexible and sensitive arrangements under which it would regulate a nonbank financial institution that was designated. To my knowledge, the Fed has not said a peep about how it would regulate a fund or a fund adviser. So we are thrown back on what Dodd–Frank says.

What does Dodd–Frank say? Dodd–Frank says, oh, let us have an 8-percent capital requirement. Now, think about that in the context of a large S&P 500 index firm. You are setting aside presumably 8 percent to hold in cash. You have now created an 8-percent tracking error against the S&P.

Well, there is more because there is enhanced prudential supervision. So the Fed's people come in and essentially tell the fund manager how to run the fund. You know, money market—mutual funds, rather, are largely not debtors to banks; they are creditors to banks. So in a banking crisis, that would mean presumably the Fed could come in and say you have to continue maintaining your lines of credit for a bank that is failing, not because it is good for your shareholders but because we think it is good for the system.

So the fiduciary obligations of the fund's adviser have now been broached in favor of protecting the banking system. And if a bank actually goes down, that SIFI-designated fund, its investors would have to put money into a bailout fund, therefore having Main Street bail out Wall Street, which is precisely what Dodd–Frank was intended to avoid.

My own view is that the market distortions that that would create are such that that particular fund or fund complex would not be too big to fail. It would be so regulated it could do nothing else but fail, because investors will say, "Thank you very much. I do not want to be in that fund. I will go to another one."

So the costs are quite significant in terms of the way the market functions and the consequences for the individual investors in that fund.

Senator ROUNDS. So in a way you have answered really my second question as well because this is—what I care about is whether or not a consumer or somebody who is using these funds and is investing that way and having professionals do it, they basically see—because of these types of activities, they see the possibility of a net return which is less because of these being paid and because of the additional guidelines that are laid in place that they then suffer with.

Mr. STEVENS. There is no question about that, Senator, in the event of designation.

Senator ROUNDS. Thank you.

Thank you, Mr. Chairman. My time has expired.

Chairman CRAPO. Thank you, Senator Rounds.

Senator Jones.

Senator JONES. Thank you, Mr. Chairman, and thanks for holding this hearing. Gentlemen, thank you all for being here today, and I want to kind of follow up with some questions about the legislation I have with Senator Rounds and others.

You know, one think I think it is important to keep in mind is that Congress can pass all these laws, you know, but the enforcement of those laws is only as good as the people that are placed in those positions, whether it is FSOC, the SEC, the Department of Justice, or whatever.

So with my questions with the bill that Senator Rounds and I have, I do not want to focus on this Administration or really a future potential Administration and take the politics. Let us just focus on the regulatory framework of what we have got here.

One of the things that I think we are doing here is that we are trying to give these nonbanks an opportunity, should they be in a position, that they are either failing, on the verge, whatever the program is, to give them an opportunity for correction.

So my first question with regard to our bill: Is there any reason why FSOC, before designating a firm as systemically important, is there any reason that they might not want to consult with a primary regulator before that designation? Let us just go down the panel.

Mr. HOLTZ-EAKIN. No. That would be entirely beneficial, and it is the step that has been missing.

Senator JONES. All right.

Mr. STEVENS. It is absolutely imperative because that regulator is the entity on the Council that has the in-depth expertise about that organization.

Senator JONES. They know those folks best.

Mr. STEVENS. Far better than any others.

Senator JONES. All right. Yes, sir?

Mr. KRESS. FSOC issued a detailed framework for how it would consult with regulators in 2015, and my understanding is that it does as a matter of routine before considering any designation.

Senator JONES. So from your perspective, Professor Kress, you do not have any objection to them consulting with the regulators before they make that designation?

Mr. KRESS. No. I think it is important.

Senator JONES. All right. So the next question is: Is there any additional cost or time or things—are there any disadvantages? Let us look at it from a different perspective, and be very candid here. Let us look at the disadvantages—are there any disadvantages from that, looking at the regulators and letting regulators try to work with these entities before the designation?

Mr. HOLTZ-EAKIN. I do not think there are any disadvantages. I think there is a tremendous advantage. Let us just look at the history. We have these nonbank SIFIs, whether they are insurance companies or GE Capital. They are in front of the FSOC, and the

FSOC says, "You are systemically dangerous," and a natural question is: Why? The FSOC should have to state why they are dangerous and then be able to turn to their primary regulator and say, "Can you take care of this?" And there has not been in the past clear designation of why they are a danger. And there has never been the chance for their primary regulator to mediate that in any way. I think those are important.

Senator JONES. Thank you.

Mr. STEVENS. One of the important things about your legislation, Senator, is that the timetable remains under the control of the FSOC. There is this sensible consequence of the legislation that they would have to at an early stage talk to the fundamental regulator. They would have to talk to the company, engage with the company, and, presumably, if there is risk in the company, find the most expedient, quickest ways of addressing it. But the idea that somehow or other this is going to entail such inordinate delay, there is nothing in the legislation that necessitates that. Our view is FSOC remains in control of the timetable, and it always has the emergency authority that Dodd–Frank provided it in the event of need.

Senator JONES. All right. Professor.

Mr. KRESS. One of my concerns is that for many types of nonbanks, there is not an appropriate regulator who would have authority to address systemic risks under their jurisdiction. Insurance holding companies, hedge funds, you can consult with the supervisors of those entities, but do they have authority to implement risk-reducing activities-based regulations? In many cases, the answer is no.

Senator JONES. All right. So the question I have got then, let us just stay with you, Professor. Is there a way, though—because the problem I have got is, given my history as a lawyer and, you know, former U.S. Attorney, I always like to try to work with people before they get in trouble. And so for those folks that you just talked about, is there a way to create that process, either strictly with FSOC or someone else, that that issue could be addressed? In other words, they see the smoke clouds on the horizon, and they want to work with somebody to prevent this designation. What would be the answer for that if there is no regulator?

Mr. KRESS. Senator, I understand that the goal of the legislation is to increase collaboration among FSOC and primary regulators as well as increase collaboration among the Council and the company. The FSOC, under its existing interpretive guidance, has a very clear three-step process in which it increasingly coordinates with regulators and with the company to get whatever information the Council needs to decide whether to designate or to find alternative ways of addressing risk.

Senator JONES. So for the people that you are concerned about, there is already a position in place, and ours would just work for the regulators. Is that what you are saying?

Mr. KRESS. I am concerned that adding additional requirements over and beyond what FSOC has already laid out would slow the process of designation, lead us to an emergency situation, and potentially make any future designation vulnerable to judicial review if a designated entity were to demonstrate any shortcomings in the process.

Senator JONES. All right. Fair enough.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

So the Financial Stability Oversight Council was set up after the financial crisis to help regulators spot the kind of big systemic risks that brought the economy to its knees and crushed working families. And some of those risks are really hard to imagine ahead of time, but others, like giant interconnected financial institutions, are pretty obvious.

A few weeks ago, two big banks—SunTrust and BB&T—announced that they are merging to create an even bigger bank, the first new too-big-to-fail bank since the financial crisis.

Now, the Federal Reserve has to approve the merger before it can go through, and I want to talk about what the Federal Reserve should consider as they are thinking about this approval.

Professor Kress, you used to work at the Fed, and the Fed's record on this, gee, kind of all goes in one direction. They have approved 100 percent of all mergers since before the financial crisis. Why is the approval rate so high?

Mr. KRESS. So that is correct, I was an attorney at the Federal Reserve here in Washington from 2010 to 2014. One of my responsibilities was analyzing bank mergers, advising the Board on legal permissibility under the Bank Holding Company Act. And I think there are largely two reasons why the approval rate is so high.

One is potential bank merger applicants will have extensive back-and-forth communications with Fed staff before even striking a deal, let alone filing an application. And if at any point during that prefiling back-and-forth the staff raises concerns that perhaps staff would not be able to recommend approval to the Board, that early warning signal, for whatever reason—whether it is a pending enforcement action or other supervisory concerns—that will deter the bank applicant from even striking the deal in the first place.

The same thing is also true that if staff does not raise early warning signals, in my experience, that can create some internal momentum for a deal, and the Fed——

Senator WARREN. And all this happens before the public has a chance to weigh in before other competitors, before the communities that will be affected, before the employees that will be affected. So all this is happening behind closed doors.

Mr. KRESS. That is correct, Senator.

Senator WARREN. OK. And you said there is another reason. Is that it? Oh, you were saying the internal momentum.

Let me just ask you, people often talk to me when I am out and around, and they say that they are really worried in banking. Small businesses, minority-owned businesses, people who are doing work in rural communities, in small towns, say they have a lot of trouble with access to capital. Does the increasing concentration in the merger of these giants have anything to do with that?

Mr. KRESS. I have not seen strong evidence to that effect.

Senator WARREN. OK. So in 2008, we learned that when giant banks fail, they bring down whole communities with them. Since then, we have put in place additional regulatory and capital requirements to try to make these banks safer. So, Professor Kress, do too-big-to-fail banks still pose a risk to financial stability and ultimately to working families around the country?

Mr. KRESS. Absolutely. In addition to my research on FSOC and nonbanks, I research and write about the too-big-to-manage phenomenon in banking, and I think the literature is clear and our past experience shows that traditional corporate governance mechanisms do not work as well for very big banks as they do for nonfinancial institutions. Big banks are opaque. They are risky in that they are highly leveraged. They do not have the same market discipline as nonfinancial institutions, and size exacerbates all of those corporate governance challenges.

So, yes, I worry that too-big-to-manage institutions pose risks both to financial stability and to consumers.

Senator WARREN. OK. That is very helpful. Too big to fail and too big to manage are problems here.

Regulators should not have been blind to the risks that led to the 2008 financial crisis, but they were. And I hope that we are better at detecting risks than we were in 2008, but we still do not have a crystal ball here.

This Administration has been actively dismantling the systems we put in place to catch the risks that we already know about. If regulators ignore the risks to our economy, like the giant banks and the big nonbank financial institutions, ordinary consumers are going to bear the brunt of this all over again. The Fed and the other regulators needs to be ready to do their jobs.

Thank you.

Chairman CRAPO. Thank you.

Senator Cortez Masto.

Senator CORTEZ MASTO. Thank you. Thank you for the hearing this morning. Gentlemen, welcome. Thank you.

Professor Kress, let me start with you. You have written that regulating systemically risky activities like credit default swaps and securitizations is not enough to prevent nonbanks from failing. Why do you think entity-specific regulation is preferable?

Mr. KRESS. I think we need entity-based nonbank SIFI designations for several reasons. One is activities-based regulation looks at risks of isolated activities one by one. But risky activities, when combined within a single firm, collectively can pose more risks than when they are conducted in isolation.

Only entity-based SIFI designations allow regulators to impose enterprisewide, consolidated capital requirements, liquidity requirements, risk management requirements that are very important to reduce the likelihood that a systemic institution will damage the real economy. Activities-based regulation on its own cannot do that.

Senator CORTEZ MASTO. In essence, you could be looking for patterns of risky behavior, right, that would lead to a larger comprehensive concern?

Mr. KRESS. Another benefit of SIFI designation is it gives regulators an insight into the activities going on within large, complex, interconnected firms. Without those designations and without that insight, I am concerned that identifying risky activities in the first place would be extraordinarily difficult.

Senator CORTEZ MASTO. So can I ask also then—banks have rules regarding risk-based capital requirements, liquidity rules, stress tests, and risk management standards. Which of those rules are nonbank firms subject to?

Mr. KRESS. Under Dodd–Frank, the expectation is that nonbanks will be subject to versions of the enhanced prudential standards in Section 165. The Federal Reserve has a statutory mandate to tailor those rules to the business models of designated nonbanks. FSOC—or, excuse me, the Federal Reserve proposed to do that with respect to insurance companies. It issued an advance notice of public rulemaking for designated nonbank SIFI insurance companies, which I think it should continue working on and finalize. And it would be expected to tailor its regulations for a mutual fund complex or for some different sort of nonbank if it were designated.

Senator CORTEZ MASTO. OK. So I am from Nevada, and I will tell you, as I sat here on the Committee for the last couple of years, it seems to me that this current Administration is removing the safeguards that we put in place during the worst crisis that we had seen in Nevada and across the country.

I am curious, and this is for the panel. Would you agree that credit default swaps on mortgage bonds were only systemic in hindsight?

Mr. HOLTZ-EAKIN. So the credit default swaps at AIG were the important element in the crisis, and they reflected, in my view, more the poor internal management at AIG than a danger in the instrument itself. I was on the Financial Crisis Inquiry Commission, and when the AIG executives testified, their chief financial officer, who was also their chief risk officer, testified that he was unaware that Goldman Sachs could demand cash of $10 billion if those swaps declined in value. So that was just fundamental——

Senator CORTEZ MASTO. So it was systemic in hindsight.

Mr. HOLTZ-EAKIN. ——mismanagement.

Senator CORTEZ MASTO. That was hindsight.

Mr. HOLTZ-EAKIN. That is—but it is not systemic. It is a company, and it is bad.

Senator CORTEZ MASTO. OK.

Mr. STEVENS. Senator, I do not know that I can answer the question specifically, but I would say that we are faced with two differing views here on the panel.

Senator CORTEZ MASTO. Right.

Mr. STEVENS. One view essentially would take very, very large parts of the financial system and deliver it to the Federal Reserve for regulation. This has never been the model in the United States. It is a significant departure. We have had two models historically. There has been bank regulation and capital markets regulation, and we have benefited from both of them. Capital markets regulation and bank regulation do not sit very well together.

I cannot speak to the insurance sector because I am talking really for the regulated funds for the asset management industry. That was not an industry that had proven to be lacking in any resilience during the crisis. Indeed, if in the crisis those credit default swaps, as Alan Greenspan said, had been held in a mutual fund, the investors in that fund would have lost money, but there would have been no bailout, there would have been no economic crisis because of the model that the fund industry follows.

It is precisely because of that and the strengths that it has that we believe it is highly inappropriate to put an overlay of prudential regulation by bank regulators on top of the fund industry.

But make no mistake. There was a headlong rush early on in the FSOC's experience to do precisely that, and that is why our industry has been so concerned about avoiding inappropriate forms of regulation for a part of the financial system that has been doing extraordinarily well on behalf of millions of ordinary Americans.

Senator CORTEZ MASTO. Thank you. And I know my time is up. Can I just follow up on that? Professor Kress, would you agree with that?

Mr. KRESS. I believe that the experience of the President's Working Group that I referenced earlier and our regulatory track record indicates that it was difficult to foresee the credit default swap storm coming.

Senator CORTEZ MASTO. OK. Thank you. Thank you, gentlemen.

Chairman CRAPO. Thank you.

Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman.

Gentlemen, do you honestly believe we can measure with any sort of accuracy systemic risk?

Mr. HOLTZ-EAKIN. Absolutely not.

Mr. STEVENS. I think it is particularly challenging, Senator, yes.

Senator KENNEDY. Professor.

Mr. KRESS. I will note that FSOC's job is not to measure systemic risk, and——

Senator KENNEDY. I know that, but we all talk around here about, you know, the level of safety that we have to reach. It is sort of like your cholesterol level. You know, if we can get it below that, we are going to live an extra 5 years. Do you really think you can measure that?

Let me give you a specific example. I am not suggesting that we should not try, but we have spent all this time and effort and money and woman power and people power passing these bills. The Chinese economy right now, let us say, they have set a goal of growing at 6 percent. They say they are growing about 6¼. They are lying. It is probably about 5 percent, maybe 4 percent, 4½. Let us suppose they go into negative growth. That is going to throw the world into a recession.

Now, are our big banks going to survive that? That is a question.

Mr. HOLTZ-EAKIN. Yes, they are.

Senator KENNEDY. You believe that we have banks right now that are not too big to fail?

Mr. HOLTZ-EAKIN. There is a difference between being too big to fail and the probability of failure.

Senator KENNEDY. I understand.

Mr. HOLTZ-EAKIN. I think probably the figure is quite low in a demand-induced recession in the United States.

Senator KENNEDY. Well, if we are so good at this stuff—and, please, I do not mean that to come—I did not mean for that to come out like it did. I am not trying to suggest that you are not all very smart and know what you are talking about. But if we are so good at this stuff, then how come we had 2008?

Mr. STEVENS. Senator, if I could just observe, that is one of the ironies here, isn't it? And I was struck by Senator Warren's comments. The idea of delivering larger and larger parts of the financial system for the regulation of the Federal Reserve would make sense if you conclude that the Federal Reserve does an extraordinarily stellar, sterling job about regulating the banking sector.

I think that it is an imperfect model even for regulating the industry for which it is fashioned to regulate. The idea that it can then get up a learning curve about every other conceivable part of the financial system and do an even better job strikes me as a triumph of hope over experience.

Senator KENNEDY. You see, my concern—and I am going to come back to you, Doc. Excuse me. You go ahead.

Mr. HOLTZ-EAKIN. Let me just focus on things that are different now in a beneficial way. This is not all a negative——

Senator KENNEDY. I know, but let me stop——

Mr. HOLTZ-EAKIN. So the reason we had——

Senator KENNEDY. Let me stop you, Doc.

Mr. HOLTZ-EAKIN. OK.

Senator KENNEDY. And I do not want to get too far down in the weeds, OK? You guys know a lot more than I do, but I am going to look at this at a macro level for a second. We talk about measuring systemic risk, and we talk about the regulation, and that begs the question. OK, if we know how to do it, why weren't we doing it in 2008? And how do you measure systemic risk?

I mean, I think that we have many banks—strike that. I think we have some banks that are still too big to fail, and I do not think we would let them fail. I think if Jamie Dimon called the President tomorrow and said, "I hate to have to tell you this, but I am about to go belly up," I think we would bail him out.

Why don't we just go the easy route and say to all our financial institutions—let us pick a number—"You have got to keep 8 percent equity"?

Mr. HOLTZ-EAKIN. So I will say three things quickly, and then your time is up.

Number one, there is no substitute for equity in the financial system. It is the greatest buffer against failures.

Senator KENNEDY. Yeah.

Mr. HOLTZ-EAKIN. I am all with you on that.

Number two, if Jamie Dimon were to call—and I say this lovingly—sure, if you want to bail out JPMorgan, that is fine, but he should lose his job. And that is what went wrong the last time we went through this. Nobody lost their job.

Senator KENNEDY. He did not lose it in 2008.

Mr. HOLTZ-EAKIN. No. I know that.

And the third thing I would say is the thing that is different now about the large banks is they are subject to stress tests, so there is a macro view at their exposure to the Chinese recession that you discussed. That is a big improvement in the supervision——

Senator KENNEDY. But the stress test assumes——

Mr. HOLTZ-EAKIN. Let me finish——

Senator KENNEDY. ——that we can measure risk.

Mr. HOLTZ-EAKIN. No. It measures entity risk. So I am going to agree with you. We are better at measuring the entity risk posed by a large bank. We still do not know how to measure systemic risk. I agree with you on that.

Senator KENNEDY. Can I have 30 seconds?

Other than—I am not recommending this. I am asking you. Other than a lot of folks losing their bonuses because they will not make as much money, why wouldn't we just say—if equity is nirvana, why wouldn't we just say, OK, all you folks are going to maintain 8 percent equity. I know you are not going to be able to take as much risk. Duh. That is the point.

Mr. HOLTZ-EAKIN. Any equity standard involves a tradeoff in higher costs to the consumers, and so all of the regulations about that tradeoff, it is safety versus the capacity to have lower-priced products.

Senator KENNEDY. Yeah, but think how much we would save on the regulation. Think how much you would save in compliance costs. You would not have Sherrod pounding on you every day.

Mr. HOLTZ-EAKIN. Are you sure about that?

[Laughter.]

Senator KENNEDY. You are right about that. That part you are right about. I mean, you know, in the old days before—the real old days, banks held a lot more equity.

Sorry, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Kennedy, and that does conclude the questioning for today's hearing.

Again, I appreciate all three of you coming and bringing your expertise and observations to us. We do need to seriously look at what the regulatory structure and system and authorities are, in my opinion, to effectively focus on a risk and the appropriate level of regulation.

I see Senator Brown wants to make an observation.

Senator BROWN. Just one quick observation. Senator Kennedy, we will continue to work together to try to find a way on too big to fail to get you and me on board in the same place, as I did with your predecessor. So thank you.

Chairman CRAPO. All right. Thank you. And with that, again, thank you to our witnesses for coming, and that concludes our hearing. We stand adjourned.

[Whereupon, at 11:08 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN MIKE CRAPO

Today, we welcome to the Committee three witnesses to testify on the Financial Stability Oversight Council, or FSOC, nonbank designation process: Douglas Holtz-Eakin, President of the American Action Forum; Mr. Paul Schott Stevens, President and CEO of the Investment Company Institute; and Professor Jeremy Kress, Assistant Professor of Business Law at the University of Michigan's Ross School of Business.

Each of these witnesses is knowledgeable about FSOC's designation process and policy, drawing from their experiences in industry, Government, and academia.

The Dodd–Frank Act established FSOC to identify and respond to potential threats to U.S. financial stability.

Dodd–Frank authorizes FSOC to subject nonbank financial companies to supervision by the Federal Reserve and prudential standards, if it deems a nonbank to pose such a threat.

In the years after Dodd–Frank was enacted, FSOC evaluated individual companies for designation as systemically important and ultimately designated four nonbank financial companies: AIG, MetLife, Prudential, and GE Capital.

At the outset, the process for nonbank designation was immeasurable and unclear, which was not only contrary to the long-established principles of our regulatory framework, but also lead to legal uncertainty that undermined the very objective of FSOC.

Several years ago, I requested a comprehensive study by the GAO on the nonbank designation process.

The report concluded that FSOC's process lacks transparency and accountability, insufficiently tracks data and does not have a consistent methodology for determinations.

In recent years, FSOC voted to rescind three of those designations, while another's designation was overturned in court.

FSOC's decisions have costly implications for designated companies, which inevitably translates into higher costs for consumers and to the overall economy.

It is important that FSOC's designation process be clear, robust, and focused on addressing real underlying risks.

The process should also take into account how the existing regulatory structure already addresses any potential risks before taking the drastic step of designating an individual company.

In 2012, FSOC issued interpretive guidance that outlined its designation process, which begins with identifying individual companies over $50 billion in total assets for further scrutiny based on a set of five other quantitative thresholds, and then gradually using more granular and company-specific information along the way.

In November 2017, Treasury issued a report entitled, "Financial Stability Oversight Council Designations", which provided recommendations to improve FSOC's designation process.

One of Treasury's key recommendations was for FSOC to prioritize an activities-based approach to designation and work with relevant regulators to address any risks posed prior to considering designating a nonbank financial company.

Among the other important recommendations made by Treasury for the nonbank designation process were to: only designate a nonbank financial company if the expected benefits to financial stability outweigh the costs of the designation; and provide a clear "off-ramp" for designated nonbank financial companies, including by identifying key risks that led to the designation and enhancing the transparency of FSOC's annual review process.

At its meeting on March 6, FSOC proposed to replace its current interpretive guidance on the nonbank designation process with new interpretive guidance that would make several substantive changes.

Some of those changes include: prioritizing an activities-based approach to designation that would focus on identifying and addressing the underlying sources of risk, and would only contemplate designating individual companies if a risk could not be addressed through an activities-based approach; conducting a cost-benefit analysis prior to designating a nonbank; eliminating the first of its three-stage process that focuses on applying quantitative thresholds to identify individual companies for further evaluation, and the six-category framework used to analyze individual companies; and instituting several procedural changes to improve FSOC's engagement with companies and regulators, and clarifying "off-ramp" opportunities for companies through risk mitigation efforts prior to or after designation.

After FSOC issued the proposed guidance, Comptroller Otting expressed support for the proposal, saying, "The proposal ensures FSOC continues to serve its primary function in a transparent, efficient and effective manner."

The proposed guidance is a step in the right direction to improve FSOC's effectiveness, transparency, and analyses.

Senators Rounds, Jones, Tillis, and Sinema have also introduced the Financial Stability Oversight Council Improvement Act, which would require FSOC to first determine that a different action would not address risks posed to financial stability prior to a vote on an initial nonbank designation.

During this hearing, I look forward to discussing how an activities-based approach will more effectively address potential risks to U.S. financial stability; the appropriate framework for evaluating activities; and additional opportunities for improvements to the process.

Thank you to each witnesses for joining the Committee this morning.

PREPARED STATEMENT OF SENATOR SHERROD BROWN

Thank you Senator Crapo for holding this hearing.

Let's remember why FSOC matters. When Wall Street takes big risks, they're doing it with Americans' money.

The financial system affects who can get loans. It affects whether people have enough money to retire, or pay medical bills, or send kids to college. When banks and other big financial firms take risks and they don't pay off, it's never the executives and the CEOs who are left with nothing—it's ordinary families who lose their jobs, lose their homes, lose their life savings.

And when too many financial institutions take too many risks at once, we all pay the price.

Right now the risks to the financial system have increased—which means the risks are greater for families buying homes and saving for retirement and paying off student loans. The biggest Wall Street banks have gotten even bigger and more interconnected. The shadow banking sector has grown and is taking on more risk. The business cycle is extended and growth is slowing. The global economy faces uncertainty from Brexit and growing debt levels in China.

And things look even worse when you look past Wall Street, and look at ordinary families: student loan debt has hit record levels. Seven million Americans are more than 3 months behind on their car payments—the highest level in 19 years. And for too many Americans who haven't felt the benefits of economic recovery, decades of income and wealth inequality have made it even harder.

This Administration is all too happy to look the other way, as long as the risks affect families' bank accounts, not bank profits.

That's what led to the last crisis.

The FSOC was created after large, interconnected firms—firms like Lehman, Bear Stearns, and AIG—wreaked havoc on the economy.

These firms didn't have strong rules to ensure they had enough liquidity or loss-absorbing capital in case of an economic shock. And there was no single regulator monitoring the entire company for systemic risks.

It was so important to address this problem that the authors of Dodd–Frank created FSOC in Title I of the bill.

But now, FSOC appears to be closed for business.

It recently rescinded the last remaining SIFI designation of the Obama administration. Prudential, the giant insurance company that grew larger and more complex after it was designated as systemically important, is apparently no longer in need of stronger safeguards and no longer a risk to financial stability.

Just last week, the FSOC issued proposed interpretive guidance to make it more difficult to designate nonbank financial firms. And it shifts the burden back on the primary regulators to identify and solve systemic risks before FSOC can take any action.

These are the same primary regulators that failed to identify the risks that led to the worst financial crisis since the Great Depression.

Even more concerning is that this approach gives unregulated shadow banks a free pass.

If you still don't believe that this Administration is a threat to financial stability, look at how FSOC's staff has been cut in half. The FSOC member agencies have fewer meetings and spend less time considering financial stability risks. The Treasury has cut a third of the staff of the Office of Financial Research, which is supposed to support the work of the FSOC.

The Financial Stability Oversight Council has all but given up its role as the agency tasked with identifying and constraining excessive risk in the financial system.

And Wall Street continues to push legislation that would further weaken FSOC, and make it impossible for future Administrations to designate nonbank financial firms.

We should be strengthening FSOC, giving it more authority to address risks, and making sure it has the staff and resources to protect Americans savings and homes from financial crisis. Instead the collective amnesia of this Administration, Wall Street, and the Senate will once again leave hardworking Americans and taxpayers holding the bag.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN

PRESIDENT, AMERICAN ACTION FORUM

MARCH 14, 2019

Chairman Crapo, Ranking Member Brown, and Members of the Committee, thank you for convening this hearing and providing me with the opportunity to appear today and share my views on the Financial Stability Oversight Council (FSOC) nonbank designation process. I had the honor and privilege of addressing the Committee on this exact topic in 2015. Although so much in the world has changed since then, FSOC's designation process has not. As a result, my comments will have a tenor similar to my previous testimony.[1]

Ten years after the financial crisis, Prudential Financial has shed its designation as a systemically important financial institution (SIFI).[2] As a result, no nonbank financial companies (NBFCs) remain designated as SIFIs. This raises questions as to the future role of FSOC in the regulation of systemically important institutions across the economy.

In my testimony I wish to make two main points:

- FSOC was given a challenging, if not impossible, mandate and responded by significantly hampering U.S. NBFCs and increasing costs for consumers without demonstrably improving the safety or soundness of the U.S. financial system; and
- The exit of the last NBFC from SIFI designation, while welcome, has demonstrated that FSOC lacks relevance in NBFC regulation. For FSOC to remain relevant, it must significantly overhaul its operating procedures, beginning with a philosophy of activities-based rather than entity-specific regulation.

Safety and Soundness

Title I, Subtitle A, of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act) established FSOC, outlined FSOC'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, the key issues involving designation revolve around nonbanks.

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 FSOC determines that "material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States."[3] In making that determination, the Dodd–Frank Act lists 10 criteria for FSOC to consider along with "any other risk-related factors that FSOC deems appropriate."[4] As such, FSOC has broad authority statutorily when evaluating companies for SIFI designation.

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.[5]

---

[1] *https://www.americanactionforum.org/testimony/fsoc-accountability-nonbank-designations/*
[2] *https://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf*
[3] 12 U.S.C. §5323 (a)(1).
[4] 12 U.S.C. §5323 (a)(2)(K).
[5] 12 U.S.C. §5323 (a)(2), (b)(2).

Some 30 U.S. banks were captured under the Dodd–Frank Act; FSOC exercised its authority to additionally designate insurers AIG, Metlife, and Prudential, and General Electric's financing arm, GE Capital.

Implications

SIFIs are subject to "enhanced prudential standards" with three key elements: first, higher capital requirements; second, the requirement to undergo annual stress testing; and third, enhanced reporting requirements including the creation of recovery and resolution plans or "living wills." The impact of these additional requirements is clear: SIFIs must set aside more capital, significantly increase compliance staff, and increase technology and data capture processing. As a result, SIFI designation is a significant cost.

AIG estimated that de-designation would save the company $150 million a year in compliance costs once FSOC de-designated it as a SIFI in 2017.[6] Additionally, previous research by the American Action Forum (AAF) found that "SIFI designation of asset managers or funds will be costly for investors. In some cases, investors could see their returns reduced by as much as 25 percent (approximately $108,000) over the long term, forgoing several multiples of their initial principal in lost returns over the course of a working life."[7] These additional costs are, of course, passed on to consumers.[8]

Criticisms and Policy Recommendations

The safety and soundness of the financial system is clearly a fundamental goal. FSOC was however tasked with a difficult mandate in that the concept of "systemic risk" has never been adequately defined and cannot be measured (let alone a "safe" level of systemic risk). FSOC's response to this challenge has been to create an environment where NBFCs were laden with excessive regulation, and increased compliance costs, that were necessarily passed on to consumers. All this, and there was no evidence that either the NBFCs designated were a risk to the stability of the financial sector or that enhanced prudential measures demonstrably decreased such a risk.

The following analysis underpins the need for wholesale reform:

1. FSOC's focus on entities that might contribute to systemic risk does not pursue the goal of systemic risk itself. Having identified banks and insurers as potential contributors to systemic risk, FSOC indicated it would then focus on asset managers. To date FSOC has declined to give the asset management industry in a clear case of picking regulatory winners and losers. Even if FSCO had given asset managers appropriate scrutiny this would still miss the key issue of what drives systemic risk itself.

In 2017, the White House directed Treasury to review FSOC's designation procedures. The key recommendation of the resulting report (the 2017 Treasury Report)[9] was that FSOC prioritize industrywide approaches to systemic risk, and moving from entity-specific designation to monitoring the specific activities that increase systemic risk across the financial system.

Activity-based regulation is more comprehensive, as it will identify all of the market participants engaged in an activity that could pose a threat to stability. This approach is substantially better than singling out one or a few large firms or funds for designation, which creates disparities in regulation across firms and sectors that could have a very real and unintended economic costs.

2. Size is not a useful indicator of risk. It seems clear that the primary factor for designation is the bluntest: the size of the organization. Size does not necessarily correlate to risk, and larger organizations tend to be better diversified and more capable of absorbing systemic shock.

FSOC has not indicated that it has appropriately considered the riskiness of the insurance industry at all. Insurers receive systemic risk—they do not drive it. Liquidity is rarely an insurance concern, as assets are matched at long rather than short terms. Insurers do not lend to other insurers and are not as interrelated as banks. We will never see a run on an insurer. AIG failed because it had come to contain an unregulated hedge fund; risk did not stem from its insurance activities. In his dissent from the FSOC's SIFI designation of Prudential Financial, Roy Woodall, appointed by President Obama as FSOC's independent member with insur-

---

[6] *https://www.ft.com/content/31b36b9a-a662-11e7-93c5-648314d2c72c*

[7] *https://www.americanactionforum.org/research/the-investor-cost-of-designating-investment-funds-as-systemically-important/*

[8] *http://responsibleregulation.com/wpcontent/uploads/2013/05/Pricing-impact-study-Oliver-Wyman-April-10-2013.pdf*

[9] *https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf*

ance expertise, noted his concerns stating, "The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance." [10]

The 2017 Treasury Report noted the lack of academic backing for FSOC's determinations and recommended that FSOC "increase the analytical rigor of designation analyses."

3. Lack of transparency. The factors used to determine SIFI status are not weighted, and the decision-making process is extremely opaque. The Government Accountability Office (GAO) has at several junctures reproached FSOC for its lack of transparency. [11] The decision to designate (or de-designate) requires only the support of two-thirds of FSOC, and the decision to designate both MetLife and Prudential was made despite objections from the FSOC members with insurance experience and after a lack of consultation with State insurance regulators. [12] GAO is not alone in suggesting more open communication with the public and companies under consideration—the Bipartisan Policy Center and many others have echoed such concerns. [13] Designation decisions available to the public should reflect the shared goal of minimizing systemic threats; if there is a specific activity or subsidiary of a designated firm that poses an acute threat, the final decision should disclose it.

4. FSOC's focus has been to punish, not to remediate. As a company moves through FSOC's three-stage evaluation process, FSOC does not inform companies of what changes could be made to either their structure or operations to avoid designation. In the supplemental procedures adopted in 2015, FSOC made some effort toward increasing the amount of communication between firms under consideration and FSOC staff. Yet ultimately, FSOC does not encourage companies to work with the Office of Financial Research and FSOC staff to clearly define a potential systemic threat through data and modeling and then explore lower cost alternatives to designation. In meeting its aim of financial stability, FSOC should consider all the tools available instead of quickly moving to designation.

5. The designation process has never involved a cost-benefit analysis. FSOC should attempt to fully assess the economic effect, both costs and benefits, of designating only certain nonbanks as SIFIs. This means producing a convincing model that a firm's failure, its financial distress, or its activities could destabilize the financial system. In such a way, FSOC can demonstrate what is at stake and how a designation will help, and then justify the costs. Preventing the next financial crisis may undoubtedly have enormous benefit, but FSOC has not clearly outlined how each firm or industry segment it has scrutinized poses an actual threat to stability. Since the economic cost of eliminating systemic risk entirely is prohibitive, FSOC's goal must be to find the "right" amount of risk, a difficult feat since FSOC can neither measure its progress nor know its target. Because of the difficulty of regulating entities posing only a potential systemic threat, designations should be firmly rooted in sound economic analyses that explore all costs and benefits (as well as alternatives to designation) and be substantially justified by applicable Dodd–Frank Act statutes.

The 2017 Treasury Report recommended that FSOC revise its guidance to specifically require a cost-benefit analysis.

6. FSOC and its staff must continue actively to engage the public, experts, and stakeholders to examine comprehensively potential systemic threats, firm types, and changes in the financial economy environment as well as areas for FSOC procedural improvement. In 2015, FSOC began the process of reviewing and evaluating its SIFI designation process for nonbanks, seeking input from stakeholders and assessing potential changes. Ultimately, this process led to the adoption of a number of positive steps toward increasing communication between FSOC staff and firms under review and adding transparency to the process. If anything, this change should encourage FSOC to continue to collaborate with stakeholders, seek input from the public, and continue to advance efforts that open up its opaque process. As FSOC considers increasingly different potential threats, firms, and industry changes, engagement with outside experts will be integral and may substantially improve public confidence in its efforts.

---

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

[11] *https://www.gao.gov/products/GAO-15-51*

[12] *http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September192013NotationalVote.pdf*; *http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/December182014MeetingMinutes.pdf*

[13] *http://bipartisanpolicy.org/library/report/Dodd-Frank's-missed-opportunity-road-map-more-effective-regulatory-architecture*

FSOC Proposes Amending Interpretive Guidance

It is in this context that last week FSOC voted unanimously to amend its interpretative guidance relating to the designation of NBFCs. FSOC has stated its intent to dedicate itself to a new approach that would replace entity-based designation with activities-based supervision. FSOC will also "enhance the analytical rigor and transparency of the Council's process for designating nonbank financial companies" and commit to the performance of cost-benefit analyses. [14] This revision to the interpretative guidance, and all future revisions to internal procedures, will be made available for public comment—a welcome demonstration of willingness to continue engaging with all stakeholders.

Conclusions

The nonbank designation process is arbitrary, inconsistent, and opaque. Four years later the only thing that has changed is the exit of the last unwilling participant from this system. Now FSOC must consider its role as a regulator. The passing of the Economic Growth, Regulatory Relief, and Consumer Protection Act (S. 2155) [15] demonstrated the need and an appetite to redress the overreach of the Dodd–Frank Act. FSOC must redefine its mission, which must involve a shift from entity-specific regulation to activities-based regulation, or be disbanded as a regulator. FSOC's decision to amend its interpretative guidance is to be welcomed and we look forward to seeing how policy will evolve in this area.

---

[14] *https://home.treasury.gov/news/press-releases/sm621*
[15] *https://www.congress.gov/bill/115th-congress/senate-bill/2155/text*

PREPARED STATEMENT OF PAUL SCHOTT STEVENS

PRESIDENT AND CHIEF EXECUTIVE OFFICER, INVESTMENT COMPANY INSTITUTE

MARCH 14, 2019

EXECUTIVE SUMMARY

- Financial stability is a matter of the utmost concern to ICI and its members. As major participants in US and global financial markets on behalf of over 100 million American investors, registered funds and their managers have every reason to support policy measures that promote the robustness and resiliency of those markets.

- Ten years after the financial crisis, the financial system clearly is more robust and resilient. ICI and its members believe that this is an appropriate time for policymakers to review post-crisis reforms and make tailored adjustments, informed by the experience of the past several years.

- Established under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Financial Stability Oversight Council (FSOC or Council) serves a valuable purpose in bringing together diverse perspectives and expertise from across the spectrum of financial regulators. This convening and coordinating power is the Council's greatest strength.

- FSOC also has the authority to designate nonbank financial companies as systemically important financial institutions (SIFIs). SIFI designation is a blunt regulatory tool, and there are numerous reasons why the Council should invoke it only in very limited circumstances—*i.e.*, when FSOC has determined that a specific company clearly poses significant risks to the financial system that cannot otherwise be adequately addressed through other means.

- ICI has supported improvements to the SIFI designation process to help avoid the risk of inappropriate designations—as would be the case if FSOC determined to proceed with the designation of a registered fund or fund manager. Such designation is unwarranted, because registered funds and their managers do not pose the risks that SIFI designation seeks to address. And it would be harmful to fund investors, because it would result in the application of ill-suited measures—such as capital requirements—designed to moderate bank-like risks. These measures would increase costs and lower returns for fund investors.

- There have been many calls for reforming FSOC and the SIFI designation process, including from members of Congress in both parties. Despite some progress, reforms are still needed in four key areas:
    - Greater engagement with a company being considered for possible designation;
    - A greater role in the process for the company's primary financial regulator;
    - More rigorous analysis of the company and its potential to pose risk to US financial system stability; and
    - Greater transparency to the financial markets and market participants.

- A November 2017 Treasury Department report took an important step in the right direction, making a series of recommendations that ICI strongly supports, including that FSOC:

- Prioritize an activities-based or industry-wide approach to addressing risks to US financial stability;
- Increase the analytical rigor of its designation analyses;
- Improve engagement and transparency in the designation process; and
- Provide a clear "off ramp" for designated nonbank financial companies.

- If implemented appropriately, the Treasury recommendations will bolster substantially the effectiveness and integrity of FSOC's work while minimizing the potential for unsound policy outcomes. Last week, FSOC released a proposal for public comment which—we were pleased to see—appears to hew closely to the Treasury recommendations. We are reviewing it carefully and look forward to submitting comments.

- Notwithstanding the Council's proposal, ICI continues to believe that Congress should confirm in statute that SIFI designation is intended to be a regulatory "tool of last resort." Bipartisan legislation recently introduced by members of this Committee—Senators Mike Rounds (R-SD), Doug Jones (D-AL), Thom Tillis (R-NC) and Kyrsten Sinema (D-AZ)—would do just that.

- S. 603, the "Financial Stability Oversight Council Improvement Act of 2019," would add a modest but important step to the SIFI designation process. It would require that, before voting on a proposed designation, the Council must consider whether the potential threat posed by a nonbank financial company could be mitigated through other means—a different action of the Council; action by the company's primary regulator; or action by the company itself. If the Council determines that such other means are impracticable or insufficient to mitigate the potential threat, the Council may proceed with a proposed designation.

- ICI accordingly urges this Committee to consider S. 603 and report it favorably to the full Senate.

Introduction

Financial stability is a matter of the utmost concern to ICI and its members. As major participants in U.S. and global financial markets on behalf of over 100 million American investors, registered funds and their managers have every reason to support policy measures that promote the robustness and resiliency of those markets. Our investors are counting on their registered fund investments to help them achieve their most important financial goals, such as saving for college, purchasing a home, or providing for a secure retirement.

Since the financial crisis, ICI and its members have engaged actively in U.S. and global policy discussions concerning systemic designation of nonbank financial companies, particularly as they relate to asset management, and whether there are potential risks to financial stability from asset management products or activities. We have made detailed submissions to the Financial Stability Oversight Council (FSOC or Council), the Office of Financial Research (OFR), the Financial Stability Board (FSB), and numerous other bodies. ICI has testified before Congress on several occasions; we have engaged in extensive public commentary; and we have sought to inform the policymaking process by providing empirical research about registered funds and their investors.[1]

Ten years after the financial crisis, the financial system clearly is more robust and resilient. ICI and its members believe that this is an appropriate time for policymakers to review postcrisis reforms and make tailored adjustments where needed to fix unintended consequences and achieve balanced regulation. Let me underscore that point—we advocate for using the experience of the past several years to inform tailored adjustments that increase regulatory efficiency and effectiveness, not measures that would undermine the progress that has been made toward a more resilient financial system.

The Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act), by design, provides FSOC and its member agencies with an array of regulatory tools, including SIFI designation authority. The Council, for example, has a risk monitoring mandate and the authority to identify gaps in regulation and make recommendations to financial regulators. As the Council observed in its proposal just last week on the SIFI designation process, the Dodd–Frank Act provided FSOC with broad discretion as to how to employ its range of authorities.

This Committee held a hearing 4 years ago to examine the SIFI designation process and consider ways to improve transparency and accountability. Testifying at that hearing, I advised that, to truly advance financial stability, that process must be open to the public, analytically based, and grounded in the historical record. I reiterate that message in my testimony today. Indeed, these principles should apply not just to SIFI determinations but across the whole of FSOC's work.

In 2017, the Treasury Department issued a thoughtful and thorough report that included specific recommendations on how to recalibrate the SIFI designation process. The report also considered—appropriately, in my view—how the SIFI designation process should fit into the broader context of the Council's authorities and recommended in effect that SIFI designation be a regulatory tool of last resort. FSOC has now issued a proposal to implement the Treasury recommendations. Based on our preliminary review, there is much to commend in the proposal. ICI will evaluate the proposal closely in consultation with our members, and we look forward to commenting on behalf of the registered fund industry.

Even if FSOC adopts such reforms, as we hope it will, ICI firmly believes that legislation is necessary to provide a more durable solution. We believe Congress should confirm that SIFI designation of nonbank financial companies should be used by the Council only in rare circumstances, where no other regulatory action suffices to address the potential risk to financial system stability. So long as FSOC's statutory authority remains unchanged, nonbank financial companies (including regulated funds and their managers) will continue to face the risk, even if remote, of inappropriate SIFI designation.

In Section II, we discuss the limitations of SIFI designation and why its use should be reserved for extraordinary circumstances. We note our continuing concern that FSOC at some future time might proceed with the designation of a registered fund or fund manager, and we describe why this course of action would be unwarranted and harmful to fund investors. In Section III, we explain that reform of the SIFI designation process is necessary in several key areas: greater engagement with a company being considered for possible designation; a greater role in the process for the company's primary financial regulator; more rigorous analysis of the com-

[1] A compendium of selected ICI work on financial stability (with links to comment letters, speeches, research papers, Congressional testimony, and other commentary) is available at *https://www.ici.org/pdf/misc_18_finstability_compendium.pdf.*

pany and its potential to pose risk to U.S. financial system stability; and greater transparency to the financial markets and market participants. In Section IV, we discuss the Treasury Department's 2017 recommendations for improving the SIFI designation process and FSOC's proposal, issued just last week, to implement those recommendations. We also observe that the global Financial Stability Board likewise is considering improvements in how it conducts its work, following a review of its processes and transparency. In Section V, we urge the Committee's support for legislation to confirm that SIFI designation is intended to be a regulatory "tool of last resort." Finally, Section VI briefly outlines our recommendations for Congress.

SIFI Designation Is a Blunt Regulatory Tool, and Its Use Should Be Reserved for Extraordinary Circumstances

ICI's support for improving the U.S. Government's capability to monitor and mitigate risks across the financial system—including by creating a new council of financial regulators—dates from the beginning of the legislative debate over financial services regulatory reform in the wake of the financial crisis.[2] Then, as now, we saw the value of bringing together diverse perspectives and expertise from across the spectrum of financial services to consider emerging risks. The coordination of regulatory policies is altogether important in light of the size and complexity of the financial system and the sheer number of Government entities involved in overseeing it. Ever since Congress created FSOC as part of Title I of the Dodd–Frank Act, we have continued to believe that the convening and coordinating power of the Council is its greatest strength.

Title I also gave FSOC the authority to designate nonbank financial companies as SIFIs, and our early views concerning the use of this power likewise remain unchanged.[3] It is fundamentally important to view SIFI designation authority in context—recognizing that it is just one regulatory tool among many afforded to financial regulators under the Dodd–Frank Act to address abuses and excessive risk taking by financial market participants, and that in many cases such designation is merely an addition to other preexisting powers. We continue to emphasize to the Committee that there are numerous reasons why the Council should invoke this extraordinarily potent, but blunt, legal authority only in very limited circumstances. As we indicated previously, these reasons include:

- The inherent difficulty of trying to predict in advance whether a given nonbank financial company is, or may prove to be, systemically significant
- The potential mismatch between the remedies that the Dodd–Frank Act prescribes for designated companies (i.e., consolidated supervision by the Federal Reserve Board and enhanced prudential standards, such as capital requirements, that largely reflect banking regulation concepts) and the risks that FSOC has identified as the basis for designation[4]
- Uncertainty about the reaction of markets and market participants to a company's designation—which could result in a competitive advantage, or disadvantage, for the company
- Increased moral hazard, if market participants succumb to the temptation to relax their own due diligence with respect to a designated company based on the expectation that the Government is monitoring and preventing risks
- Reduced competition and consumer choice—for example, if companies exit certain businesses, or reduce their participation in those businesses, to avoid designation by FSOC

To the preceding list, we would add that SIFI designation authority necessarily requires FSOC to single out individual companies—even though other companies may have similar structures or engage in similar activities. As all this suggests, there is and should be a very high bar for determining that a single company has the potential to threaten the stability of the U.S. financial system.

These challenges, potential negative consequences, and shortcomings of the SIFI designation tool are why we repeatedly have advised that the use of this tool should be reserved for extraordinary circumstances. By this, we mean those (presumably quite limited) circumstances when FSOC has determined that a specific company

[2] See, e.g., Testimony of Paul Schott Stevens, President and CEO, ICI, Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, on Establishing a Framework for Systemic Risk Regulation (July 23, 2009).

[3] See, e.g., Letter from Paul Schott Stevens, President and CEO, ICI, to FSOC, dated Nov. 5, 2010, available at *https://www.ici.org/pdf/24696.pdf*.

[4] We elaborate on this point later in this section of the testimony.

clearly poses significant risks to the financial system that cannot otherwise be adequately addressed through other means. Moreover, use of the tool should reflect FSOC's determination that the regulatory regime presented by Title I of the Dodd–Frank Act is the appropriate response to address the identified risks.

Our long-standing position is in line with views expressed by senior Government officials directly involved in the formation of FSOC and its early years of operation. With foresight, as we have noted previously, former Federal Reserve Board Chairman Ben Bernanke expressed his expectation that use of the SIFI designation tool would be limited.[5] And in hindsight, former Treasury Under Secretary for Domestic Finance Mary Miller recently lamented that she now believes that during the time she was involved, FSOC spent too much time on designations and not enough on regulatory coordination.[6]

Underpinning our views about limiting the use of SIFI designation is the simple notion that FSOC's primary goal should be to reduce systemic risk, and that there can be more effective, less burdensome, and/or more expedient ways to do so. Even those who argue for broader use of SIFI designation as a regulatory tool acknowledge that it is not a panacea.[7]

Designation of a Registered Fund/Fund Manager Would Be Unwarranted and Harmful to Fund Investors

ICI and its members consistently have called for improvements to the SIFI designation process that will help avoid the risk of inappropriate designations. We remain concerned that FSOC at some future time might proceed with the designation of a registered fund or fund manager. Why would such a designation be inappropriate? Because registered funds don't fail like banks do—fund investors bear any investment losses, so there's no need for a Government bailout.[8] Unlike banks, fund managers act solely as agents, providing investment services to a fund by contract. The registered fund structure and comprehensive regulation of funds and their managers under the Federal securities laws already limit risks and risk transmission. And, as more than seven decades of historical experience demonstrates, registered fund investors do not panic or redeem heavily in the face of market downturns or turmoil.[9]

Testifying in the House of Representatives years ago, William McNabb, then ICI Chairman and Chairman and CEO of the Vanguard Group, pointed to press reports that FSOC was evaluating two large asset management firms for possible designation. He warned:

---

[5] During a Congressional hearing in connection with the development of the Dodd–Frank Act, Chairman Bernanke was asked expressly for his views on the number of firms that might be considered to be "systemically significant, too big to fail, too interconnected to fail." He responded: "A very rough guess would be about 25. But I would like to point out that virtually all of those firms are organized as bank holding companies or financial holding companies, which means the Federal Reserve already has umbrella supervision. So, I would not envision the Fed's oversight extending to any significant number of additional firms." See "Regulatory Perspectives on the Obama administration's Financial Regulatory Reform Proposals, Part II": Hearing before the House Committee on Financial Services (Serial No. 111-68), 111th Congress (2009), p. 47 (question by Rep. Campbell).

[6] Remarks by Mary Miller at Functions and Firms: Using Activity and Entity-based Regulation to Strengthen the Financial System, conference cosponsored by the Office of Financial Research and the University of Michigan Center on Finance, Law and Policy (Nov. 15–16, 2018, Washington, DC) (Functions and Firms Conference) ("with the hindsight of now 4 years out of the Government and back in the real economy and Main Street, I would say that we probably spent too much time on the designation work and not enough time on another very important role that FSOC can play, which is regulatory coordination. And I think if we could have done that differently we would have moved some things through the pipeline sooner, we might have gotten more buy-in on some very important concepts that followed the financial crisis that we should have jumped on."), available at ***http://financelawpolicy.umich.edu/conferences/functions-and-firms-using-activity-and-entity-based***, video for day 2, panel 6 at approximately 12:35 to 13:10. See also "Is Dodd–Frank Oversight Council Still Relevant?" by John Heltman, *American Banker* (March 5, 2019) (noting the observation by former Treasury official David Portilla that FSOC's success "will be in the power of convening the body and ensuring the regulators talk to each other and are sharing information and . . . not leaving [risks] unaddressed.").

[7] A key "take away" from the discussion at the Functions and Firms Conference was that several of the participants view activities-based and entity-based approaches as complementary—as even the full name of the conference suggests. See conference video, supra n. 6.

[8] See, e.g., Investment Company Institute, "Orderly Resolution of Mutual Funds and Their Managers" (July 15, 2014), available at ***https://www.ici.org/pdf/14_ici_orderly_resolution.pdf.***

[9] For more detail on this experience, see "Regulated Fund Shareholders' Reaction to Market Turmoil, 1944–January 2019", at Appendix A to this testimony.

> If the FSOC continues down this path, it could result in extension of the Federal Reserve's supervisory authority to companies whose business is rooted in the capital markets and which the Federal Reserve does not have the expertise to regulate. And it could mean the application of bank regulatory standards that are entirely out of keeping with the way in which [registered] funds and their managers are structured, operated and currently regulated and with the expectations of investors and the capital markets.[10]

It is important for the Committee to bear in mind what is at stake. Of greatest concern are the harms that SIFI designation would bring to fund investors by applying measures that are designed to moderate bank-like risks and are ill-suited to registered funds and their managers. These measures include capital and liquidity requirements, along with prudential supervision by the Federal Reserve Board. Designated funds or managers also would have to pay additional fees or assessments to defray Federal Reserve supervisory costs and FSOC and OFR expenses. And a designated fund could be assessed to cover costs associated with the resolution of a distressed financial institution deemed systemically important. Stated more plainly, this means that fund investors could have to help bail out a distressed, "too big to fail" financial institution—even though a major goal of the Dodd–Frank Act was to prevent "Main Street" from having to bail out "Wall Street."

Based on these requirements, designated funds would face higher costs resulting in lower investment returns for individuals saving for retirement, education, and other life goals. The resulting competitive imbalances would distort the fund marketplace, potentially reducing investor choice. Designation also could have far-reaching implications for how a fund's portfolio is managed, depending on how the Federal Reserve exercises its supervisory charge under the Dodd–Frank Act to "prevent or mitigate" the risks presented by large, interconnected financial institutions. As I have explained in previous Congressional testimony, regulated funds and their managers could be subject to a highly conflicted form of regulation, pitting the interests of banks and the banking system against those of millions of investors.[11]

While the prospect of such an ill-suited designation does not currently loom as large as it did in 2014, there are improvements that can be made to the SIFI designation process and to the Council's designation authority that would help avoid such an outcome in the future. I discuss those areas for improvement in the remainder of my testimony.

The SIFI Designation Process Should Be Redesigned in Light of "Lessons Learned"

Calls for reform of the SIFI designation process are not new. And these calls have not come just from industry stakeholders. They have come from the Government Accountability Office, in reports dating back to 2012.[12] They have come from Republican and Democratic members of Congress in letters to FSOC.[13] And they have come most emphatically from members of the House of Representatives from both parties, with the April 2018 passage of H.R. 4061, the FSOC Improvement Act, by a bipartisan vote of 297 to 121.

The Council itself has recognized shortcomings in its own process. By this, I do not mean just the current FSOC, but also the Council as constituted under the prior Administration. In November 2014, just 2½ years after adopting its rule and guidance outlining the designation process, FSOC staff convened roundtable discussions including academics and various stakeholders, including ICI. In early 2015, FSOC principals endorsed a set of "supplemental procedures" designed to improve the

[10] See Statement of F. William McNabb III, Chairman and CEO, The Vanguard Group, and Chairman, ICI, on "Examining the Dangers of the FSOC's Designation Process and Its Impact on the U.S. Financial System" (May 20, 2014) at 2, available at *https://www.ici.org/pdf/14_house_fsoc.pdf.* The testimony highlights several ways in which registered funds and their managers are fundamentally different from banks. It explains why SIFI designation of a fund manager is unwarranted and why even the very largest registered funds likewise are not SIFIs. And it discusses the investor harm and market distortion that would stem from such a SIFI designation.

[11] See Statement of Paul Schott Stevens, President and CEO, ICI, on "FSOC Accountability: Nonbank Designations" (March 25, 2015) (2015 FSOC Testimony), available at *https://www.ici.org/pdf/15_senate_fsoc.pdf*, at 15–18 (discussing in greater detail the highly adverse consequences of inappropriate designations to investors and the capital markets). See also Paul Schott Stevens, "Designation's Vast Reach Into Investor Portfolios", *ICI Viewpoints* (March 24, 2015), available at *https://www.ici.org/viewpoints/view_15_designation.*

[12] See, e.g., 2015 FSOC Testimony at n. 4.

[13] Id. at n. 3.

Council's engagement with companies and other regulators and increase transparency to the public.[14]

In my 2015 FSOC Testimony, I explained that ICI welcomed those changes as an initial positive first step toward providing greater fairness and clarity in the designation process. But I also advised that more needed to be done to achieve that goal.

My message today, 4 years later, is much the same. The SIFI designation process is still in need of reforms in several key areas:

- Greater engagement with a company being considered for possible designation;
- A greater role in the process for the company's primary financial regulator;
- More rigorous analysis of the company and its potential to pose risk to U.S. financial system stability; and
- Greater transparency to the financial markets and market participants.

I discuss each of these areas briefly below.

Greater Engagement With a Company Being Considered for Possible Designation

Meaningful dialogue between a company being considered for SIFI designation and FSOC and its staff is of utmost importance. To be meaningful, such a dialogue needs to begin as early as possible in the process. If a company is given an early indication as to why FSOC has selected it for review, the company is in a position to provide pertinent information about its business, structure and operations. With a more complete picture of the company and its risk profile, the Council and its staff can engage in a more informed review of the company or determine that no further investigation is necessary. This benefits FSOC by allowing it to make smart use of its limited resources, and it provides a fairer process for the company.

To its credit, FSOC recognized early on the value of more robust engagement with companies under review. Its 2015 supplemental procedures include several measures designed to increase communications with the company at various stages of the designation process. But these are not guaranteed protections, because FSOC issued them informally. Unless and until FSOC incorporates these procedures into its interpretive guidance through a public notice and comment process, they will remain "supplemental" and thus subject to amendment or rescission at the Council's discretion.[15]

Greater Role for the Company's Primary Financial Regulator

The current process calls for consultation with a company's primary financial regulator prior to any final designation of the company. This is merely a recitation of the requirement in Section 113(g) of the Dodd–Frank Act. The supplemental procedures contemplate that the Council will notify and consult with the primary regulator at an earlier stage of the process but, as mentioned above, those procedures are not currently incorporated into the existing guidance and thus are subject to amendment or rescission at the Council's discretion.

ICI strongly believes that the designation process should expressly require early and robust involvement by the primary regulator. A company's primary financial regulator has its own regulatory tools, some of which may provide another, possibly better avenue to address identified risks than SIFI designation. In addition, a primary financial regulator can evaluate whether an identified risk at one company exists more broadly and therefore would be more effectively handled on an industry-wide or cross-industry basis.

Working with a primary financial regulator in this manner gives FSOC more flexibility to address identified risks. Importantly, FSOC would retain control of the designation process and would still be able to make systemic designations when necessary.

---

[14] See FSOC, "Supplemental Procedures Relating to Nonbank Financial Company Determinations" (Feb. 4, 2015), available at *https://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental-Procedures-Related-to-Nonbank-Financial-Company-Determinations-February-2015.pdf.*

[15] Last week, FSOC adopted a rule stating that the Council shall not amend or rescind its interpretive guidance on nonbank financial company determinations, which appears in Appendix A to 12 CFR part 1310, without providing the public with notice and an opportunity to comment consistent with the Administrative Procedure Act. FSOC, "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies", RIN 4030-AA03 (March 6, 2019), available at *https://home.treasury.gov/system/files/261/Final-Rule-Regarding-Notice-and-Comment.pdf.* The 2015 supplemental procedures are not part of Appendix A to 12 CFR part 1310.

More Analytical Rigor and Attention to Actual Experience

It has long been ICI's view that such an important and consequential regulatory decision as SIFI designation must be based on a robust, empirical analysis that considers all of the factors that Congress enumerated in Section 113 of the Dodd–Frank Act, including the degree to which a firm is already regulated and the prospects of using that preexisting regulatory structure to address perceived risks. In my 2015 FSOC Testimony, I called for this analysis to be thorough and objective, and to include consideration of the company's structure, activities and historical experience. I also observed that requiring a consideration of the costs and benefits of designation would put the Council's decision making on par with the Administrative Procedure Act's requirements for significant rulemakings and the Obama administration's executive orders regarding rulemaking processes. [16]

Regrettably, the Council's analysis in many instances has fallen well short of these standards. This was seen, for example, in the Council's stated basis for designating Prudential Financial, Inc. as a SIFI in 2014. The independent member with insurance expertise on the Council at the time, Roy Woodall, dissented from that decision, observing that FSOC's "underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the regulatory environment, and the state of insurance company resolution and guaranty fund systems." [17]

The same has been true outside the SIFI context. Following a lengthy review of asset management products and activities, the Council released an April 2016 public update discussing what it found to be financial stability risks stemming from liquidity and redemption risks in mutual funds, particularly in funds invested in less liquid assets. ICI was disappointed by the Council's findings, because they largely ignored the extensive data and analysis that ICI and other commenters had provided to the Council in early 2015 on these very questions. ICI's letter highlighted the tremendous growth in both stock and bond funds since the mid-1940s, the several episodes of severe market stress occurring over the same seven decades—and the lack of any empirical evidence of destabilizing redemptions by stock and bond funds during those episodes. ICI's 2015 letter also explained why the historical data paint a consistent picture—i.e., because mutual funds' historical experience is grounded in their comprehensive regulatory framework, the nature of their investor base, and the realities of fund portfolio management. [18] In announcing its findings of potential financial stability risks, however, the Council cited no evidence that long-established, historical patterns of mutual fund investor behavior have changed or are likely to do so. In effect, its observations about "the potential for outflows [from mutual funds] to cause fund distress, and hence broader stress" amounted to mere conjecture.

To underscore the importance of rigorous empirical analysis as a basis for sound policymaking, ICI undertook a case study of the scenario that seemed to concern FSOC the most—the prospect of destabilizing redemptions from mutual funds invested in less liquid assets. Using publicly available data about high-yield bond funds and their experience from early 2014 to early 2016 (a period that included significant stress in the high-yield bond market), ICI's chief economist tested the predictions about destabilizing redemptions that had been suggested by the Council and by other policymakers and academics. The result? Contrary to those predictions, the data show that investors were purchasing (as well as selling) shares in high-yield bond funds, and in the underlying bonds, during this period of market stress. And, on a net basis, trading volumes of high-yield bonds actually rose when the high-yield bond market was under the greatest degree of stress. We submitted this

---

[16] Exec. Order No. 13563, 76 FR 3821 (Jan. 21, 2011) (requiring certain agencies to engage in cost-benefit analysis before rulemaking); Exec. Order 13579, 76 FR 41585 (July 14, 2011) (encouraging independent regulatory agencies to engage in cost-benefit analysis before rulemaking).

[17] See "Views of the Council's Independent Member Having Insurance Expertise" (Sept. 19, 2013), available at *https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf.*

[18] See, e.g., Letter to FSOC from Paul Schott Stevens, President and CEO, ICI, dated March 25, 2015 (March 2015 Letter), available at *https://www.ici.org/pdf/15_ici_fsoc_ltr.pdf*. As explained in detail on pp. 14–36 of the letter, the "realities" of registered fund portfolio management include the following: funds have sources of cash to meet redemptions, other than through sales of portfolio assets; funds typically have multifaceted liquidity management practices; portfolio rebalancing in accordance with stated investment strategies helps keep funds' cash ratios relatively stable, irrespective of market events; and funds can vary their purchases and sales of portfolio securities to accommodate redemptions.

analysis to the Council and urged it to reexamine its hypotheses about mutual funds in accordance with ICI's findings.[19]

Fortunately, recent analyses by the Council appear to be putting greater weight on evidence and less on conjecture. In its 2017 decision to rescind the designation of American Insurance Group (AIG), for example, the Council made clear that it had reexamined one of its key theories. When FSOC designated AIG as a SIFI, one of the arguments it used was that if AIG ever came under financial distress, "there could be a forced, rapid liquidation of a significant portion of AIG's assets as a result of [insurance] policyholder surrenders or withdrawals that could cause significant disruptions to key markets, including corporate debt and asset-backed securities markets." In other words, the Council postulated that if AIG experienced financial distress, its policyholders could behave like depositors at a bank, causing a "run" on AIG that would cascade through the financial markets. But in determining to rescind AIG's designation, the Council reconsidered that view. Based upon "additional consideration of incentives and disincentives for retail policyholders to surrender policies, including analysis of historical evidence of retail and institutional investor behavior," the Council determined that there was "not a significant risk that asset liquidation by AIG would disrupt trading in key markets or cause significant losses or funding problems for other firms with similar holdings."[20] ICI welcomes this development, because more precise and accurate analysis is essential to sound policy outcomes.

Greater Transparency to Financial Markets and Market Participants

In the four cases in which FSOC voted to designate a nonbank financial company as a SIFI, the company received a lengthy, detailed report discussing FSOC's findings and conclusions, and only a very abbreviated summary was made available to the public. These summaries did not give other companies and the broader public sufficient insight into FSOC's concerns about systemic risk or the business practices giving rise to those risks. ICI has long believed that a more detailed public report—perhaps a redacted version of FSOC's report to the company—could offer these insights while still maintaining the confidentiality of sensitive, proprietary information about the designated company.

Greater transparency from FSOC also would be helpful in areas other than SIFI designation, and we have two suggestions to offer in that regard. First, while we welcome FSOC's practice of issuing prompt "readouts" after closed-door meetings, the readouts and subsequent minutes from those meetings provide the public with little insight into FSOC's observations and areas of focus or concern. ICI recommends that FSOC release detailed minutes shortly after its closed meetings, as is the practice of the Federal Reserve Board's Federal Open Market Committee.

Second, as a matter of good Government, FSOC should inform the public about which staff members at the different agencies are involved in FSOC work. This information, which is not currently available, would promote engagement by stakeholders and other interested parties with the appropriate staff members on issues relevant to the FSOC agenda. Among other benefits, such engagement can provide educational opportunities and information resources to staff of agencies that do not otherwise possess expertise with respect to a particular financial industry sector.

Proposed Reforms Would Promote FSOC's Pursuit of Its Mission

As we have established, there has been growing recognition of the continuing need for reforms to address the areas highlighted above. Recent developments in this regard are significant and promising. Most notably, in November 2017, the U.S. Treasury Department published a report making recommendations for improving FSOC's nonbank SIFI designation process (FSOC Report).[21] And at an open meeting just last week, FSOC voted to issue for public comment a proposal to implement

[19] For further detail, see Letter from Paul Schott Stevens, President and CEO, ICI, to FSOC, dated July 18, 2016 (commenting on FSOC Update on Review of Asset Management Products and Activities), and accompanying analysis in Appendix B to the letter, available at *https://www.ici.org/pdf/16_ici_fsoc_ltr.pdf.*

[20] For further detail, see Sean Collins, "Applying Evidence to Theories on Regulated Funds", *ICI Viewpoints* (Oct. 12, 2017), available at *https://www.ici.org/viewpoints/view_17_fsoc_aig.*

[21] Department of the Treasury, "Financial Stability Oversight Council Designations" (Nov. 2017), available at *https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf.* The report came in response to a Presidential Memorandum that is available at *https://www.whitehouse.gov/the-press-office/2017/04/21/presidential-memorandum-secretary-treasury.*

those recommendations and other changes.[22] There also are encouraging signs in the global financial stability policy realm—a related area of interest to the Committee.[23] We discuss these developments below.

FSOC Report

ICI welcomed the release of the FSOC Report as an important step in the right direction.[24] This thorough and thoughtful report reviews the purposes, composition, and authorities of the Council and articulates five policy goals—in our view, laudable and appropriate ones—that Treasury believes FSOC's processes should be designed to achieve:

- Leverage the expertise of primary financial regulatory agencies;
- Promote market discipline;
- Maintain a level playing field among firms;
- Appropriately tailor regulations to minimize burdens; and
- Ensure the Council's designation analyses are rigorous, clear, and transparent.

The report discusses the effects and efficacy of nonbank financial company designations in achieving the Council's purposes. It acknowledges many of the concerns ICI and others have been raising for almost a decade and offers a series of constructive recommendations for improvements. The recommendations and related discussion in the report reflect a solid understanding of the lessons learned from experience to date and seek to address the areas highlighted in the previous section of this testimony.

The FSOC Report followed on the heels of another Treasury Department report—one that reviewed the U.S. regulatory structure for asset management and insurance (Asset Management Report).[25] Consistent with ICI's long-held views, the Asset Management Report acknowledged that entity-based systemic risk evaluations generally are not the best approach for mitigating risks arising from asset management. Presaging aspects of the FSOC Report, Treasury recommended that Federal regulators focus on risks arising from asset management products and activities and on implementing regulations that strengthen the asset management industry as a whole.

For its part, the FSOC Report recommends that FSOC:

- *Prioritize an activities-based or industrywide approach to addressing risks to U.S. financial stability.* The report indicates that prioritizing an activities-based approach would have many benefits. It would: (a) enable FSOC to "identify the underlying sources of risks to financial stability, rather than addressing risks only at a particular nonbank financial company"; (b) "address some of the potential limitations that could arise from designations" (e.g., competitive disadvantages and unnecessarily burdensome regulatory requirements); and (c) "preserve the option to consider designation in the rare instance, such as the historical case of Fannie Mae and Freddie Mac, where it was clear that individual institutions could pose a threat to financial stability, but a primary regulator has not taken or cannot take adequate steps to address the risk."[26]
- *Increase the analytical rigor of designations analyses.* The report recognizes the "considerable and continuing uncertainty among market participants about how the Council makes its decisions, which factors the Council views as most relevant in identifying a company that could pose risks to financial stability, and

[22] FSOC, "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies", RIN 4030-ZA00 (March 6, 2019) (FSOC Proposal), available at *https://home.treasury.gov/system/files/261/Notice-of-Proposed-Interpretive-Guidance.pdf.*

[23] For example, in July 2015, the Committee held a hearing on "The Role of the Financial Stability Board in the U.S. Regulatory Framework" at which I testified. See *https://www.banking.senate.gov/hearings/the-role-of-the-financial-stability-board-in-the-us-regulatory-framework.*

[24] See ICI News Release, "ICI Applauds FSOC Reforms of SIFI Designation Process" (March 6, 2019), available at *https://www.ici.org/pressroom/news/19_news_sifi*.

[25] Department of the Treasury, "A Financial System That Creates Economic Opportunities: Asset Management and Insurance" (Oct. 2017), available at *https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf.* The report made recommendations—including with respect to asset management and systemic risk—to better align the current regulatory structure with the Administration's "Core Principles" for regulation of the U.S. financial system. Exec. Order No. 13772 (Feb. 3, 2017).

[26] FSOC Report at 19.

how a company can take action to avoid designation."[27] According to the report, increased analytical rigor would promote certainty in FSOC's conclusions and increase transparency to firms and the public. The report makes several specific recommendations in this regard, including that FSOC evaluate the likelihood of the company's material financial distress as a threshold question and conduct a cost-benefit analysis.

- *Improve engagement and transparency in the designation process.* The report recommends enhancements to FSOC's engagement with companies under review, engagement with primary regulators, and public transparency.
  - *Engagement with Companies Under Review.* The report recommends that FSOC explain to a company at an earlier stage the key risks that have been identified. The report notes: "[i]f a company is aware of the potential risks the Council has identified during its preliminary review, the company can take action to mitigate those risks" prior to designation, thus helping achieve the goal of addressing potential risks to U.S. financial stability.[28]
  - *Engagement with primary regulators.* The report describes several benefits of deep engagement with a nonbank financial company's primary financial regulator and recommends that FSOC (i) actively solicit the regulator's views regarding risks at the company and potential mitigants, (ii) share its preliminary views regarding potential risks at the company, and request that the regulator provide information regarding those risks and whether they are adequately mitigated, e.g., by existing regulation or the company's business practices, and (iii) during the designation process, continue to encourage the regulator to use its existing authorities to address any risks to U.S. financial stability.
  - *Public transparency.* The report recommends that FSOC release publicly the full explanation of its basis for any future nonbank financial company designations or rescissions of designations (redacting confidential information), to give the public the greatest possible understanding of FSOC's reasons for its actions.
- *Provide a clear "off-ramp" for designated nonbank financial companies.* The report recommends, for example, that FSOC's explanation of the final basis for any designation highlight the key risks that led to the designation and the factors that were most important, which would make clear to the company the steps it could take to address the Council's concerns.

ICI strongly supports the Treasury recommendations. If implemented appropriately, they will bolster substantially the effectiveness and integrity of FSOC's work while minimizing the potential for unsound policy outcomes.

FSOC Proposal

Since the release of the Treasury FSOC Report, ICI and its members have been urging prompt action to implement the recommendations. At the same time, we recognize that the subject matter is complex and determining how to implement the recommendations effectively and appropriately—and to the satisfaction of the range of FSOC members—involves challenges. Further, we commend FSOC for making known early on its intent to handle this matter through a notice and comment process. Given the important themes underlying many of the recommendations, FSOC should proceed in a transparent and accountable manner.

Consistent with its plan, FSOC last week proposed for public comment revised guidance to govern the nonbank SIFI designation process.[29] ICI is reviewing the proposal carefully and looks forward to submitting comments. Our preliminary reaction is very positive, as it appears that FSOC has hewed closely to the recommendations in the Treasury report. Under the proposal:

- FSOC has firmly committed to addressing risks through an activities-based approach and would only consider designating entities as SIFIs as a last resort—as we have long urged.
- If FSOC did decide to pursue designation, that process would be more transparent, accountable, and rigorous.
- The proposed changes seek to facilitate more constructive—and appropriate—engagement between nonbank financial companies and the Council.

---

[27] FSOC Report at 23.
[28] Id. at 30.
[29] FSOC Proposal, supra n. 22. FSOC also adopted a rule requiring that any future changes to the guidance be subject to a notice and comment process. See supra n. 15.

- The proposed changes would elevate the crucial role of primary regulators, who are best suited to work with the company under review to mitigate potential risks before imposing the costly burden of SIFI designation.

For the benefit of the Committee, we include a more detailed summary of the FSOC proposal in Appendix B.

Similar Recalibration at FSB

In testimony before this Committee in July 2015, I discussed the role of the FSB in the U.S. regulatory framework.[30] Like FSOC, as part of its postcrisis agenda, the FSB trained its focus on the asset management sector and on large registered U.S. funds and fund managers. At first, the FSB set out to develop methodologies to identify global systemically important funds or fund managers, closely following a pattern it had established in the banking and insurance sectors. It later put this work on pause while conducting a review of potential "structural vulnerabilities" in asset management. My testimony illustrated that the work of the FSB related to asset management exhibited many of the same fundamental problems that have pervaded FSOC's work.[31] These problems included: a tendency to view the asset management sector through a banking lens; an inadequate role for subject matter experts; reliance on conjecture and theory rather than empirical data and actual experience; indications that desired results, rather than the public record, might be driving the FSB's work; and insufficient transparency and accountability in the FSB's consultation and designation process.

I am pleased to report some signs of progress on the FSB front. For example, consistent with ICI's urging, the FSB properly entrusted the implementation of several of the policy recommendations that emerged from its asset management review to the International Organization of Securities Commissions (IOSCO)—a body with a deep well of relevant subject matter expertise.

More generally, late last year, after conducting a review of its processes and transparency, the FSB agreed to take certain actions—including actions to improve communication and engagement with external stakeholders along the lines ICI has recommended.[32] In addition, the FSB has turned some of its focus to evaluating the effectiveness and efficiency of reforms that have been implemented and considering whether any adjustments are needed.

Some of these changes appear to reflect the direction in which the new FSB chairman, Federal Reserve Board Vice Chairman for Supervision Randal Quarles, is seeking to steer the organization. Based on his recent inaugural speech as FSB chairman, there is reason to be encouraged.[33] His remarks focused on the core principles he believes should guide the FSB's future work: engagement, including improved outreach and transparency with a broad range of constituencies; rigor, so that assessment of financial sector vulnerabilities is based on "cutting edge thinking and a disciplined methodology"; and analysis, including critical analysis of the effects of reforms to determine if there are improvements that can be made—for example, to achieve resiliency in less burdensome and more efficient ways.

I believe Chairman Quarles' leadership and policy approach will serve the interests of all who participate in and benefit from a robust financial system, including millions of Americans who invest in registered funds to meet their most important financial goals.

A Legislative Solution Is Still Appropriate and Necessary

In the release explaining its proposal, the Council emphasizes that the Dodd–Frank Act gives it broad discretion to determine how to respond to potential threats to financial stability. As we indicate above, our initial analysis of the proposal is

[30] See Statement of Paul Schott Stevens, President and CEO, "ICI on The Role of the Financial Stability Board in the U.S. Regulatory Framework" (July 8, 2015), available at *https://www.ici.org/pdf/15_senate_banking_fsb.pdf.*

[31] For details, see id. See also Statement of Paul Schott Stevens, President and CEO, ICI, Before the U.S. House of Representatives Committee on Financial Services Subcommittee on Monetary Policy and Trade, on The Financial Stability Board's Implications for U.S. Growth and Competitiveness (Sept. 27, 2016), available at *https://www.ici.org/pdf/16_house_fsc_fsb.pdf.*

[32] See Letter from Paul Schott Stevens, President and CEO, ICI, to the Secretariat of the FSB, dated Sept. 21, 2016 (responding to Consultative Document; "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities"), available at *https://www.ici.org/pdf/16_ici_fsb_ltr.pdf*, at 40.

[33] See "Ideas of Order: Charting a Course for the Financial Stability Board", Remarks by Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, Chair, Financial Stability Board, at Bank for International Settlements Special Governors Meeting, Hong Kong (Feb. 10, 2019), available at *http://www.fsb.org/wp-content/uploads/Quarles-Ideas-of-order-Charting-a-course-for-the-Financial-Stability-Board.pdf.*

quite positive. ICI believes that the Council has outlined a sound approach to using its range of authorities, from information sharing to SIFI designation. Nevertheless, we continue to believe that Congress should confirm in statute that SIFI designation is intended to be a regulatory "tool of last resort."

Bipartisan legislation recently introduced by Members of this Committee—Senators Mike Rounds (R-SD), Doug Jones (D-AL), Thom Tillis (R-NC), and Kyrsten Sinema (D-AZ)—would do just that. S. 603, the "Financial Stability Oversight Council Improvement Act of 2019", would add a modest but important step to the SIFI designation process. It would require that, before voting on a proposed designation, the Council must consider whether the potential threat posed by a nonbank financial company could be mitigated through other means—a different action of the Council; action by the company's primary regulator (which could include implementing standards/safeguards pursuant to Council recommendations under Section 120); or action by the company itself, as detailed in a written plan submitted promptly to the Council. If the Council determines that such other means are impracticable or insufficient to mitigate the potential threat, the Council may proceed with a proposed designation.

The bill preserves maximum flexibility for the Council. While it requires the Council to consult with the primary regulator and the company, it does not dictate how the Council should do so. Nor does the bill preclude the Council from proceeding expeditiously. What it does do is help to ensure that the Council consider the range of options available and make an informed decision about how to address the potential threat to financial stability.

S. 603 comports well with the current requirements of the Dodd–Frank Act. Section 113(g) of the Act already requires FSOC to consult with the primary regulator for a company that is being evaluated for possible designation. The bill simply would specify that this consultation must happen at an early stage of the process—that is, before FSOC votes on a proposed designation. And, importantly, S. 603 affirmatively preserves the Council's emergency powers as outlined in Section 113(f).

ICI accordingly urges this Committee to consider S. 603 and report it favorably to the full Senate.

Recommendations

ICI is pleased to offer its recommendations for addressing the matters we discuss above.

- Congress should encourage FSOC's current effort to implement the Treasury Department's FSOC reform recommendations through the pending proposal and a public notice and comment process.
- Congress should enact legislation, such as S. 603, to codify in statute that FSOC's nonbank SIFI designation authority is intended to be used only in extraordinary circumstances, as a regulatory tool of last resort.
- Congress should continue to monitor U.S. involvement in the FSB. It also should support Chairman Quarles in his reform efforts which, if successful, will benefit U.S. investors.

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

Appendix A
Regulated Fund Shareholders' Reactions to Market Turmoil, 1944–January 2019

The notion that investors in regulated funds are flighty, prone to panic, and likely to trigger "runs" and "fire sales" of assets—events that would propagate and exacerbate turmoil in financial markets—is not new.

- In the 1930s, US Supreme Court Justice Louis Brandeis and others pushed the idea that investment companies helped cause the crash of 1929 by dumping stocks.
- In 1940, an official at the then-new US Securities and Exchange Commission testified that a "run" on a mutual fund could trigger "an undesirable effect upon the stock market."
- In 1959, *Time* magazine claimed that "in a falling market, millions of panicky, inexperienced investors would redeem their shares, forcing [mutual] funds to liquidate huge blocks of stock and collapse the market."
- In 1994, famed economist Henry Kaufman warned that "the technology is in place for a cascade of selling by investors in mutual funds," creating "an economic shock."
- And since the global financial crisis, a host of academics and US and global regulatory bodies have promoted theories about fund investor runs, first-mover advantages, asset-sale "waterfalls," and other speculative phenomena that could pose severe risks to the financial system at large.

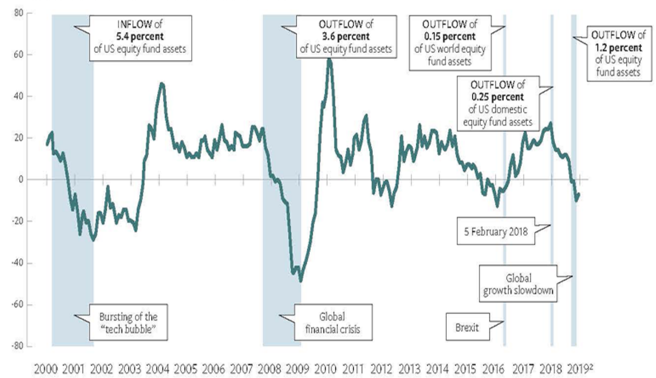
These theories, however, find little support in history, data, or empirical analysis. Since the mid-1990s, the Investment Company Institute has conducted extensive research on market cycles affecting US equity and bond funds, as well as US funds investing in emerging markets. In the past decade, that work has been extended to funds based in Europe and Canada.

In episode after episode, the message is the same: shareholders in regulated funds do not panic or redeem heavily in the face of market downturns or turmoil. In facts, funds often have inflows during falling markets. When funds do have net outflows, they do not occur precipitously. And even when funds are in net outflow, they frequently are buyers of securities in the market. In the pages that follow, we detail the reactions of regulated fund investors to market episodes, from January 2019 back to the early days of the US regulated fund industry.

Since the financial crisis, ICI has amassed a considerable body of work—comment letters, research papers, speeches, and *ICI Viewpoints* commentaries—on these and other issues related to regulated funds and financial stability. That work can be found at https://www.ici.org/ICI_Work_On_Financial_Stability.

US Equity Mutual Funds: Net Flows Are Modest During Market Events

Total return on equities, percent;[1] 2000–2019[2]



[1] The total return on equities is measured as the year-over-year percent change in the MSCI All Country World Daily Gross Total Return Index.

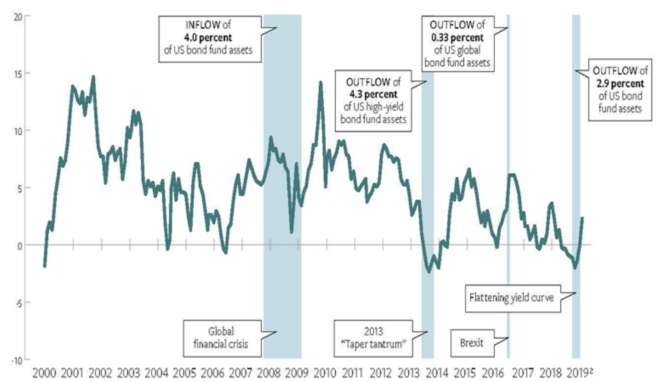
[2] Data are through January 31, 2019.

Note: Net new cash flow data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, MSCI, and Bloomberg

US Bond Mutual Funds: Net Flows Are Modest During Market Events

Total return on bonds, percent;[1] 2000–2019[2]



[1] The total return on bonds is measured as the year-over-year percent change in the FTSE US Broad Investment Grade Bond Index.

[2] Data are through January 31, 2019.

Note: Net new cash flow data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, FTSE Russell, and Bloomberg

Market Events and Investor Reactions

Since the Global Financial Crisis (2010–Present)

GLOBAL GROWTH SLOWDOWN, OCTOBER–DECEMBER 2018 | US equity and bond funds; European equity and bond funds

Fear of a severe slowdown in global economic growth—stemming in part from lower-than-expected GDP growth in China and deteriorating trade relations between China and the United States—contributed to a dip in stock markets around the world in the fourth quarter of 2018.

Between October 3 and December 24, 2018, the S&P 500 fell 19.6 percent, wiping out all of its gains in the first three quarters of the year. During the same period, returns on stocks elsewhere around the world fell 11.9 percent.[1] Despite this decline in worldwide stock markets, cumulative outflows from US equity funds amounted to only 0.5 percent of total net assets from October through December.

Cumulative estimated outflows from equity UCITS totaled only 0.5 percent of total net assets from October through December.

Investors closely monitored the continued tightening of US monetary policy along with broader issues concerning geopolitical risk. The US Treasury yield curve flattened substantially in the fourth quarter of 2018, as the difference in rates between 10-year and 3-month US Treasuries fell from 100 basis points in early October to just 24 basis points by year-end. Additionally, in June, the ECB signaled its intent to end its quantitative easing scheme at the end of 2018, creating uncertainty in the European corporate debt market.

US bond funds experienced cumulative outflows of 1.9 percent of total net assets from October through December.

Fixed income UCITS experienced cumulative estimated outflows of 1.8 percent of total net assets from October through December.

FEBRUARY 5, 2018 | US equity funds

On February 5, 2018, the Dow Jones Industrial Average suffered its largest single-day point drop ever—down 1,175 points.

US domestic equity exchange-traded funds (ETFs) had net redemptions in February, but domestic equity mutual funds had net purchases of $8.6 billion in stocks. Net fund

[1] As measured by the MSCI All Country World Daily ex-US Total Return Index.

redemptions accounted for just 0.25 percent of trading.[2] Federal Reserve Board Chairman Jerome Powell testified, "I don't think [ETFs] were particularly at the heart of what went on, on those days."[3]

BREXIT, JUNE 2016 | US global equity and bond funds; European equity and bond funds

On June 23, 2016, British voters shocked markets by voting to leave the European Union. In the first two trading days after the vote, stocks lost $3 trillion in value worldwide.

In the week ended June 29, US funds invested in world equities had outflows of 0.15 percent of assets; US global bond funds had outflows of 0.33 percent.[4]

Bond UCITS had estimated inflows totaling 0.1 percent of assets during the Brexit period.[5] Equity UCITS had estimated outflows of 1.2 percent of assets.[6]

OIL PRICES, 2015–2016 | Canadian equity and bond funds

From April 2015 to January 2016, Canadian stock prices fell more than 20 percent as global oil prices tumbled.

Investor purchases of Canadian-domiciled equity funds exceeded redemptions for most of the period, with net inflows of 0.8 percent of assets. Canadian-domiciled bond funds saw net inflows of 2.5 percent during the period, and global and high-yield bond funds domiciled in Canada saw strong inflows.[7]

---

[2] William F. Truscott, Chairman's Address: 60th General Membership Meeting, available at https://www.ici.org/ pressroom/ speeches/18_gmm_truscott.

[3] Monetary Policy and the State of the Economy, Hearing Before the Committee on Financial Services, House of Representatives, February 27, 2018, Serial No. 115-76, page 29, available at https://financialservices.house.gov/ uploadedfiles/115-76.pdf.

[4] "Matching Models to Reality: Doomsayers Are Disappointed—Again—as Funds Weather Brexit Shock," *ICI Viewpoints*, July 13, 2016, available at https://www.ici.org/viewpoints/view_16_bond_fund_ series_01 ("Brexit Viewpoints").

[5] Letter from Paul Schott Stevens, President and CEO, ICI, to Secretariat, Financial Stability Board, dated September 21, 2016, available at https://www.ici.org/ pdf/16_ici_fsb_ltr.pdf ("FSB Letter").

[6] FSB Letter.

[7] FSB Letter.

DECEMBER 2015 | US high-yield bond funds

The US high-yield bond market—generally considered less liquid than the market for Treasury or investment grade corporate bonds—was under considerable stress due to falling oil prices and signs of slowing growth in emerging economies. Yields on below–investment grade bonds rose 100 basis points from early November to December 9. On December 9, Third Avenue Focused Credit Fund, a US high-yield bond fund, announced that it had suspended investor redemptions and would liquidate.

US high-yield bond funds saw outflows of 1.2 percent of fund assets over a two-week period. But US mutual funds remained buyers of high-yield bonds, and outflows quickly tapered off and remained subdued.[8] US high-yield bond ETFs added liquidity to the market.[9]

AUGUST 24, 2015 | US equity exchange-traded funds

After a disorderly opening in US stock markets, many ETFs experienced multiple trading halts amid rapidly fluctuating prices. Some ETFs traded at substantial discounts to their underlying value.

Investigations by securities regulators and exchanges showed that conflicting rules on trading halts and re-openings exacerbated selling pressures and led to multiple trading halts. Exchanges revised many market structure rules.[10]

GERMAN BUND SELL-OFF, 2015 | European bond and equity funds

In spring 2015, the market for the German 10-year bund sold off rapidly, driving the yield up 75 basis points in two months.

Bond UCITS had estimated inflows of 0.4 percent of assets during the sell-off. Equity UCITS had estimated inflows of 1.5 percent of assets.[11]

---

[8] FSB Letter.

[9] "High-Yield Bond ETFs: A Source of Liquidity," *ICI Viewpoints*, December 22, 2015, available at https://www.ici.org/viewpoints/view_15_hybf_etf.

[10] "Research Note: Equity Market Volatility on August 24, 2015," Staff of the Office of Analytics and Research, Division of Trading and Markets, US Securities and Exchange Commission, December 2015, available at https://www.sec.gov/marketstructure/research/ equity_market_volatility.pdf.

[11] FSB Letter.

"TAPER TANTRUM," 2013 | US high-yield bond funds; European bond funds; Canadian bond funds; emerging market bond funds

US Federal Reserve Board officials indicated that they were planning to "taper" purchases of US Treasury bonds. US interest rates rose about 100 basis points from late spring through the fall of 2013—the sharpest four-month rise in interest rates since 1994—with spillover to European and Canadian bonds. Yields on emerging market debt denominated in US dollars widened by 94 basis points relative to Treasury yields.

US high-yield bond mutual funds experienced cumulative outflows of 4.3 percent of assets from May through October.[12]

Bond UCITS had estimated outflows of 2.2 percent of assets.[13]

Canadian-domiciled bond mutual funds had outflows of 1.7 percent of assets.[14]

Detailed analysis of bond trading in emerging markets shows no destabilizing effects from fund flows during this episode.[15]

EUROZONE DEBT CRISIS, 2011 | European bond and equity funds

Several member states in the eurozone experienced difficulties refinancing their debts in 2011. Bond yields rose sharply, and some banks with heavy exposure to these debts faced higher funding costs.

Bond UCITS had estimated outflows of 1.8 percent of assets during the eurozone debt crisis.[16] Equity UCITS experienced estimated outflows of 4.1 percent of assets.[17]

---

[12] Rochelle Antoniewicz, "What Happens When Rates Rise? A Forecast of Bond Mutual Fund Flows Under a 2013 Taper Tantrum Interest Rate Scenario," *ICI Research Report* (December 2016), available at https://www.ici.org/pdf/rpt_16_bmff_forecast.pdf.

[13] FSB Letter.

[14] FSB Letter.

[15] "Taper Tantrum" Paper.

[16] FSB Letter.

[17] FSB Letter.

During the Global Financial Crisis (2007–2009)

GLOBAL FINANCIAL CRISIS, 2007–2009 | US equity and bond funds; European equity and bond funds; Canadian equity and bond funds

During the global financial crisis, stock and bond markets globally suffered intense pressure and heavy losses. In the United States, the S&P 500 fell 53 percent—losing more than half of its value—from October 31, 2007, to February 27, 2009. From August to December of 2008, spreads between yields on lower-rated bonds and Treasury securities widened by nearly 300 basis points.

US equity mutual fund outflows totaled 4.1 percent of assets from November 2007 to February 2009. US bond mutual funds experienced inflows totaling 4.0 percent of assets for the entire crisis period. From September to December 2008, however, US bond mutual funds had outflows totaling 3.6 percent of assets.[18]

Equity UCITS had estimated outflows of 2.5 percent of assets. Bond UCITS had estimated outflows of 12.9 percent of assets, exacerbated by German officials' decision to guarantee all bank deposits, drawing assets out of bond funds.[19]

Canadian equity funds had outflows of 2.4 percent of assets during the crisis. Canadian bond funds had outflows of 5.5 percent of assets.[20]

1996–2006

BURSTING OF THE "TECH BUBBLE," 2000–2001 | US equity funds

The dot-com bubble began to burst in mid-March 2000. From February 29, 2000, to September 28, 2001, the NASDAQ and S&P 500 indexes declined by 68 percent and 24 percent, respectively.

Over this same period, US equity mutual funds received net inflows totaling $227 billion, or 5.4 percent of assets. Equity mutual funds did experience outflows in five separate months, but none were precipitous: the largest monthly outflow was 0.9 percent of assets in September 2001.[21]

[18] Letter from Paul Schott Stevens, President and CEO, ICI, to Elizabeth M. Murphy, Secretary, US Securities and Exchange Commission, dated November 1, 2013, available at https://www.ici.org/pdf/13_ici_ofr_asset_mgmt.pdf ("SEC-OFR Letter").

[19] FSB Letter.

[20] FSB Letter.

[21] SEC-OFR Letter.

ASIAN FINANCIAL CRISIS, 1997 | US emerging market equity funds

Rapid appreciation of the US dollar and economic problems in Southeast Asia caused stock markets in Thailand, Malaysia, Indonesia, and the Philippines to fall by more than 40 percent from July to September. In a second round of turmoil between September and year-end, the stock markets of Asian emerging economies plummeted an average of 31 percent. Latin American stocks were also affected.

US global emerging market equity mutual funds, which held 1.2 percent of the market capitalization of emerging markets at year-end 1996, experienced net inflows throughout 1997, except for December.

Mutual funds focused on Asian and Latin American emerging markets experienced moderate outflows. US emerging market mutual funds were net buyers of Asian stocks throughout most of 1997.[22]

The First 50 Years (1944–1995)

THE BOND MELTDOWN, 1994–1995 | US bond funds

The Federal Reserve sharply tightened monetary policy, boosting its target for the federal funds rate from 3 percent to 6 percent. The yield on the 10-year Treasury note rose 1.85 percentage points, sending bond returns into negative territory for months.

During this time, US bond mutual funds experienced net outflows totaling 11.3 percent of their assets. These net outflows, though, occurred smoothly rather than precipitously. In no month during the 12-month period from February 1994 to January 1995 did net outflows exceed 2 percent of bond mutual funds' assets.[23]

BLACK MONDAY, OCTOBER 1987 | US equity funds

On Monday, October 19, 1987, the Dow Jones Industrial Average fell by a then-record 508 points. From October to December 1987, the stock market declined by 23 percent.

Over these three months, net outflows from US equity mutual funds totaled 4.2 percent of their assets. The largest one-month net outflow from equity mutual funds during this period was 3.2 percent in October 1987, when the S&P 500 declined by 22 percent in a single month.[24]

---

[22] Mitchell A. Post and Kimberlee Miller, "US Emerging Market Equity Funds and the 1997 Crisis in Asian Financial Markets," *ICI Perspective* 4, no. 2 (June 1998), available at https://www.ici.org/pdf/per04-02.pdf.

[23] SEC-OFR Letter.

[24] SEC-OFR Letter.

BEAR MARKET, 1973–1974 | US equity funds

Global tensions and a sharp spike in oil prices triggered a deep and long-lasting recession in the United States and elsewhere. From January 1973 to December 1974, the S&P 500 declined 42 percent.

Outflows from US equity mutual funds over this period were modest, cumulating to $3.2 billion, or 5.8 percent of fund assets. During this period, the maximum one-month net outflow from US equity mutual funds was 0.6 percent of assets.[25]

STOCK MARKET CYCLES, 1945–1990 | US equity funds

From 1945 to 1990, there were 12 additional major US stock market cycles (as identified by peaks and troughs in the S&P 500 index) of varying magnitudes and lengths (in addition to the 1973–1974 bear market and 1987's Black Monday).

In eight of these 12 cycles, US equity mutual funds experienced inflows even during the contraction phase of the cycle. In the four cycles with outflows during the contraction, the largest monthly outflow was 1.1 percent of assets.[26]

[25] SEC-OFR Letter.

[26] John Rea and Richard Marcis, "Mutual Fund Shareholder Activity During US Stock Market Cycles, 1944–95," *ICI Perspective* 2, no. 2 (March 1996), available at https://www.ici.org/pdf/per02-02.pdf.

Appendix B

Summary: FSOC Proposal to Reform the SIFI Designation Process[*]

- Activities-Based Approach. The proposed activities-based approach includes a two-step process.
    - *First*, FSOC would monitor financial markets and market developments, in consultation with relevant financial regulatory agencies, to identify products, activities, or practices that could present risks to financial stability. This step to a large degree imports into the guidance the role of FSOC's Systemic Risk Committee. *See* Charter of the Systemic Risk Committee of the FSOC, section 2 (available at https://www.treasury.gov/initiatives/fsoc/governance-documents/Documents/The%20Council%27s%20Committee%20Charters.pdf.)
        - In determining whether an activity presents risks to U.S. financial stability, FSOC will consider, among other factors, whether the activity is complex or opaque, conducted without effective risk-management practices, significantly correlated with other financial products, or either highly concentrated or significant and widespread.
    - *Second*, FSOC will work with the "relevant financial regulatory agencies" (a term that FSOC indicates will be interpreted more broadly than the "primary federal regulatory agency" that is responsible for overseeing a market or practice) to seek to implement actions to address any identified potential risk. The goal of this step would be for the existing regulators to take actions to mitigate the identified risks. This step would typically result in "relatively informal actions," but could include FSOC making a recommendation under section 120 of the Dodd-Frank Act for an agency to apply new or heightened standards. As an illustration of the limits of an activities-based approach, the proposal notes that FSOC only will use section 120 "to the extent that its recommendations are consistent with the statutory mandate of the relevant primary financial regulatory agency."
- Reforms to Designation Process. The proposal also would reform the designation process. Notable changes include the following:
    - *Analytic framework*. FSOC's evaluation of a nonbank financial company for potential designation would focus on how the negative effects of the company's material financial distress, or of the nature, scope, size, scale, concentration, interconnectedness or mix of the company's activities, could be transmitted to or affect other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning.
        - To complete such an analysis, FSOC will focus on three transmission channels: (1) the exposure transmission channel; (2) the asset liquidation transmission channel; and (3) the critical function or service transmission channel.

[*] FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, RIN 4030-ZA00 (March 6, 2019), available at https://home.treasury.gov/system/files/261/Notice-of-Proposed-Interpretive-Guidance.pdf.

  - The proposal would eliminate the six-category framework included in the current guidance FSOC uses for evaluating companies for a potential designation. This framework had been regarded in various quarters as difficult to apply in practice, and its analytic benefit was unclear. The proposed elimination should provide greater ex-ante transparency around how FSOC analyzes companies for potential designation.

- *Definition of key terms*. The proposal would define key terms, including "material financial distress" and "threat to the financial stability of the United States," as outlined below.
  - "Material financial distress" would be defined as "being in imminent danger of insolvency or defaulting on financial obligations."
  - "Threat to the financial stability of the United States" would be defined as "the threat of an impairment of financial intermediation or of financial market functioning that would be sufficient to inflict severe damage on the broader economy."
- *Cost-benefit analysis*. The proposal contemplates that FSOC would perform a cost-benefit analysis prior to making a designation. Then, FSOC only would make a designation if the expected benefits justify the expected costs. FSOC would consider ranges of quantified benefits and costs, as well as non-quantified benefits and costs.
- *Likelihood of material financial distress*. FSOC would assess the likelihood of a company's material financial distress, applying qualitative and quantitative factors.
- *Two-stage process*. The proposal would condense the current three-stage designation process set out in the existing guidance into two stages, by eliminating the current stage 1. The proposal also would codify certain aspects of FSOC's 2015 supplemental procedures, which provide opportunities for engagement with the company under consideration for designation.
- *Off-ramps*. Under the "new" stage 1, the company would be able to provide information to FSOC, allowing an opportunity for a "pre-designation 'off-ramp.'" The proposal also would clarify the "off-ramp" process for a designated company, so that the company could identify changes it could consider making to address the concerns that motivated FSOC's original designation decision. The proposal states that the process is designed to encourage companies to address the key factors that led to designation.

PREPARED STATEMENT OF JEREMY C. KRESS

ASSISTANT PROFESSOR OF BUSINESS LAW, UNIVERSITY OF MICHIGAN ROSS SCHOOL OF BUSINESS

MARCH 14, 2019

Chairman Crapo, Ranking Member Brown, Members of the Committee, I am honored to appear before you to discuss the Financial Stability Oversight Council's nonbank systemically important financial institution (SIFI) designations. Nonbank SIFI designations are an essential policy tool for regulating systemic risk. I am therefore concerned that recent efforts to de-emphasize nonbank SIFI designations—or eliminate them altogether—would expose the financial system to many of the same dangers it experienced in 2008.

I will make three points in my testimony today.[1] First, nonbank SIFI designations are crucial for preventing catastrophic nonbank failures like the collapses of Bear Stearns, Lehman Brothers, and AIG. Nonbank SIFI designations protect the financial system by deterring nonbanks from becoming systemically important and by applying heightened safeguards to firms that nonetheless become excessively large, complex, or interconnected. By contrast, nonbanks' baseline regulatory regimes are generally not well suited to accomplish these goals.

Second, criticisms of nonbank SIFI designations are unpersuasive. For example, despite critics' complaints, nonbank SIFI designations do not impose bank-centric rules on nonbanks. To the contrary, the Federal Reserve has gone to great lengths to recognize the distinct regulatory issues associated with nonbank financial companies, and to tailor its approach accordingly. Moreover, to the extent that heightened regulations create an uneven playing field for designated nonbank SIFIs, this differential is a feature, not a bug. Enhanced safeguards for nonbank SIFIs ensure that companies have incentive to avoid becoming or remaining systemically important.

Third, proposals to replace nonbank SIFI designations with an activities-based approach are deeply misguided. Activities-based regulation, on its own, will not prevent systemic collapses like those we experienced in 2008. It is unrealistic to expect that regulators will identify and appropriately regulate all such activities ex ante, especially given financial companies' strong incentives to restructure or rename activities to avoid regulation. By contrast, policymakers are much more likely to consistently and accurately identify nonbank financial companies whose distress could threaten financial stability.

A purely or predominantly activities-based approach to nonbank systemic risk will fail for yet another reason: the U.S. regulatory framework is not configured to implement effective activities-based regulation. The U.S. regulatory system is riddled with gaps in areas like insurance, hedge funds, and FinTech. Because FSOC lacks authority to implement activities-based rules directly, this pervasive jurisdictional fragmentation would undermine efforts to enact and enforce uniform, consistent activities-based rules throughout the financial system.

To be sure, if configured appropriately, activities-based regulation could address some sources of nonbank systemic risk. As currently structured, however, the United States' regulatory framework is simply not conducive to effective activities-based nonbank regulation.

Proponents of an activities-based approach to nonbank systemic risk contend that activities-based rules would merely supplement, rather than displace, nonbank SIFI designations. But make no mistake: the procedural barriers to nonbank SIFI designations that FSOC proposed last week would make it exceedingly difficult for the Council to designate new nonbank SIFIs and for any such designation to survive judicial review. Moreover, the Council's apparent enthusiasm for activities-based nonbank regulation rings hollow given that the FSOC has not used its existing statutory authority to propose a single activities-based rule in more than 2 years under Secretary Mnuchin's leadership.

In sum, I am deeply concerned about recent initiatives to roll back nonbank systemic risk regulation. Efforts to marginalize the Council by diminishing its legal authority, politicizing its work, and reducing its budget collectively increase risks to the financial system and ultimately threaten the real economy.

---

[1] Portions of this testimony are adapted from Jeremy C. Kress, Patricia A. McCoy, and Daniel Schwarcz, "Regulating Entities and Activities: Complementary Approaches to Nonbank Systemic Risk", 92 *S. Cal. L. Rev.* (forthcoming 2019).

Background on Nonbank SIFI Designations and Proposed Procedural Barriers

A. The Financial Crisis, Nonbank Systemic Risk, and the FSOC

The 2008 financial crisis demonstrated unequivocally that nonbank financial institutions can threaten U.S. and global financial stability. The failures of Bear Stearns, Lehman Brothers, and AIG proved that nonbanks—like banks—are capable of propagating risk throughout the financial system. Yet, traditionally, investment banks, insurance companies, and other nonbank financial companies generally have not been subject to macroprudential regulation designed to limit the risks these firms pose to the financial system and the broader economy.

After the crisis, Congress created FSOC to address the problem of nonbank systemic risk.[2] The Dodd–Frank Act gave FSOC two tools to achieve this goal. First, under section 113 of Dodd–Frank, FSOC may designate an individual nonbank SIFI for enhanced regulation if the Council determines that the firm's material financial distress or "the nature, scope, size, scale, interconnectedness or mix of [its] activities" could pose a threat to U.S. financial stability.[3] Any nonbank entity that FSOC designates as a SIFI becomes subject to consolidated supervision and regulation by the Federal Reserve, including risk-based capital, leverage, liquidity, and risk-management requirements.[4] This is FSOC's so-called "entity-based" approach. Second, under section 120 of Dodd–Frank, FSOC may recommend that the primary financial regulatory agencies adopt "new or heightened standards or safeguards" for any financial activity that could propagate systemic risks.[5] This is FSOC's "activities-based" approach.

B. Nonbank SIFI Designations and De-Designations

At first, FSOC embraced its SIFI designation authority. The Council promulgated, through notice-and-comment rulemaking, formal procedures for evaluating a nonbank's systemic importance.[6] Then, in 2013 and 2014, the Council designated three insurance-focused companies—Prudential, AIG, and MetLife—and General Electric's captive finance subsidiary, GE Capital, as nonbank SIFIs. FSOC concluded, through increasingly detailed analyses, that material financial distress at any of these four companies could pose a threat to U.S. financial stability and that enhanced oversight was therefore appropriate for each firm.

But now, just 5 years later, FSOC has reversed all of its original nonbank SIFI designations. To be sure, the Council's unanimous rescission of GE Capital's SIFI status in 2016 was well warranted. After its SIFI designation, GE Capital substantially reduced its systemic footprint, shrinking by more than half and reducing its reliance on risky short-term funding.[7] GE Capital's designation, restructuring, and consequent de-designation demonstrate that nonbank SIFI designations, when used appropriately, are effective deterrents against firms becoming and remaining systemically important.

Each of the Council's three subsequent de-designations, however, was hasty and ill-conceived. After Treasury Secretary Steven Mnuchin became Chair of the Council, FSOC rescinded AIG's SIFI status by a contested 6–3 vote. AIG's de-designation was considerably more controversial than GE Capital's, as AIG—one of the primary culprits of the financial crisis—did not appreciably reduce its systemic footprint fol-

[2] My views about FSOC have been shaped by excellent scholarship on the Council and nonbank systemic risk. See, e.g., Hilary J. Allen, "Putting the 'Financial Stability' in Financial Stability Oversight Council", 76 *Ohio St. L. J.* 1087 (2015); Jeffrey N. Gordon, "Dynamic Precaution in Maintaining Financial Stability: The Importance of FSOC", in *Ten Years After the Crash* (Sharyn O'Halloran and Thomas Groll, eds., forthcoming 2019); Patricia A. McCoy, "Systemic Risk Oversight and the Shifting Balance of State and Federal Authority Over Insurance", 5 *U.C. Irvine L. Rev.* 1389 (2015); Daniel Schwarcz and David Zaring, "Regulation by Threat: Dodd–Frank and the Nonbank Problem", 84 *U. Chi. L. Rev.* 1813 (2017); Christina Parajon Skinner, "Regulating Nonbanks: A Plan for SIFI Lite", 105 *Geo. L. J.* 1379 (2017); Robert F. Weber, "The FSOC's Designation Program as a Case Study of the New Administrative Law of Financial Supervision", 36 *Yale J. Reg.* 359 (2019).

[3] 12 U.S.C. §5323(a)(1).

[4] 12 U.S.C. §5365(b)(1)(A).

[5] 12 U.S.C. §5330(a).

[6] "Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies", 77 FR 21,637 (Apr. 11, 2012).

[7] See Ted Mann and Joann S. Lublin, "Why General Electric Is Unwinding Its Finance Arm", *Wall St. J.* (Oct. 13, 2015), *https://www.wsj.com/articles/why-general-electric-is-unwinding-its-finance-arm-1444784781.*

lowing its designation.[8] Then, after MetLife prevailed in its lawsuit contesting its SIFI designation on procedural grounds, the Council abruptly reversed its litigation position and dropped its appeal of MetLife's case.[9]

Most troublingly, FSOC de-designated Prudential in October 2018, even though Prudential had increased in size and complexity since becoming a SIFI.[10] The Council's rescission of Prudential's SIFI status was not only unwise, it was also illegal.[11] When it de-designated Prudential, FSOC (1) violated its formal procedures by second-guessing the Council's original assessment of Prudential's systemic importance, (2) performed misleading quantitative analyses while dismissing more reliable indicators of Prudential's systemic importance, and (3) ignored its statutory mandate to consider Prudential's existing regulatory scrutiny.[12] These shortcomings substantially undermine the Council's conclusion that Prudential is not systemically important and render FSOC's action arbitrary and capricious.[13] Unfortunately, in contrast to MetLife, which had an unambiguous statutory right to contest its SIFI designation, it is unclear whether individual citizens or public interest groups have standing to sue FSOC when the Council illegally de-designates a SIFI.[14]

C. Proposed Procedural Barriers to New Nonbank SIFI Designations

These de-designations appear to be part of a concerted effort by the Trump administration and some members of Congress to de-emphasize—or permanently eliminate—nonbank SIFI designations as a regulatory tool. In November 2017, the Treasury Department published a report deriding nonbank SIFI designations as a "blunt instrument" and proposing procedural barriers to new nonbank SIFI designations.[15] For example, the Treasury Department would require FSOC to assess a potential designee's likelihood of financial distress and perform a quantitative cost-benefit analysis of each designation. Just last week, FSOC proposed to adopt these procedural barriers through amendments to its interpretive guidance.[16]

If enacted, these new policies would substantially undermine FSOC's ability to designate nonbank SIFIs in the future. First, consider the proposed requirement that FSOC assess a company's likelihood of financial distress. As a threshold matter, this proposal directly conflicts with the text of the Dodd–Frank Act, which instructs FSOC to assume that a firm is in distress and analyze whether that distress could pose a threat to U.S. financial stability.[17] Even setting statutory considerations aside, however, this proposed requirement is seriously misguided. As FSOC's prior experience demonstrates, it can take years for the Council to evaluate a nonbank for potential designation, for the Federal Reserve to establish regulations appropriately tailored to a nonbank SIFI's business model, and for a designated nonbank SIFI to bring itself into compliance with those safeguards. Thus, waiting to designate a nonbank until it is vulnerable to distress could be too late. By the

---

[8] See Gregg Gelzinis, "Deregulating AIG Was a Mistake", *Ctr. for Am. Progress* (Oct. 11, 2017), *https://www.americanprogress.org/issues/economy/reports/2017/10/11/440570/deregulating-aig-mistake/*.

[9] Interestingly, FSOC's decision to drop its appeal in the MetLife case was supported by a majority of FSOC's voting members, rather than the two-thirds of voting members that would have been required to formally rescind MetLife's designation. See Press Release, Dept. of Treasury, Secretary Mnuchin Statement on the MetLife, Inc. v. Financial Stability Oversight Council Appeal (Jan. 18, 2018), *https://home.treasury.gov/news/press-releases/sm0254*.

[10] Prudential had grown by more than $100 billion in assets since its designation. Meanwhile, Prudential's complexity and interconnectedness with other financial companies also increased. Its notional derivatives exposures and repurchase agreements rose by more than 30 percent after its designation. See Jeremy Kress, "Prudential Hasn't Earned the Right To Shed SIFI Label", *Am. Banker* (March 13, 2018), *https://www.americanbanker.com/opinion/prudential-hasnt-earned-the-right-to-shed-sifi-label*.

[11] See Jeremy C. Kress, "The Last SIFI: The Unwise and Illegal Deregulation of Prudential Financial", 71 *Stanford L. Rev. Online* 171 (2018).

[12] See id.

[13] An agency's decision is arbitrary and capricious if the agency did not rely on the factors Congress intended or the decision runs counter to the evidence before the agency. See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co. 463 U.S. 29, 42-43 (1983). In addition, an agency may not "simply disregard rules that are still on the books." FCC v. Fox Television Stations, Inc., 556 U.S. 502, 515 (2009).

[14] See Weber, supra n. 2, at 425-32.

[15] U.S. Dep't of the Treasury, Financial Stability Oversight Council Designations, "Report to the President of the United States Pursuant to the Presidential Memorandum Issued April 21, 2017".

[16] Notice of Proposed Interpretive Guidance Regarding Nonbank Financial Company Determinations (March 6, 2018), *https://home.treasury.gov/system/files/261/Notice-of-Proposed-Interpretive-Guidance.pdf*.

[17] 12 U.S.C. §5323(a)(1).

time the relevant capital, liquidity, and other safeguards associated with designation go into effect, the nonbank SIFI may already have collapsed.[18]

Subjecting nonbank SIFI designations to quantitative cost-benefit analyses would be equally unwise. Quantifying the costs and benefits of nonbank SIFI designations poses serious analytical challenges. For example, the stability-enhancing benefits of financial regulations are notoriously difficult to calculate accurately. As many scholars have recognized, quantifying the benefit of a crisis averted is nearly impossible.[19] Moreover, because of the infrequency of financial crises, financial regulatory cost-benefit analyses are highly sensitive to crude economic loss and discount rate assumptions. For these reasons, empirical cost-benefit analysis of the Council's nonbank SIFI designations would be susceptible to ex post second-guessing by a reviewing court, thereby creating litigation risk for the Council and deterring it from attempting to use its SIFI designation authority in the first place.

In lieu of nonbank SIFI designations, FSOC now purports to prioritize an activities-based approach to nonbank systemic risk. In its proposed interpretive guidance, the Council states that it will consider using its SIFI designation authority "only if a potential risk or threat cannot be addressed through an activities-based approach." Under this activities-based approach, the Council would coordinate with various Federal and State financial regulatory agencies and encourage them to address risks arising from specific activities, either informally or through the Council's formal section 120 recommendation authority.[20]

Parallel initiatives in Congress would codify similar procedural barriers to nonbank SIFI designations and formally prioritize FSOC's activities-based approach. For example, the Financial Stability Oversight Council Improvement Act would prohibit FSOC from voting on a proposed nonbank SIFI designation unless the Council determines that a different approach would be impracticable or insufficient to mitigate the threat the company could pose to U.S. financial stability.[21] For the reasons explained below, these administrative and legislative efforts to de-emphasize nonbank SIFI designations are ill-advised and, if enacted, would recreate the same feeble approach to nonbank systemic risk that proved woefully inadequate in 2008.

Nonbank SIFI Designations Are Critical for Preventing Systemic Nonbank Insolvencies

Retaining nonbank SIFI designations as a viable regulatory tool is necessary to prevent catastrophic nonbank failures like Bear Stearns, Lehman Brothers, and AIG. FSOC's nonbank SIFI designation authority achieves two essential regulatory objectives: the threat of designation deters nonbanks from becoming systemically important, and tailored Federal Reserve regulation safeguards companies that nonetheless become excessively large, complex, or interconnected.

First, the prospect of nonbank SIFI designation serves as a powerful deterrent against nonbanks becoming systemically important. Ordinarily, a nonbank has strong incentive to expand its systemic footprint. That is because any financial company perceived as systemically important can borrow at favorable rates if the market believes that the Government would bail out the firm, rather than allow it to fail.[22] FSOC's nonbank SIFI designation authority, however, counteracts this incentive. Because designation subjects a company to potentially costly regulation, the threat of designation dissuades firms from seeking to become systemically important. Thus, as Professors Daniel Schwarcz and David Zaring have written, "the FSOC designation regime incentivizes nonbanks to eschew activities and strategies

[18] Moreover, conditioning a firm's designation on its vulnerability could actually hasten its collapse. Any SIFI designation issued under this standard would signal that FSOC views the company as unstable, potentially triggering a run and creating the instability SIFI designations are designed to prevent.

[19] See, e.g., John C. Coates IV, "Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications", 124 *Yale L. J.* 882, 960-69 (2015); Jeffrey N. Gordon, "The Empty Call for Benefit-Cost Analysis in Financial Regulation", 43. *J. Legal Stud.* S351, S373-75 (2014).

[20] Interestingly, the Council states that it will "make recommendations under section 120 of the Dodd–Frank Act only to the extent that its recommendations are consistent with the statutory mandate of the relevant primary financial regulatory agency." Notice of Proposed Interpretive Guidance Regarding Nonbank Financial Company Determinations, supra n. 16, at 14. It is not clear how FSOC intends to address stability risks within the jurisdiction of agencies, like the Securities and Exchange Commission and State insurance regulators, that lack a statutory financial stability mandate.

[21] S. 3577, 115th Cong. (2018).

[22] See, e.g., Viral V. Acharya et al., "The End of Market Discipline? Investor Expectations of Implicit Government Guarantees" 35 (Munich Personal RePEc Archive, Working Paper No. 79700, 2016).

that they anticipate would subject them to designation."[23] Moreover, as GE Capital's experience demonstrates, this incentive is even stronger for companies ultimately designated as nonbank SIFIs. Indeed, such firms have especially powerful motivation to simplify or shrink themselves in an effort to escape their designations.

Second, in the event that a nonbank becomes and remains systemically important, FSOC's nonbank SIFI designation authority enables the Council to subject the firm to appropriately tailored safeguards and thus protect the broader financial system. The Federal Reserve's macroprudential regulatory tools are uniquely suited to limit the risk that a designated nonbank SIFI will experience a systemic failure. For example, consolidated risk-based capital and leverage limits ensure that SIFIs maintain a sufficient capital cushion to absorb potential losses. Liquidity rules require SIFIs to hold a minimum amount of liquid assets to protect against funding runs. Stress tests simulate adverse economic conditions to ensure that SIFIs can withstand a severe downturn. Corporate governance reforms focus on improving enterprise risk management across SIFI's operations. Finally, ex ante resolution planning is crucial if a systemically important nonbank must be liquidated through Dodd–Frank's Orderly Liquidation Authority.

To be clear, these macroprudential safeguards are necessary because most traditional nonbank regulatory regimes lack reliable financial stability regulatory tools. Insurance regulation is the most straightforward example. In the United States, insurance regulation has long been the responsibility of the States, with little Federal involvement. But the State-based system of insurance regulation suffers from serious flaws with respect to systemic risk regulation. Most critically, the U.S. insurance regulatory system lacks well developed consolidated regulation and supervision of insurance holding companies.[24] And, in most States, the insurance commissioner is subject to a narrow regulatory mandate to protect an insurance subsidiary's policyholders, not to limit financial stability risks. In sum, absent nonbank SIFI designations and ensuing Federal Reserve oversight, some systemically important nonbanks will not be subject to consolidated, macroprudential supervision and regulation that is necessary to prevent a repeat of the 2008 crisis.

Criticisms of Nonbank SIFI Designations Are Unpersuasive

Critics of FSOC's nonbank SIFI designation authority have long complained that SIFI designations impose bank-centric rules on nonbanks, create an uneven playing field, are opaque, and are driven by international advisory bodies. None of these criticisms is convincing. Some critiques were overblown from the start; others have been addressed through reforms adopted by FSOC and the Federal Reserve. In any event, these arguments have little merit.

First, despite critics' complaints, nonbank SIFI designations do not result in the imposition of bank-centric rules on nonbanks. To the contrary, policymakers have taken several steps to tailor nonbank SIFI regulation to the distinct regulatory issues associated with designated nonbank financial companies. For example, Congress passed The Insurance Capital Standards Clarification Act of 2014, which specifically authorized the Federal Reserve to tailor its capital standards for insurers to the distinctive risks posed by each firm. And, in fact, the insurance SIFI capital standards the Federal Reserve proposed in 2016 reflect thoughtful consideration of the differences between bank and insurance company business models.[25] Moreover, the Federal Reserve has established a specialized team of insurance-focused experts to supervise nonbank SIFIs.

Second the fact that nonbank SIFI designations create an uneven playing field for designated firms is by design. Heightened capital, liquidity, and other rules help to ensure that nonbank firms have incentive to avoid being designated in the first place, and to shed their status quickly if they are so designated. Further, the costs of being designated are less unfair than critics suggest, as they help offset the funding advantages that come along with being perceived as systemically important.

Third, FSOC has taken numerous steps to enhance the transparency of the nonbank SIFI designation process. For example, it developed a formulaic quantitative test to select only a small subset of all nonbank financial firms for potential designation.[26] The Council began informing firms earlier when they were being con-

[23] Schwarcz and Zaring, supra n. 2, at 1851.

[24] While the States have attempted to improve groupwide supervision of insurance holding companies since 2008, they still have not implemented consolidated capital requirements and other critical regulatory tools. Moreover, the efficacy of these State-level reforms is speculative because they largely have not been tested since the financial crisis.

[25] "Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities", 81 FR 38,631 (June 14, 2016).

[26] Financial Stability Oversight Council Guidance for Nonbank Financial Company Determinations, 12 CFR pt. 1310, app. A., §III.a (2018)

sidered for designation, and it established a formal process for reevaluating such designations.[27] FSOC also began releasing more detailed explanations for its designation decisions that provide clearer indications of how firms can achieve de-designation. Thus, while FSOC can surely further improve the transparency of its designation process, critics' concerns about opacity are overblown.

Finally, in contrast to critics' complaints, the Council's nonbank SIFI designation decisions are not driven by international advisory bodies. FSOC alone selects firms to evaluate for potential designation, and the Council makes its own, independent judgment about whether a firm meets the criteria for SIFI designation. While international advisory groups like the Financial Stability Board (FSB) have processes for evaluating financial institutions' systemic importance, their evaluations are not binding on the Council. Indeed, FSOC reversed the designations of AIG and MetLife even though the FSB considered those firms to be global systemically important insurers.[28] Thus, while the FSB and other advisory bodies facilitate global coordination, they do not detract from the independence of FSOC's nonbank SIFI designations.

In sum, criticisms of FSOC's nonbank SIFI designation authority are wholly unconvincing. Critics' complaints were either exaggerated from the outset or have been largely addressed by reforms policymakers adopted to improve the SIFI designation process. Accordingly, opponents' critiques should hold little weight in the continued debate over the appropriateness of nonbank SIFI designations.

An Activities-Based Approach, On Its Own, Would Not Prevent a Recurrence of the 2008 Crisis

Recent efforts to prioritize an activities-based approach to nonbank systemic risk—by codifying a preference for activities-based regulation or erecting procedural barriers to nonbank SIFI designations—are deeply misguided. Proponents of this approach assume that by regulating systemically risky activities, policymakers can prevent the systemic failures of nonbank entities. This assumption, however, is wrong. Activities-based regulation, on its own, cannot prevent catastrophic nonbank failures like Bear Stearns, Lehman Brothers, and AIG. Instead, a purely activities-based approach would recreate the conditions that led to the last financial crisis.

Legislative and regulatory proposals to prioritize an activities-based approach are problematic for three distinct reasons. First, activities-based regulation is poorly suited to prevent systemically important nonbanks from imperiling financial stability. Second, even if activities-based regulation could work in theory, an effective activities-based approach is impossible in practice, given the current U.S. regulatory framework. Finally, prioritizing an activities-based approach would slow the process of designating nonbank SIFIs and thereby increase the likelihood of a catastrophic nonbank collapse.

A. An Activities-Based Approach Will Not Prevent Systemic Nonbank Failures

On its own, an activities-based approach is insufficient to stop nonbanks from propagating risks throughout the financial sector. That is because policymakers are unlikely to identify and appropriately regulate all potentially systemic activities ex ante. Moreover, even if regulators were to issue appropriate activities-based rules, a purely activities-based approach ignores the unique and potentially dangerous ways in which individual activities might interact when combined within a single financial institution.

First, an activities-based approach is inherently grounded in an unrealistic expectation that policymakers will identify and appropriately regulate all potentially systemic activities ex ante. As the 2008 crisis demonstrated, numerous known and unknown activities can create systemic risk. In the last crisis alone countless activities and products—subprime mortgages, mortgage-backed securities, collateralized debt obligations, repurchase agreements, commercial paper, and securities lending, among others—contributed to systemic risk. The prospect that policymakers will identify and properly regulate all such systemic activities ex ante seems far-fetched. A purely activities-based approach is especially unlikely to succeed given financial companies' incentives to restructure or rename activities to avoid regulation.

The experience of the President's Working Group on Financial Markets (PWG) in the lead-up to the 2008 financial crisis exemplifies the difficulty of identifying systemically risky activities. President Reagan formed the PWG in 1988 to coordinate

---

[27] See Examining Insurance Capital Rules and FSOC Process: Hearing Before the Senate Subcomm. on Securities, Insurance, and Investments, 114th Cong. 7-8 (2015) (testimony of Daniel Schwarcz, Professor, University of Minnesota Law School).

[28] Fin. Stability Bd., 2016 List of Global Systemically Important Insurers (G–SIIS) (Nov. 21, 2016), *http://www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-insurers-G-SIIs.pdf.*

financial market oversight across various jurisdictions.[29] Comprised of the heads of the major U.S. regulatory agencies, the PWG was essentially a precursor to FSOC, with a mandate to address systemically risky activities.[30] While the financial sector amassed mortgage-related risks during the mid-2000s, however, the PWG focused on issues entirely unconnected to the looming crisis. Indeed, at the time, the PWG was primarily concerned with hedge funds, mutual funds, and terrorism risk insurance. It was not until March 2008 that the PWG finally recommended improved standards for mortgage origination, securitizations, and derivatives—the week before Bear Stearns failed.[31] This is not to fault the PWG for failing to anticipate the crisis—few people foresaw the market crash. But PWG's experience during the mid-2000s underscores that regulators face serious challenges in identifying the specific activities that will transmit systemic risks.

By contrast, policymakers are much more likely to consistently and accurately identify nonbank entities whose distress could threaten financial stability. As FSOC has demonstrated through its analytical framework, it is relatively straightforward to predict which nonbank entities could plausibly transmit systemic risks and which would not. Furthermore, nonbank SIFI designations need not perfectly distinguish between nonbanks that are systemically significant and those that are not. To the contrary, FSOC can deter nonbanks from seeking out systemic importance as long as the designation process is even roughly accurate. The mere prospect of being designated as a SIFI creates uncertainty, which a firm will likely seek to avoid by reducing its size and complexity.

Furthermore, even if policymakers could identify and regulate each potentially risky activity, that alone would not be enough to prevent a systemically important nonbank from failing. That is because an activities-based approach is designed to limit risks associated with individual financial activities or products, in isolation. But a financial institution's risk profile is the product of all of the firm's activities and how they interact with one another. AIG is a classic example. AIG's failure was not solely attributable to its now-infamous credit default swaps on mortgage-related assets. Instead, AIG's failure was also due to its securities lending activities, in which the firm invested collateral in mortgage-backed securities.[32] AIG's credit default swaps and securities lending activities posed highly correlated risks—the firm suffered significant losses from both activities when mortgage assets declined in value and counterparties demanded payouts. A purely activities-based approach, however, is blind to these types of interactions among all of a firm's activities.

In sum, a purely or predominantly activities-based approach will not prevent a recurrence of the systemic nonbank failures the financial sector experienced in 2008. Entity-based nonbank SIFI designations, by contrast, are well suited to safeguard systemic nonbanks. Nonbank SIFI designations address the interrelationship of a firm's activities through enterprise-level safeguards like capital requirements, liquidity rules, and risk management standards. And, as noted above, policymakers are much more likely to be able to identify nonbank SIFIs, rather than trying to predict the precise activities through which such firms might transmit systemic risk. Accordingly, proposals to prioritize an activities-based approach while erecting procedural barriers to nonbank SIFI designations will weaken regulators' ability to prevent another financial crisis.

B. Effective Activities-Based Regulation Is Impossible in the Current U.S. Regulatory Framework

Proposals to shift to an activities-based approach suffer from another critical drawback: even if activities-based regulation could work in theory, effective activities-based regulation is not possible in the current U.S. legal and regulatory framework. FSOC faces two significant obstacles in carrying out an activities-based approach to nonbank systemic risk.

1. Effective Activities-Based Regulation Is Impossible Because FSOC Lacks Authority To Mandate Activities-Based Rules

First, FSOC lacks legal authority to implement activities-based reforms. Instead, the Council's section 120 activities-based power is strictly precatory. FSOC may recommend that an agency adopt new activities-based rules. But an agency has no

[29] See Exec. Order No. 12,631, 3 CFR §559 (1988).

[30] In contrast to FSOC, the PWG lacked authority to designate systemically risk entities for enhanced regulation or supervision.

[31] See The President's Working Group on Financial Markets, Policy Statement on Financial Market Developments (2008), *https://www.treasury.gov/resource-center/fin-mkts/Documents/pwgpolicystatemktturmoil_03122008.pdf.*

[32] See Daniel Schwarcz and Steven L. Schwarcz, "Regulating Systemic Risk in Insurance", 81 *U. Chi. L. Rev.* 1569, 1585-86 (2014).

legal obligation to actually implement such rules.[33] And, in fact, there are many reasons why an agency might resist implementing activities-based regulations at FSOC's urging. For example, the agency might be captured by the financial sector it regulates, or it might try to protect its regulatory turf against intrusion by the Council. Thus, it is inadvisable to rely heavily or exclusively on an activities-based approach to nonbank systemic risk because FSOC's activities-based powers are extremely weak.

The feebleness of FSOC's activities-based approach is especially concerning because the Council proposes to forfeit its one credible threat when an agency declines to adopt activities-based rules at FSOC's urging. Ordinarily, if an agency refuses an FSOC recommendation, the Council may respond by designating firms within the agency's jurisdiction as nonbank SIFIs. In fact, the Council threatened to do just that in 2012, after the SEC initially resisted enacting enhanced regulations on money market mutual funds.[34] Because agencies fear losing authority over companies within their jurisdiction, the threat of SIFI designation may encourage an agency to adopt FSOC's recommended rules.[35] Indeed, that is what happened when the SEC ultimately implemented MMMF reforms after the Council threatened to designate certain MMMFs or their advisors. Now, however, FSOC essentially proposes to take the threat of nonbank SIFI designations off the table. By enacting onerous procedural barriers, FSOC will make the threat of SIFI designations noncredible. In sum, creating new hurdles for nonbank SIFI designations further decreases the likelihood that an activities-based approach will work in practice.

2. Jurisdictional Fragmentation in U.S. Financial Regulation Would Make an Activities-Based Approach Unworkable

The second obstacle to effective activities-based regulation is the jurisdictional fragmentation that pervades the U.S. regulatory system. This fragmentation prevents policymakers from overseeing and regulating systemically important activities on a systemwide basis. In some cases, the regulatory system suffers from problematic gaps, where no regulatory agency has authority over particular conduct. For instance, in areas like insurance, hedge funds, and FinTech, even if the Council were to recommend heightened macroprudential rules, it is not clear that any Federal agency would have jurisdiction to implement those recommendations. In other cases, the U.S. regulatory system features complicated overlaps, where multiple agencies share responsibility for certain financial activities. This happens in areas like mortgages, securities, and derivatives. These overlaps would unduly complicate efforts to enact and enforce uniform, consistent activities-based rules throughout the U.S. financial system.

None of this is to say that a well-designed activities-based approach cannot help preserve financial stability. To the contrary, activities-based regulation has the potential to combat some—but not all—sources of nonbank systemic risk, if configured appropriately. For example, an activities-based approach is uniquely well-suited to address systemic risks that may arise from correlations across numerous different nonbanks' investment activities, risk management practices, or product features. An activities-based approach may also be better designed to address certain risks arising from complex relationships among firms that require regulators or other market actors to mediate intercompany relationships through market infrastructure, such as clearinghouses and exchanges.

As currently configured, however, the fragmented U.S. regulatory framework is not designed to realize these potential benefits of activities-based regulation. To operationalize an effective activities-based approach, Congress would need to dramatically reform the U.S. regulatory system. For example, Congress could create a single stability regulator with authority to oversee activities spanning different segments of the financial sector, similar to the regulatory structure in Australia and other "multi-peaked" systems. A regulator of this sort would obviate many of the structural problems with activities-based regulation. Absent these reforms, however, an activities-based approach to nonbank systemic risk will not succeed in the current U.S. regulatory framework.

C. Prioritizing an Activities-Based Approach Would Slow the Process of Nonbank SIFI Designations

Finally, proposals to prioritize an activities-based approach—and consider nonbank SIFI designations only as a last resort—could dramatically slow the proc-

---

[33] If an agency elects not to adopt an FSOC recommendation under section 120 of the Dodd–Frank Act, it must only "explain in writing" why it chose not to implement the rule. 12 U.S.C. §5330(c)(2).

[34] See Allen, supra n. 2, at 1118-19; Schwarcz and Zaring, supra n. 2, at 1862-63.

[35] Schwarcz and Zaring, supra n. 2, at 1860-64.

ess of designating a nonbank SIFI, even when conditions clearly warrant such a designation. The designation process that FSOC and some members of Congress envision would involve multiple rounds of consultation and coordination among the relevant regulatory agencies before the Council could potentially resort to nonbank SIFI designations. This multistep process would take so long in practice that by the time FSOC even considered addressing escalating risks through nonbank SIFI designations, it could be too late.[36] The SIFI designation process is already lengthy, with extensive evaluation and ample opportunity for the relevant company to present evidence to the Council. Moreover, it takes additional time for the Federal Reserve to develop appropriately tailored rules for any company designated as a nonbank SIFI, and even more time for the company to bring itself into compliance with those safeguards. Further delaying the designation process by mandating that the Council first exhaust all activities-based remedies is therefore highly inadvisable.

Proponents of an activities-based approach mistakenly view nonbank SIFI designations as an emergency response to be used if activities-based regulation fails to address systemic risks. Indeed, the Council's proposed amendments to its interpretive guidance commit that FSOC will consider a nonbank SIFI designation "only in rare instances such as an emergency situation."[37] This view gravely misconstrues the purpose of nonbank SIFI designations. A nonbank SIFI designation is not an emergency tool; instead, it is a prophylactic strategy to protect a systemically important nonbank from experiencing distress in the first place.[38] In order for the capital, liquidity, resolution planning, and other safeguards associated with nonbank SIFI designations to have their intended effect, FSOC must proactively use nonbank SIFI designations as an ex ante crisis-prevention strategy, not as a belated crisis response.

Conclusion

In sum, it is critical that FSOC retain nonbank SIFI designations as a viable regulatory tool. Recent proposals to de-emphasize or eliminate nonbank SIFI designations—either formally or through onerous procedural requirements—ignore the unique ways in which SIFI designations can prevent catastrophic nonbank failures. Moreover, these proposals overlook the serious practical challenges that an activities-based approach would face in the United States' fragmented regulatory framework. Nonbank SIFI designations are therefore essential to mitigate nonbank systemic risk and prevent the next Bear Stearns, Lehman Brothers, or AIG from triggering another financial crisis.

---

[36] This is especially true if, as the Council proposes, it only designates nonbanks it determines to be vulnerable to financial distress.

[37] "Notice of Proposed Interpretive Guidance Regarding Nonbank Financial Company Determinations", supra n. 16, at 27.

[38] See Gregg Gelzinis, "Don't Put SIFI Designations on the Back Burner", *Am. Banker* (Jan. 29, 2018), *https://www.americanbanker.com/opinion/dont-put-sifi-designations-on-the-back-burner.*

RESPONSES TO WRITTEN QUESTIONS OF SENATOR KENNEDY FROM DOUGLAS HOLTZ-EAKIN

Q.1. Please discuss the potential threats posed by ILC's to safety and soundness because their commercial owners are exempt from consolidated supervision.

A.1. I do not see any particular issue with the safety and soundness of an ILC per se, as they have been regulated successfully by the FDIC and States for a number of years.

Q.2. Should a handful of States be allowed to unilaterally determine national financial regulatory and economic policy?

A.2. The U.S. has typically embraced a fair amount of Federal–State heterogeneity in its regulatory structure without having any single State force the Federal Government's hand. Presumably the same outcome can prevail in this instance.

Q.3. Are you concerned that if the FDIC approves Square's application to become an insured depository institution, other FinTech companies like Amazon or Google or Paypal that have extensive commercial interests will also attempt to become banks?

A.3. We have seen interest from Walmart, SoFi, and others. It is entirely conceivable that there could be additional applications for an ILC charter. Opposition to Walmart obtaining a charter was for the most part motivated not by any fears of the safety and soundness of the financial system at large but more by dislike of Walmart itself and fears of the competitive advantages such a large institution would enjoy. Any inherent advantages Walmart could have offered consumers—particularly those with less or no access to credit—would have necessarily lowered the prices of banking services across the system.

Q.4. Would you agree that holding companies are created to strengthen safety and soundness, not weaken it?

A.4. Holding companies are usually created to better organize connected financial institutions, to the enjoy the benefits of, for instance, economies of scale or a centralized administration. Holding companies enjoy protection from losses. Holding companies usually confer considerable tax advantages on the entities in the group. I would not agree that safety and soundness—particularly of the industry of a whole—are considerations when the decision is made to incorporate.

Q.5. Without consolidated supervision, how can regulators effectively enforce the source of strength doctrine for commercial ILC holding companies?

A.5. The pervasive use of bank holding companies as the vehicle for Federal financial regulation was greatly expanded during the financial crisis when Goldman Sachs and other investment banks were essentially forced to become bank holding companies. That might suggest that this one-size-fits-all approach is not needed and that the key is to avoid a financial crisis.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM DOUGLAS HOLTZ-EAKIN

Q.1. How do the regulators for insurance companies and hedge funds become fully informed of all the activities in which insurance companies participate?

A.1. There is no substitute for the experience gained as a result of being a financial institution's primary regulator. It is for this reason that any action by a nonprimary regulator—in this case FSOC—will usually be an inferior substitute, as action is taken without the benefit of this experience. Key to the development of an effective activities-based regulatory framework will be the requirement that the FSOC consult first with primary regulators, particularly before making any future designations.

Q.2. Could a large complex nonbank financial entity engage in risky activities completely unbeknownst to its board or regulator? Do you have historic examples of regulators being unaware that a regulator was unaware of risky investments or activities by a nonbank large and complex financial institution?

A.2. It is possible but unlikely that a nonbank financial entity engage in risky activities completely unbeknownst to its regulator. It is even less likely that the entity's board is completely unaware. Instead the more likely scenario is that an activity is known but that the scope or riskiness of that activity is not adequately measured (to the extent that such things can be adequately measured). Responsibility is shared by the financial entity (for a failure in internal controls or a failure to adequately disclose), its auditor (for a failure to adequately test the entity's assumptions), and its primary regulator (for permitting activities it is not itself capable of supervising).

The best example of failure on the part of entity, auditor, and regulator is of course the role of American Insurance Group (AIG) in the 2008 financial crisis. A London-based division of AIG insured collateralized debt obligations (CDOs) against possibility of default via a credit default swap. Although insurance is the primary business of AIG credit default swaps are complex contract/derivatives that have more in common with banking products. The CDOs AIG insured involved the failure of an additional actor in this space, credit rating agencies, which inadequately assessed the risk of these highly complex instruments. It is not clear that AIG's primary regulator in the U.S., the U.K., or at group level was aware of the riskiness of this portfolio. We do however note that the difficulties with AIG stem from it effectively acting as an unregulated hedge fund rather than an insurer.

Q.3. Do you think the FSOC as it is currently comprised has both the expertise and the authority to appropriately assess nonbank significantly important financial institutions?

A.3. One cannot expect a third-party regulator such as the FSOC to somehow have better information than the involved parties, especially in light of the dearth of insurance experience on the FSOC. A single voting member with dedicated insurance expertise is not sufficient to assess these large, complex, but not inherently unsafe institutions. That is even if the advice of the insurance expert is taken. As noted in my written statement, the FSOC independent member with insurance expertise, Roy Woodall, dissented from the decision to designate Prudential Financial a systemically important financial institution.

The alternative is to ensure that FSOC procedures ensure the accumulation of a sufficient body of evidence and expertise to support any decision to designate.

Q.4. What progress has the G20 made in terms of adopting reforms that allow for a resolution framework in their jurisdictions?

A.4. This is not an area of personal expertise, but I will note that since the adoption of the series of Basel Accords resolution frameworks for U.S. and other jurisdictions are more alike than different. There also does not seem to be appetite at the level of G20 for significant regulatory advancement at this point on resolution frameworks—even Basel IV is seen as simply the final implementation of the Basel III framework.

Q.5. What more needs to be done in terms of cross-border cooperation on orderly resolution of globally significant financial institutions—both banks and nonbanks?

A.5. To a large extent this is already embedded as policy within resolution frameworks. When vetting and approving resolution plans domestic regulators are instructed to look closely at a bank's activities, regardless of jurisdiction. Hence there does not seem to be any crucial gap that needs to be filled.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM PAUL SCHOTT STEVENS

Q.1. Your testimony expresses support for moving to an activities-based or industrywide approach to addressing risks to financial stability.

Could such an approach expose small firms that pose no systemic risk to increased regulatory burdens? How should we mitigate such an outcome?

A.1. The Dodd–Frank Act provided FSOC with authority to evaluate systemic risk on an entity and/or an activity basis. An activities-based approach may be more appropriate where potential risky activity is spread across parts of the financial system. Rulemakings by the relevant financial regulator(s) should be tailored to the potential risks identified by FSOC, and done in accordance with the Administrative Procedures Act and applicable protections to help mitigate burdens to small firms.

Q.2. Does an activities-based approach to designation pose a risk to industry competition and innovation?

What additional steps should be taken to ensure consumers continue to benefit from a competitive and innovative marketplace?

A.2. An activities-based approach is less likely to present risks to industry competition and innovation. By targeting activities, problematic behavior can be curtailed across the board. No one firm will operate at a disadvantage vis-a-vis its competitors.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR KENNEDY FROM PAUL SCHOTT STEVENS

Q.1. Please discuss the potential threats posed by ILC's to safety and soundness because their commercial owners are exempt from consolidated supervision.

Should a handful of States be allowed to unilaterally determine national financial regulatory and economic policy?

Are you concerned that if the FDIC approves Square's application to become an insured depository institution, other FinTech companies like Amazon or Google or Paypal that have extensive commercial interests will also attempt to become banks?

Would you agree that holding companies are created to strengthen safety and soundness, not weaken it? Without consolidated supervision, how can regulators effectively enforce the source of strength doctrine for commercial ILC holding companies?

A.1. The Investment Company Institute (ICI) is the leading association representing regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI is not involved in matters related to ILCs and is not in a position to answer your questions.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM PAUL SCHOTT STEVENS

Q.1. How do the regulators for insurance companies and hedge funds become fully informed of all the activities in which insurance companies participate?

A.1. The Investment Company Institute is the leading association representing regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide.

While a number of ICI members are affiliated with insurance companies, ICI is not expert in matters involving the regulation of insurance companies and hedge funds. Accordingly, I am not in a position to comment on how regulators oversee their activities.

Q.2. Could a large complex nonbank financial entity engage in risky activities completely unbeknownst to its board or regulator? Do you have historic examples of regulators being unaware that a regulator was unaware of risky investments or activities by a nonbank large and complex financial institution?

A.2. It is widely recognized that in the most recent financial crisis, regulators were caught off guard by excessive risk taking in various areas—by banks as well as by nonbanks. The Dodd–Frank Act aimed to solve for these gaps and shortcomings in part by raising the regulatory bar (for example, through increasing capital and liquidity requirements for banks and overhauling the derivatives markets) and in part by creating the Financial Stability Oversight Council. FSOC provides a forum for financial regulators to share information, identify potential risks to financial stability, promote market discipline, and respond to emerging threats.

Q.3. Do you think the FSOC as it is currently comprised has both the expertise and the authority to appropriately assess nonbank significantly important financial institutions?

A.3. As a former chief of staff to the National Security Council, I agree that convening a forum of experts with diverse perspectives can serve an important function. Given the multiagency structure of our financial regulatory system, the mere creation of the FSOC, to bring together the many U.S. financial regulators, is worthwhile. Section 113 of the Dodd–Frank Act clearly gives FSOC the authority to assess nonbank financial companies for potential designation as systemically important financial institutions (SIFIs). Based on the makeup of the U.S. regulatory system, however, banking regulators outnumber capital markets regulators on the FSOC. FSOC should take care to avoid any bank-centric bias as it analyzes firms and activities. Legislation ICI supports, S. 603, the FSOC Improvement Act, would assure early involvement by a nonbank financial company's primary regulator in assessing potential risks and how best to address them. For the mutual fund industry, our primary regulator is the Securities and Exchange Commission. The SEC has the expertise to properly assess companies under its jurisdiction and should play a leading role in any FSOC analysis of companies and activities over which it has authority.

Q.4. What progress has the G20 made in terms of adopting reforms that allow for a resolution framework in their jurisdictions?

A.4. The Financial Stability Board is made up of the national financial authorities from the G20 and several other jurisdictions around the globe, as well as various international standard-setting bodies such as the International Organization of Securities Commissions. Resolution has been a key area of focus for the FSB. According to a November 2018 progress report by the FSB, [1] jurisdictions have made the most progress on a resolution regime for global systemically important banks (G–SIBs), and all G–SIBs have resolution plans in place. The report notes that only some jurisdictions have introduced similar plans for insurers, and more work remains to be done.

Resolution planning is of critical importance for banks. If a bank fails, taxpayers would be on the hook to meet the bank's obligations to depositors. In sharp contrast, resolution planning is simply not necessary for ICI's member funds.

Mutual funds do not experience "disorderly failure." Mutual funds do not guarantee returns to investors, and investors know a fund's gains or losses belong to them alone. Unlike banks, mutual funds typically use little to no leverage. Without leverage, it is virtually impossible for a fund to become insolvent, i.e., for its liabilities to exceed its assets. A fund that does not attract or maintain sufficient assets ordinarily will be merged with another fund or liquidated through an established and orderly process.

Several features of the structure and regulation of mutual funds, along with the dynamic and competitive nature of the fund management business, facilitate "orderly resolution" of funds and their managers. These features include the independent legal character

[1] FSB 2018 Resolution Report: "Keeping the Pressure Up", available at *https://www.fsb.org/wp-content/uploads/P151118-1.pdf.*

of a fund and Investment Company Act provisions concerning separate custody of fund assets, restrictions on affiliated transactions, and board oversight. The industry is very competitive, and mutual funds and their managers are highly substitutable. No single mutual fund or fund manager is so important or central to the financial markets or the economy that the Government would need to intervene or offer support to protect financial stability.

Q.5. What more needs to be done in terms of cross-border cooperation on orderly resolution of globally significant financial institutions—both banks and nonbanks?

A.5. As discussed in response to your first question, ICI is the leading trade association for regulated funds. Given the unnecessary resolution planning for funds described in response to Question 4, it is not within our expertise to comment on cross-border cooperation on orderly resolution of globally significant financial institutions.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SINEMA FROM PAUL SCHOTT STEVENS

Q.1. In addition to alternate actions by FSOC and the nonbank's primary regulator, your testimony contemplates actions by the companies themselves to mitigate systemic risk. How does the FSOC Improvement Act improve the precision and accuracy of the FSOC's analysis, which as you alluded to in your testimony, improves overall policy outcomes?

A.1. The FSOC Improvement Act helps to ensure that the Council consider the range of options available and make an informed decision about how to address a particular potential threat to financial stability. Meaningful dialogue between a company being considered for SIFI designation and FSOC and its staff is of utmost importance. If a company is given an early indication as to why FSOC has selected it for review, the company is in a position to provide pertinent information about its business, structure, and operations. With a more complete picture of the company and its risk profile, the Council and its staff can engage in a more informed review of the company and its activities. In some situations, it may be possible for the company to take steps, such as making changes to a line of business, that would address the Council's concerns. Whether or not such action is sufficient, of course, would remain a matter of sole discretion for the Council.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TOOMEY FROM JEREMY C. KRESS

Q.1. What impact would designating a particular mutual fund as a nonbank SIFIs have on that fund's investors?

Would you expect a designation to cause investors to move their investments to other, nondesignated mutual funds?

A.1. It is not accurate to assume that the designation of a mutual fund as a nonbank SIFI would cause the funds' investors to move their investments to nondesignated mutual funds. The Federal Reserve is responsible for developing prudential standards for companies that FSOC designates as nonbank SIFIs. Congress has directed the Federal Reserve to tailor prudential standards for nonbank SIFIs, taking into account their unique capital structure and activities, among other factors.[1] The Federal Reserve must specifically consider differences between nonbank SIFIs and bank holding companies when developing such standards.[2]

Consistent with this statutory mandate, the Federal Reserve has gone to great lengths to recognize the distinct regulatory issues associated with nonbank financial companies, and to tailor its approach accordingly. For example, the insurance SIFI capital standards the Federal Reserve proposed in 2016 reflect thoughtful consideration of the differences between bank and insurance company business models.[3]

If the FSOC were to designate a mutual fund, the Federal Reserve would be required to tailor its prudential standards to mutual funds' unique regulatory issues. Until the Federal Reserve develops such standards, it would be presumptuous to draw any conclusions about how mutual funds' investors would be affected, or how such investors would react.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR CORTEZ MASTO FROM JEREMY C. KRESS

Q.1. How do the regulators for insurance companies and hedge funds become fully informed of all the activities in which insurance companies participate?

A.1. Regulators are inherently limited in their oversight of insurance holding companies and hedge funds because they lack well-defined legal authority to oversee such firms on a consolidated, enterprisewide basis.

In the United States, insurance regulation has long been the responsibility of the States, with little Federal involvement. But the State-based system of insurance regulation suffers from serious flaws. Most critically, although State insurance commissions regulate insurance subsidiaries, insurance conglomerates like AIG, MetLife, and Prudential traditionally have not been regulated at the holding company level. This critical gap in insurance regulation may allow insurance holding companies to engage in activities or amass risks without detection, as AIG did by issuing credit default swaps out of an unregulated, non-insurance, affiliate before the Financial Crisis. While some States now purport to supervise insurance holding companies on a groupwide basis, it is doubtful that State supervisors have the resources or incentives to appropriately police insurance conglomerates' worldwide activities.[1]

Hedge fund regulation suffers from similar limitations. Hedge funds have traditionally been exempt from prudential regulation and supervision. In 1998, this lack of oversight had disastrous consequences, when the country's largest hedge fund, Long-Term Cap-

[1] 12 U.S.C. §5365 (a)(2)(A).
[2] 12 U.S.C. §5365 (b)(3)(A).
[3] "Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities", 81 FR 38,631 (June 14, 2016).
[1] See Jeremy Kress, "Prudential Hasn't Earned the Right to Shed SIFI Label", *Am. Banker* (March 13, 2018), *https://www.americanbanker.com/opinion/prudential-hasnt-earned-the-right-to-shed-sifi-label*.

ital Management, collapsed, necessitating a Government-orchestrated bailout. Although the Dodd–Frank Act enhances the SEC's ability to collect information from hedge fund advisers, it did not authorize the SEC to adopt meaningful, risk-reducing regulations for hedge funds and their advisers. [2]

In sum, I am concerned that the baseline regulatory regimes for insurance companies and hedge funds are not well suited to identifying and appropriately regulating the potentially risky activities in which such firms engage.

Q.2. Could a large complex nonbank financial entity engage in risky activities completely unbeknownst to its board or regulator? Do you have historic examples of regulators being unaware that a regulator was unaware of risky investments or activities by a nonbank large and complex financial institution?

A.2. AIG is the most prominent example of a large, complex nonbank financial institution that engaged in risky activities without appropriate oversight by its board or regulators. AIG's collapse in 2008 stemmed, in large part, from its issuance of credit default swaps on mortgage-linked securities out of its subsidiary AIG Financial Products (AIGFP). Neither AIG's board nor its regulators appreciated the risks of this activity. The board of directors was "too removed from the activities on the ground to understand the risks." [3] Moreover, no agency had authority to supervise—let alone regulate—AIG's credit default swap activities because AIGFP was a noninsurance subsidiary.

Q.3. Do you think the FSOC as it is currently comprised has both the expertise and the authority to appropriately assess nonbank significantly important financial institutions?

A.3. In general, I believe that FSOC has appropriate authority to assess the systemic importance of individual nonbank financial institutions. Section 113 of the Dodd–Frank Act authorizes FSOC to designate a nonbank financial company if the firm "could pose a threat to the financial stability of the United States" in one of two ways: (1) in the event of its "material financial distress" or (2) based on "the nature, scope, size, scale, interconnectedness, or mix of [its] activities." [4] In 2012, FSOC issued, through notice-and-comment rulemaking, a three-step formal process for evaluating a nonbank's systemic importance. [5] As outlined in this process, FSOC generally has the legal authority it requires to identify nonbank SIFIs.

I am deeply concerned, however, that the FSOC, as it is currently comprised, does not have the requisite authority to implement the activities-based approach to nonbank systemic risk that the Council proposed in March 2019. Under section 120 of the Dodd–Frank Act, FSOC may recommend that the primary financial regulatory agencies adopt new or heightened standards for any fi-

[2] See Cary Martin Shelby, "Closing the Hedge Fund Loophole: The SEC as the Primary Regulator of Systemic Risk", 58 *B.C. L. Rev.* 639 (2017).

[3] See Edward Simpson Prescott, "Too Big To Manage? Two Book Reviews", 99 *Econ. Q.* 143, 157 (2013). See id. at 143 ("[U]nder the Sullivan regime, there is evidence that AIG's senior management was unaware of the risks that AIGFP was actually taking.").

[4] 12 U.S.C. §5323(a)(1).

[5] "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies", 77 FR 21,637 (Apr. 11, 2012).

nancial activity.[6] FSOC now proposes to rely primarily or exclusively on this authority, in lieu of its nonbank SIFI designation power.

But in practice, FSOC lacks the ability to implement even a minimally effective activities-based approach. Critically, FSOC's authority to recommend activities-based rules is nonbinding. Thus, even if FSOC were to propose new regulations on certain financial activities—for example, derivatives trading or securities lending—the primary financial regulatory agencies would have no obligation to adopt the Council's recommendation. There are many reasons why an agency might resist implementing activities-based regulations at FSOC's urging. For example, the agency might be captured by the financial sector it regulates, or it might try to protect its regulatory turf against intrusion by the Council. Furthermore, even if agencies wanted to adopt FSOC's activities-based recommendations, jurisdictional gaps or overlaps could prevent them from enacting and enforcing uniform, consistent activities-based rules.[7] As I suggested in response to Chairman Crapo's question at the hearing on March 14, Congress could mitigate these problems by giving FSOC direct rule-writing authority.

Finally, I am also concerned that FSOC currently lacks the expertise to appropriately monitor systemic risks because of misguided budget and staffing cuts by the Council and Office of Financial Research.[8] Systemic risk prevention is of the utmost importance. The Trump administration's unwise decision to slash the budgets and staffs of these critical agencies leaves the financial system vulnerable to another financial crisis.

Q.4. What progress has the G20 made in terms of adopting reforms that allow for a resolution framework in their jurisdictions?

A.4. Cross-border resolution is outside the scope of my expertise. I would be happy to speak with your staff to suggest other financial regulatory scholars who would be better equipped to opine on this topic.

Q.5. What more needs to be done in terms of cross-border cooperation on orderly resolution of globally significant financial institutions—both banks and nonbanks?

A.5. Cross-border resolution is outside the scope of my expertise. I would be happy to speak with your staff to suggest other financial regulatory scholars who would be better equipped to opine on this topic.

---

[6] 12 U.S.C. §5330(a).

[7] My written testimony contains a more complete analysis of the limitations of FSOC's activities-based authority.

[8] See, e.g., Ryan Tracy, "Washington's $500 Million Financial-Storm Forecaster Is Foundering", *Wall St. J.* (Feb. 19, 2018), *https://www.wsj.com/articles/washingtons-500-million-financial-storm-forecaster-is-foundering-1519067903.*

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT SUBMITTED BY JULIE A. SPIEZIO, SENIOR VICE PRESIDENT AND GENERAL COUNSEL, THE AMERICAN COUNCIL OF LIFE INSURERS

Chairman Mike Crapo (R-ID) and Ranking Member Sherrod Brown (D-OH), 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 Financial Stability Oversight Council's (FSOC) authority to require supervision and regulation of nonbank financial institutions as systemically important financial institutions (non-bank SIFIs).

On March 13, the FSOC issued for public comment proposed interpretive guidance regarding nonbank SIFI designation and determination processes. While our membership is still in the process of conducting a thorough review of the proposal, ACLI is highly encouraged with the Council's stated objective to ensure its work is clear, transparent and analytically rigorous, and enhances engagement with companies, regulators and other stakeholders. Importantly, the ACLI is supportive of the proposal for the Council to prioritize its efforts to identify, assess, and address potential risks and threats to U.S. financial stability through a process that emphasizes an activities-based approach (ABA), as well as reforms to enhance the analytical rigor and transparency in the processes the Council would undertake if it were to consider designating a nonbank entity as a SIFI subject to supervision by the Federal Reserve. We also appreciate the emphasis throughout the proposal to work more closely with the primary regulators, including the state regulators for insurance, for both the preferred activities-based approach as well as any possible designations.

The proposed guidance aligns with the U.S. Treasury's November 2017 report to the President of the United States on FSOC Designations. Treasury's FSOC report contains a number of important recommendations advocated by ACLI including prioritizing a sector-wide ABA approach to potential risks posed by nonbank financial companies; greater coordination and reliance on primary functional regulators; increasing the analytic rigor of determination analyses; improving engagement and transparency in the determinations process; and providing a clear "off-ramp" for designated nonbank financial companies. The report reflects many of the principles of transparency, accountability, and due process that are supported by ACLI and its members.

We applaud Senators Mike Rounds (R-SD), Doug Jones (D-AL), Thom Tillis (R-NC) and Kyrsten Sinema (D-AZ) for introducing bipartisan legislation, the "Financial Stability Oversight Council Improvement Act of 2019". This legislation would stipulate that the Council may not vote on a proposed determination with respect to a U.S. nonbank financial company unless the Council first determines, in consultation with the company and the primary financial regulatory agency with respect to the company, that a different action by the Council or the agency (including the application of new or heightened standards and safeguards under section 120 of the Dodd-Frank Act), or by the company under a written plan that is submitted promptly to the Council, is impracticable or insufficient to mitigate the threat that the company could pose to the financial stability of the United States. We commend Sens. Rounds, Jones, Tillis and Sinema for their leadership on this issue and look forward to a constructive dialogue concerning their bipartisan proposal.

THE AMERICAN COUNCIL OF LIFE INSURERS

The ACLI advocates on behalf of 280-member companies dedicated to providing products and services that promote consumers' financial and retirement security. Ninety million American families depend on our members for life insurance, annuities, retirement plans, long-term care insurance, disability income insurance, reinsurance, dental and vision and other supplemental benefits. ACLI represents member companies in state, federal and international forums for public policy that supports the industry marketplace and the families that rely on life insurers' products for peace of mind. ACLI members represent ninety-five percent of industry assets in the United States.

THE FSOC SHOULD PRIORITIZE AN ACTIVITIES-BASED OR INDUSTRY-WIDE APPROACH TO POTENTIAL RISKS POSED BY NONBANK FINANCIAL COMPANIES

While we believe the FSOC has a vital role to play in helping identify and mitigate potential systemic risk in the U.S. economy, the use of its authority with respect to past designations of nonbank entities as systemically important financial institutions (SIFI) was arbitrary, inconsistent and highly problematic. The use of its authority to designate individual firms as nonbank SIFIs ignored more efficient and effective regulatory tools to mitigate perceived systemic risk concerns, and diverted important resources away from its more important role as a cross-sectoral macro-prudential overseer of the economy that can identify potential systemic risk in a timely fashion.

The designation of insurers merely produced duplicative supervision and regulation requirements, excessive and unnecessary regulatory costs and burdens, and harmed competition in the insurance market place without actually identifying or mitigating perceived systemic risk. We are pleased and support the FSOC's recent decision to remove its insurance company designations and its intent to adopt an ABA to systemic risk moving forward.

In our view, prioritizing an ABA appropriately focuses FSOC's resources on identifying, assessing and mitigating potential systemic risk to U.S. financial stability. An ABA is much more efficient and effective than subjecting a handful of insurers, who are already highly supervised and regulated by state insurance regulators, with another layer of duplicative and potentially conflicting supervision and regulation particularly if based solely on size or perceived complexity. The use of an ABA would appropriately align the FSOC's principal role with making advisory recommendations to primary financial regulatory agencies, which for insurance companies are the state commissioners, on applying new or heightened safeguards for financial activities that could increase risks to the U.S. financial markets.

ACLI is highly encouraged by the proposed interpretive guidance, and particularly with the decision to transition away from entity-based determinations toward an ABA to protecting the U.S. financial system. ACLI particularly applauds the emphasis placed in the proposed interpretive guidance to leverage the knowledge and expertise of existing primary financial regulatory agencies to mitigate identified potential risks to U.S financial stability.

RECENT AND ON-GOING ENHANCEMENTS TO THE STATE-BASED INSURANCE SYSTEM

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 more vigilant in identifying, and aggressive in addressing, issues of concern that might jeopardize the insurance company 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.

Recently the NAIC has undertaken a new macroprudential initiative (MPI), which is designed to provide financial stability by analyzing existing macroeconomic trends, post-financial crisis regulatory reforms, and identifying potential enhancements and/or additions to further improve state regulators' ability to address macroprudential impacts. The goal of the MPI is to consider "new or improved tools" to enable regulators to better monitor and respond to the impact of external financial and economic risks on insurers that might be transmitted externally, and increase awareness of state legislators' monitoring capabilities regarding macroprudential trends. The NAIC has several MPI workstreams underway, including improved liquidity and counterparty risk exposure monitoring tools.

FSOC SHOULD ENHANCE THE ANALYTICAL RIGOR AND TRANSPARENCY AND ENGAGEMENT WITH PRIMARY FINANCIAL REGULATORS WHEN CONSIDERING MAKING A DETERMINATION TO SUBJECT A NONBANK FINANCIAL COMPANY TO SUPERVISION BY THE FEDERAL RESERVE

We are pleased that recent activities of the FSOC have demonstrated a clear objective to address prior shortcomings of the designation process by leveraging the expertise of primary financial regulators, appropriately tailoring regulations to cost-effectively minimize burdens, and ensuring the Council's designation analyses are rigorous and transparent.

We believe it's imperative for the FSOC to revise its interpretive guidance to codify certain existing practices as well as to implement new enhancements to its processes. Enhancing the analytical rigor and transparency, along with engagement with primary financial regulators, will greatly benefit regulators, industry and the public should the FSOC consider using its designation authority at some point in the future.

INCONSISTENT PROCESS AS APPLIED TO DIFFERENT SECTORS OF THE FINANCIAL SERVICES INDUSTRY; LACK OF UNIFORM, CONSISTENT OR TRANSPARENT METHODOLOGY

The FSOC process has been extremely inconsistent as applied to different sectors of the financial services industry. This broad discrepancy in application of FSOC's authority is illustrated by the very different approaches taken towards different industries, without explanation. The insurance industry has seen individual companies subject to scrutiny and designation, while for other industries FSOC has focused on reviewing and identifying specific practices that may pose significant risk, or taken no action at all rather than singling out and designating specific firms.

Within the insurance sector itself, for past FSOC designation processes, there was no evidence of a uniform, consistent or transparent methodology being applied to each individual company under review. Life insurance companies that had gone through the designation process did not receive adequate information or explanation of FSOC analyses and decisions. Documents provided by FSOC to insurance companies offered little insight into the basis for designation decisions. These documents typically offered only conclusory statements, predictions, and speculations that are unsupported by factual and economic analysis or historical precedent. At the time, companies were not provided with enough information that would allow them to take positive steps to avoid designation or be de-designated through appropriate action.

THE ROLE OF PRIMARY FINANCIAL REGULATORS

Of particular concern with the FSOC process as applied to insurers had been its past failure to appropriately consider the role of existing primary financial regulators. This led to a lack of understanding and failure to recognize the strong insurance regulatory framework in place through the state-based system, even though one of the explicit statutory requirements FSOC is directed to consider is the "degree to which the company is already regulated by one or more primary financial regulatory agencies". The state-based insurance regime has a long and successful track record of insurance regulation. In the past, and contrary to this statutory requirement, the FSOC has not appropriately considered the authority and tools available under the state-based insurance regime, including numerous and substantial reforms policymakers have implemented since the financial crisis. Failure to appropriately consider the role of existing primary financial regulators was another sign of the lack of due process in FSOC designation of individual insurers. This fundamental shortcoming was repeatedly highlighted by the voting member of FSOC with insurance expertise.

APPLICATION OF THE MATERIAL FINANCIAL DISTRESS STANDARD HAS FAILED BASIC PRECEPTS OF ACCOUTABILITY, TRANSPARENCY AND CONSISTENCY

The Dodd-Frank Act authorizes FSOC to designate a nonbank financial company for supervision by the Federal Reserve Board if either (1) material financial distress at the company, or (2) the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the company, could threaten the financial stability of the United States. Each of the initial designations made by FSOC had been based on the material financial distress standard alone. In each case, FSOC simply assumed the existence of material financial distress had or could occur at the company, and then concluded that such distress could be transmitted to the broader financial system.

We believe that past FSOC analysis used a flawed application of the material financial distress standard for designation. This led to distorting the purpose of designations by failing to account for the vulnerability of prospective designees, and departs from the requirements of the Dodd-Frank Act and FSOC's own regulatory guidance.

In closing we support issuing clear and transparent guidance to provide nonbank companies with sufficient information to understand the Council's concerns regarding risks to financial stability, ensure its work is analytically rigorous, and to promote leveraging the knowledge and expertise of primary financial regulators.

CONCLUSION

The ACLI thanks the Committee for convening this important hearing and for its comprehensive oversight over the non-bank financial institution designation process. We support FSOC's decision to revise its interpretive guidance and support legislation that would codify the requirement to use ABA prior to considering an entity-based approach for mitigating perceived systemic risk concerns. We look forward to working with policymakers to ensure FSOC's future focus remains on the overall financial stability of the U.S. economy.

STATEMENT SUBMITTED BY THE REINSURANCE ASSOCIATION OF AMERICA

RAA
REINSURANCE
ASSOCIATION
OF AMERICA

STATEMENT

REINSURANCE ASSOCIATION OF AMERICA

STATEMENT FOR THE RECORD

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

HEARING ON

"FINANCIAL STABILITY OVERSIGHT COUNCIL NONBANK DESIGNATIONS"

MARCH 14, 2019

The Reinsurance Association of America (RAA) appreciates Chairman Crapo, Ranking Member Brown, and other Senate Banking, Housing, and Urban Affairs (Committee) members' interest in the U.S. property casualty (re)insurance industry. Thank you for holding today's hearing entitled, "Financial Stability Oversight Council Nonbank Designations." The RAA is the leading trade association of property and casualty (P&C) reinsurers doing business in the United States. RAA membership is diverse, including reinsurance underwriters and intermediaries licensed in the U.S. and those that conduct business on a cross border basis. The RAA also has life reinsurance company affiliates. The RAA represents its members before state, federal and international bodies.

The RAA has performed a substantial analysis (attached) of whether the P&C insurance and reinsurance industry could contribute to systemic risk. The analysis demonstrates that rather than being a potential source of systemic risk, P&C (re)insurance is a material mitigant of systemic risk in the financial markets and broader economy.

A key consideration of any evaluation of an industry's potential contribution to systemic risk is first defining systemic risk. The RAA's analysis defines systemic risk consistent with the definitions promulgated by the Federal Reserve and the Financial Stability Board (FSB), which define the potential for systemic risk arising when a large interconnected

1445 New York Avenue, NW
7th Floor
Washington, D.C. 20005
202/638-3690
www.reinsurance.org

financial institution fails, causing serious negative consequences on either the financial system or the real economy. The RAA agrees with the Financial Stability Oversight Council (FSOC) and other U.S. financial regulators that the potential insurance market impact of the failure of P&C (re)insurers, such as decreases in (re)insurance capacity or potential increases in the cost of (re)insurance, do not rise to the systemic risk level because they would not seriously impact the overall financial system or economy.

The RAA analysis, which was presented to the International Association of Insurance Supervisors (IAIS), the FSOC and other U.S. and international supervisors following the financial crisis, demonstrates that P&C (re)insurance does not meet any of the FSB's four primary criteria for systemic risk including: (1) Size, (2) Interconnectedness, (3) Substitutability, and (4) Liquidity. The analysis also demonstrates that in a very extreme stress test scenario, the (re)insurance industry is unlikely to default on its obligations and that the real source of systemic risk relates to uninsured economic losses.

In fact, expanded utilization of (re)insurance would reduce systemic risk by further diversifying insurance and credit risks and by transferring more of the enormous exposure currently borne by taxpayers, such as the mortgage default risk to the government sponsored enterprises (GSEs) following a major U.S. earthquake. Finally, our analysis clearly shows that through several financial crises since the 1970's, (re) insurance related impairments are rare and are utterly insignificant compared to potential bank-related systemic risks.

Thank you for the opportunity to submit RAA's statement for today's hearing record and for your consideration of our position.

EVALUATING SYSTEMIC RISK

Property & Casualty Reinsurance

IAIS Reinsurance Subcommittee and Reinsurance Transparency Subgroup

Toronto Canada
27, July 2011

RAA

Definitions of Systemic Risk

Financial Stability Board

- "The risk of disruption to the flow of financial services that is (i) caused by an impairment of all or parts of the financial system; and (ii) has the potential to have serious negative consequences for the real economy."

- "Fundamental to this definition is the notion that systemic risk is associated with negative externalities and/or market failure and that a financial institution's failure or malfunction may impair the operation of the financial system and/or the real economy. "

Definitions of Systemic Risk

Federal Reserve Chairman Ben Bernanke

"The possibility that the failure of a large interconnected firm could lead to a breakdown in the wider financial system; systemic risks threaten the stability of the financial system as a whole and consequently the broader economy, not just that of one or two institutions."

RAA

(Re)insurance Business Model

The (re)insurance business model is not a source of systemic risk.

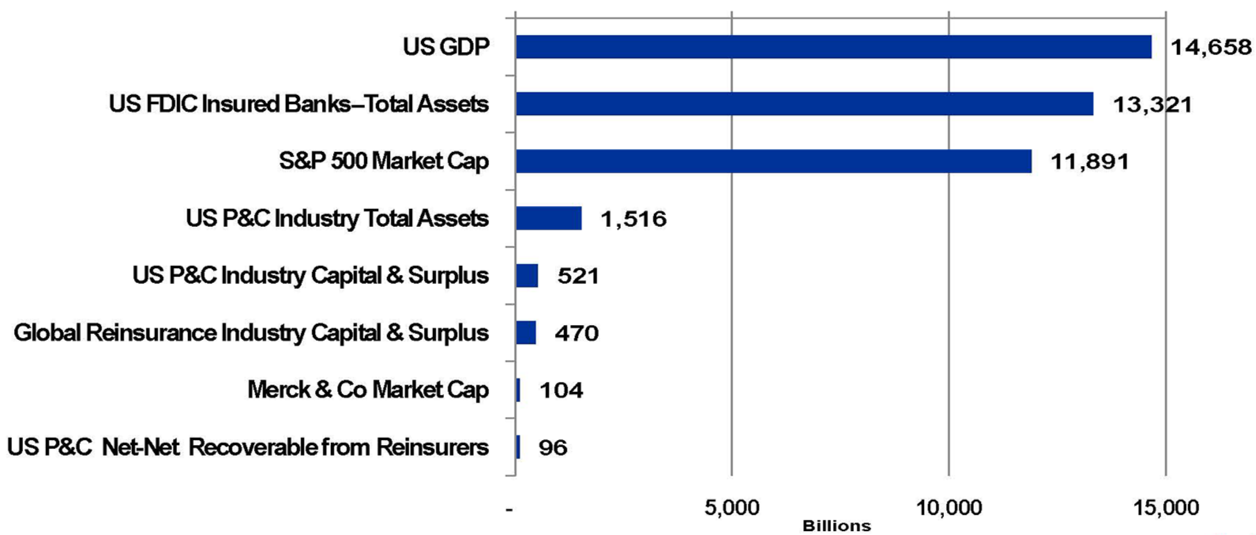
- It is fundamentally different from other financial institutions.
- Inverted production cycle: obligations are pre-funded at the inception of the policyholder relationship.
- Lack of leverage limits interconnectedness.
- (Re)insurance obligations are not callable. Cash outflows may only be triggered by an external insured event.
- Insured loss events are not correlated with financial crises or economic cycles.

FSB Systemic Risk Attributes

The FSB has identified four primary attributes for the evaluation of systemic risk

- Size
- Interconnectedness
- Substitutability
- Time / Liquidity

Size - Reinsurance recoverables are not systemic risk amounts relative to U.S. financial markets or economy.

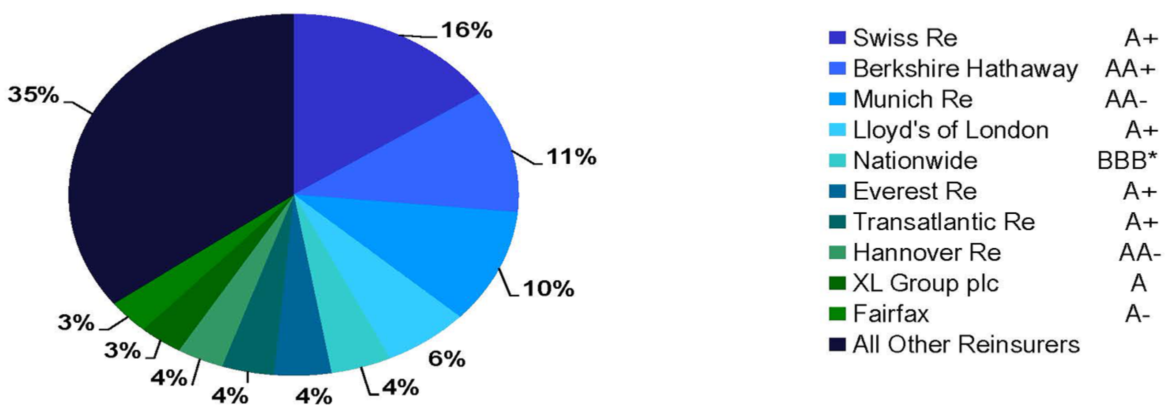


Size - Small relative size / reinsurance credit risk is further reduced by offsetting amounts.

U.S. P&C Industry Exposure to Reinsurance Recoverables	
2009 Results	**$ Millions**
Total Assets	1,515,926
Reinsurance Recoverables on Paid Losses	14,444
Policyholders' Surplus	520,600
Net Recoverables (Paid, Case & IBNR, net of amounts owed to reinsurer)	233,816
Less Funds Held	23,502
Less LOCs, Trust Funds, & Other Collateral	114,654
Equals Net Net Recoverable	95,661
Recoverables Analysis	
Net Net Recoverable as % of PHS	18.4%
Net Net Recoverable as % of Total Assets	6.3%
Recoverable on Paid Loss as % of PHS	2.8%
Recoverable on Paid Loss as % of Total Assets	1.0%

Interconnectedness - Insurance risk is spread broadly and globally. Reinsurance is a net credit enhancement for many cedents.

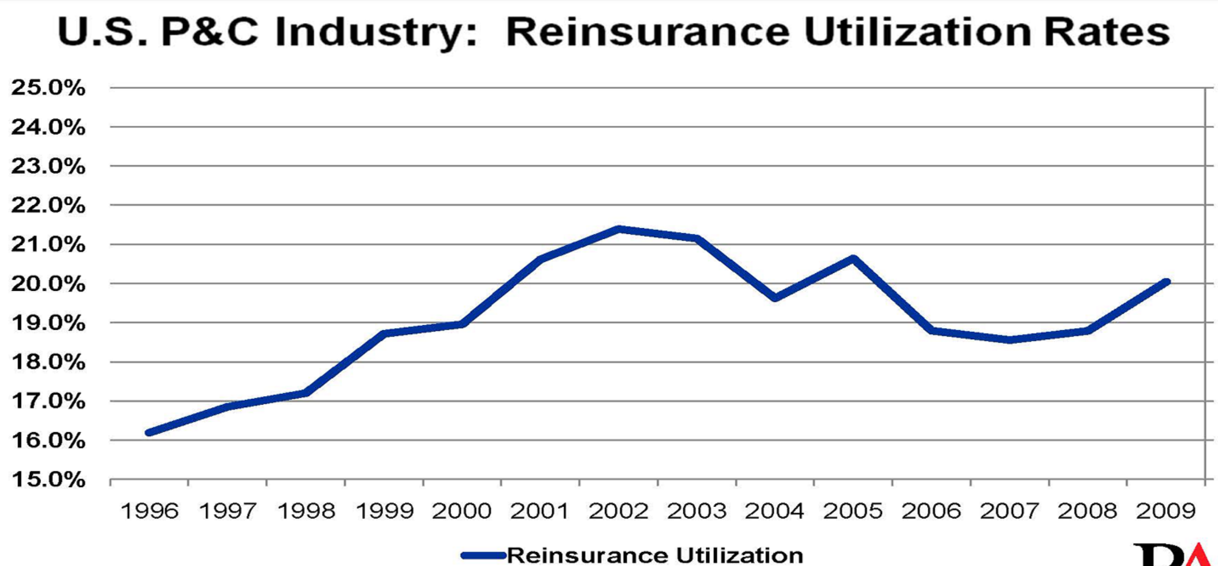
Top US P&C Groups
3rd Party Reinsurance Net-Net Recoverables Concentration



*Note: Nationwide's AM Best Rating = A+. Approximately 90% of this net-net recoverable is due from Nationwide Indemnity Co., an entity used to run off asbestos and environmental obligations.

Interconnectedness & Substitutability

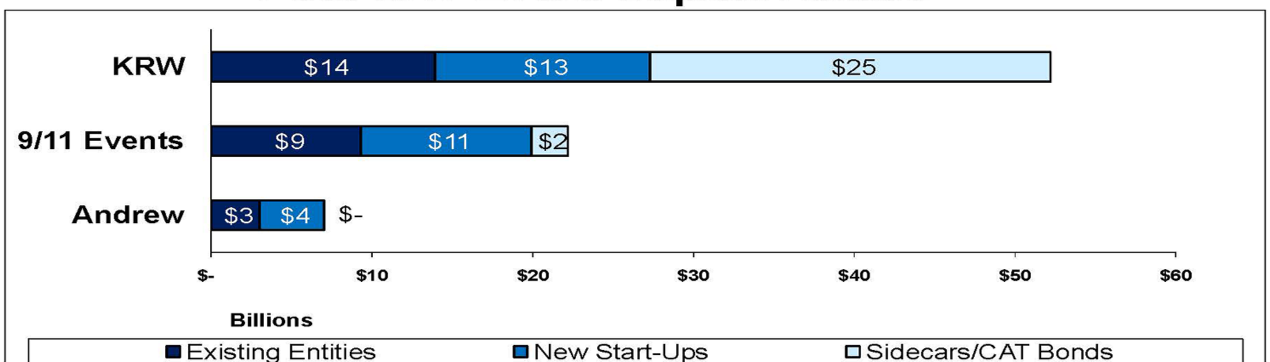
P&C industry cessions to the global reinsurance market are only 20% of gross premium.



RAA

Substitutability - Capital is quickly replaced following significant events. Alternative forms of capital have become more prevalent.

Post CAT-Event Capital Raised

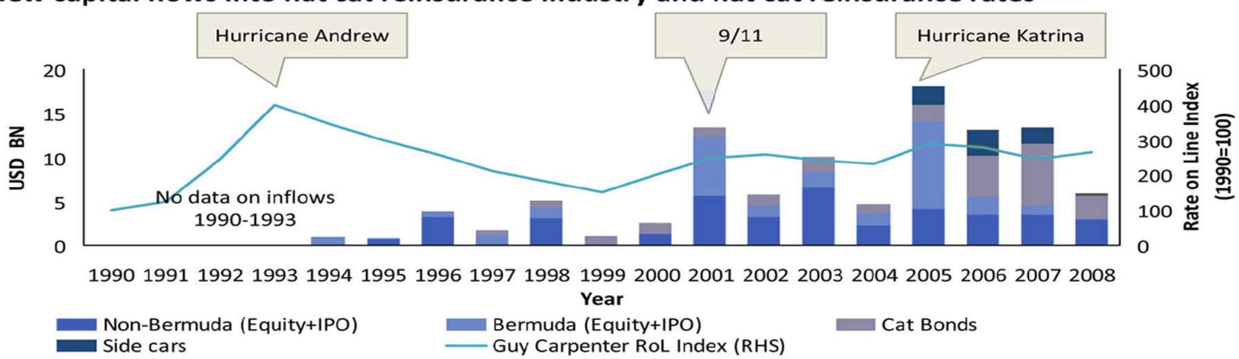


	KRW	9/11 Events	Andrew
New Capital Raised	$52.2 B	$22.2 B	$7.0 B
Est. Loss Industry Wide	$65.0 B	$41.0 B	$15.5 B
New Capital % of Est. Loss	80.3%	54.1%	45.2%

RAA

New capital inflow into reinsurance shows high substitutability

New capital flows into nat cat reinsurance industry and nat cat reinsurance rates



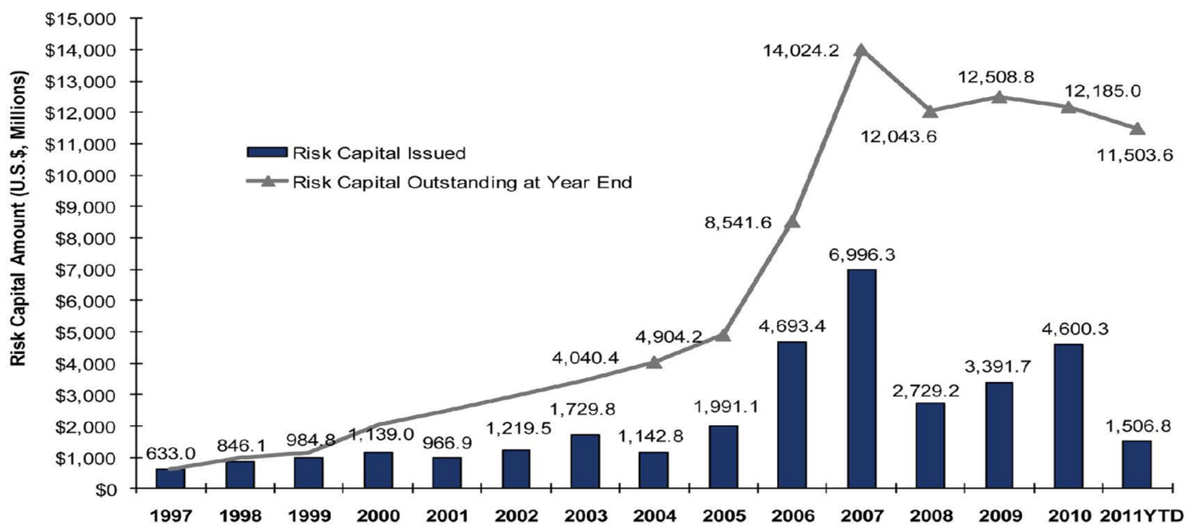
- Reinsurance rates increase for years following big catastrophes
- This attracts steady inflow of capital in the industry through new entrants or capital increases of existing reinsurers (including side cars and cat bonds)
- In addition, capital base of reinsurers is also progressively rebuilt after large natural catastrophes through the higher reinsurance rates

Reinsurance capacity has always increased after natural catastrophes – insurance capacity is highly substitutable

 Source: Thomson, Guy Carpenter, AON Benfield, Dealogic, Oliver Wyman analysis

Substitutability - Catastrophe Bond Market Growth Continues

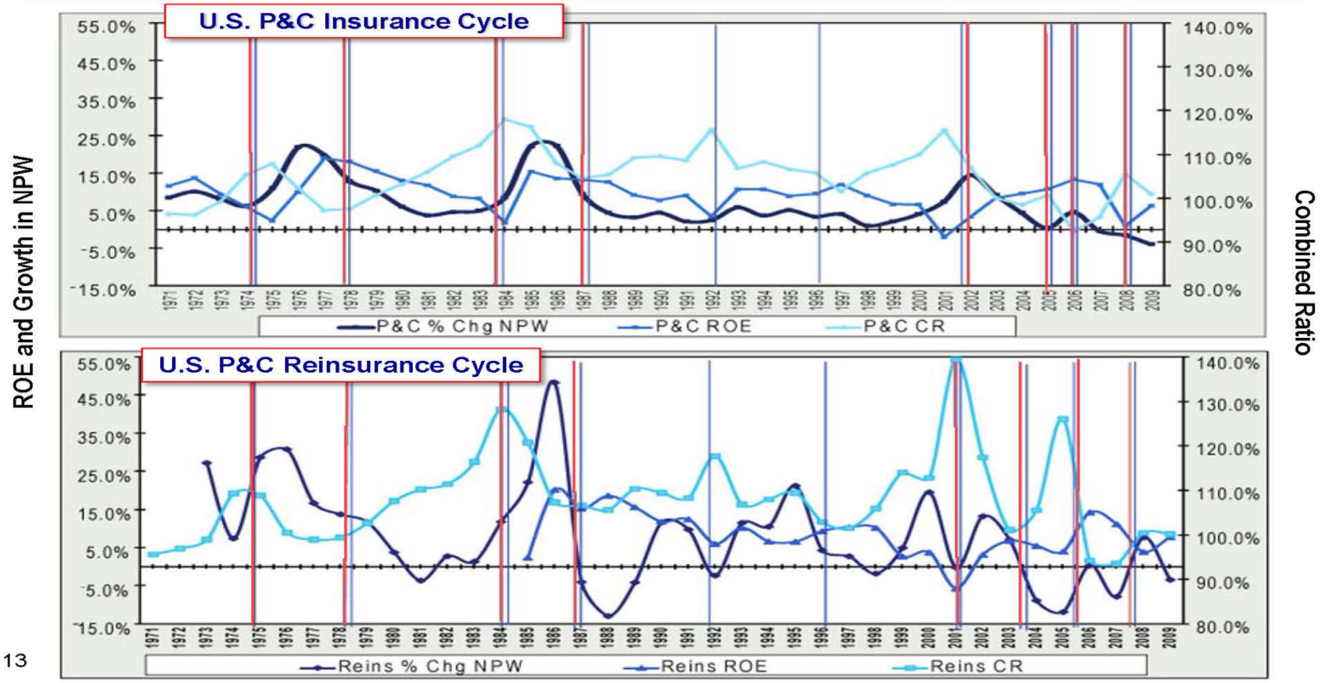
RISK CAPITAL ISSUED AND OUTSTANDING, 1997 – 2011 YTD



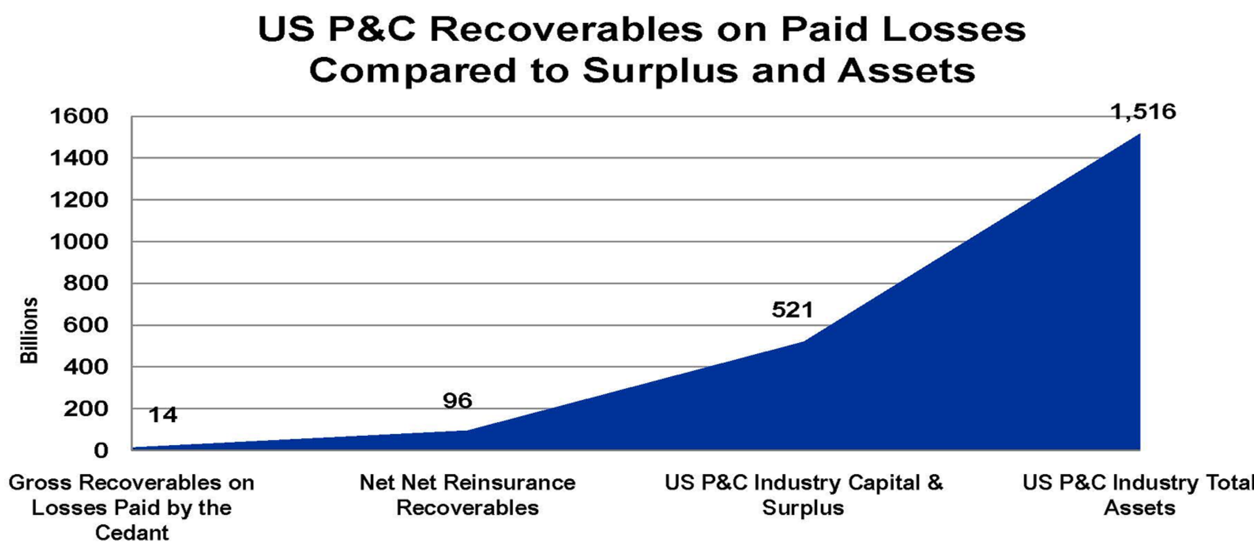
Source: GC Securities *As of May 31, 2011*

RAA

Substitutability - Capital flows follow the reinsurance cycle. Reinsurance absorbs insurance industry volatility and adds stability.



Time/Liquidity - (Re)insurance obligations are not callable, significantly limiting the systemic risk potential.

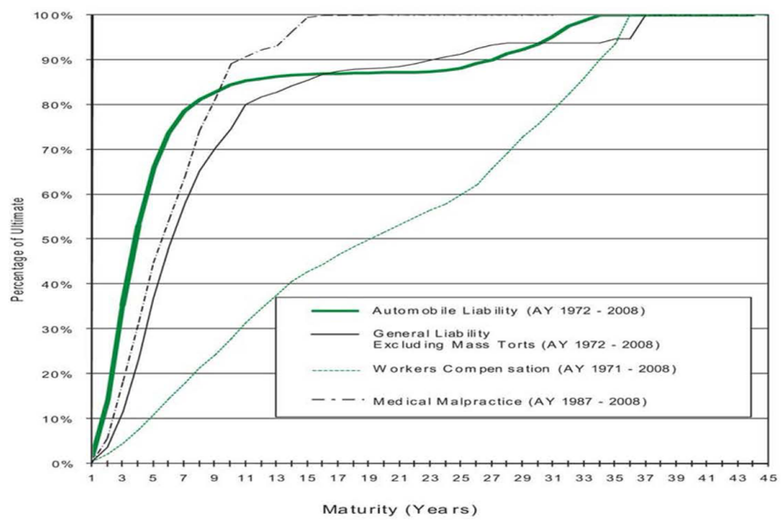


$14 Billion Reinsurance Recoverable on Paid Losses are the only amounts currently due. Reflects the illiquid nature of insurance and reinsurance obligations.

RAA

Time/Liquidity - Liability reinsurance losses emerge over many years.

Historical Loss Development Paid Losses Excess Reinsurance

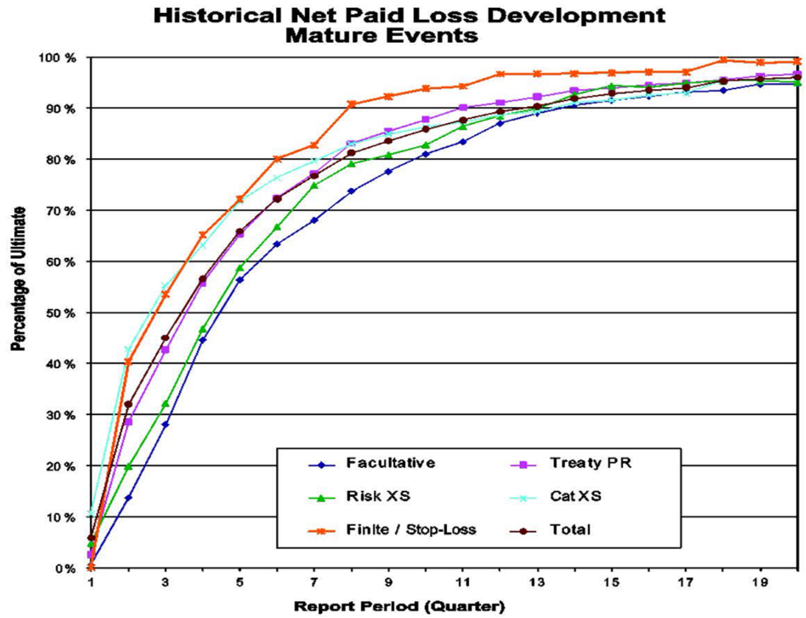


RAA Historical Loss Development Study, 2009 Edition

RAA

Time / Liquidity

Reinsured property catastrophe losses also emerge more slowly than might be expected.

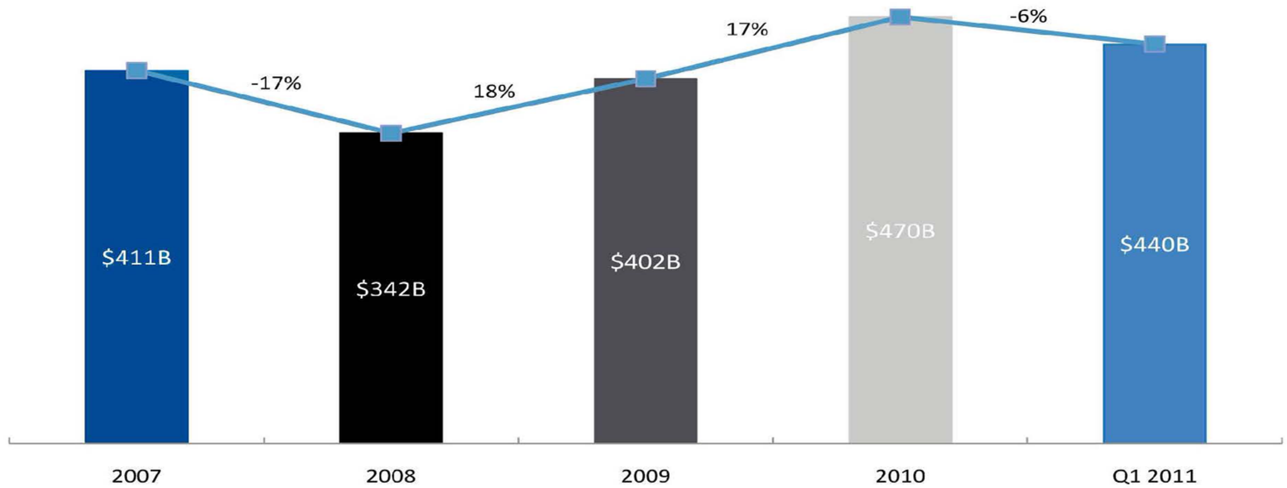


RAA

Assumptions Underlying A Global Reinsurance Stress Test Scenario

Reinsurer capital was minimally impacted by the financial crisis. It recovered quickly and remains adequate for demand.

Change in Reinsurer Capital



Source: Individual Company Reports, Aon Benfield Analytics

Economic losses are 5 to 20 times greater than reinsured losses.

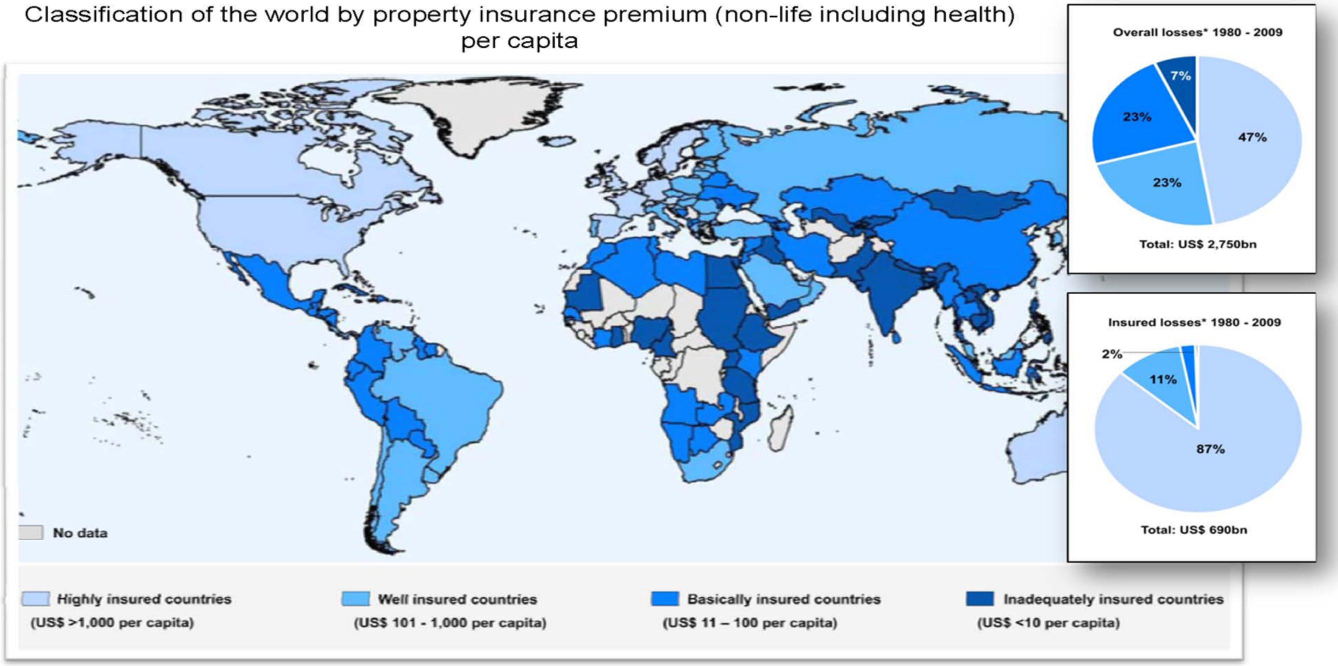
The Range can be impacted by:

- type of reinsurance (XOL v. QS)
- type of peril (take-up rate/exclusions)
  - e.g. Earthquake/Flood
- location (insurance penetration)
  - e.g. developed v. developing economies
- level of government participation in the reinsurance market

RAA

Natural Catastrophes in differently insured countries

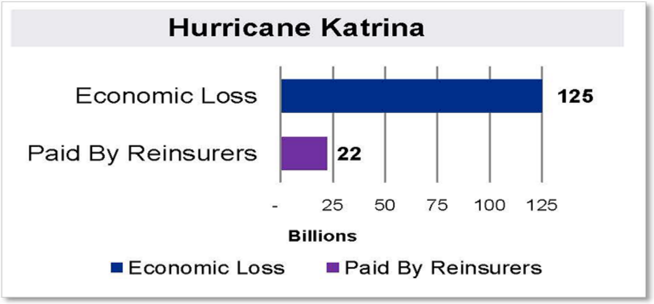
Classification of the world by property insurance premium (non-life including health) per capita

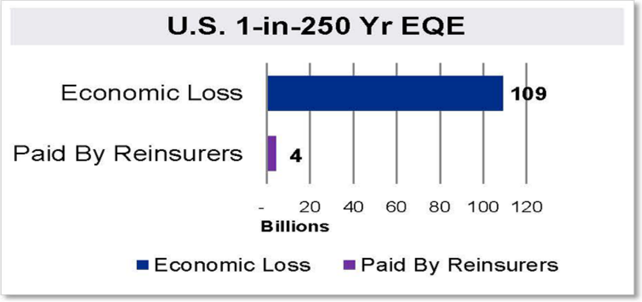


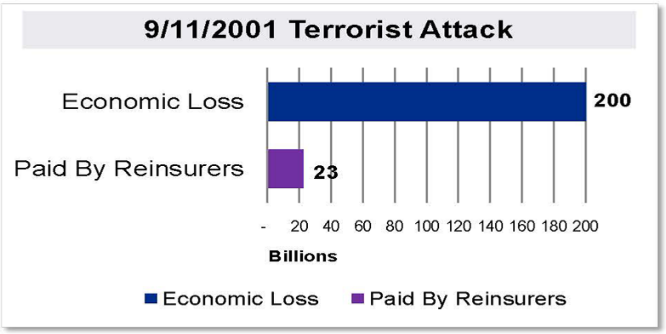
Source: MR NatCat*SERVICE* as at July 2010

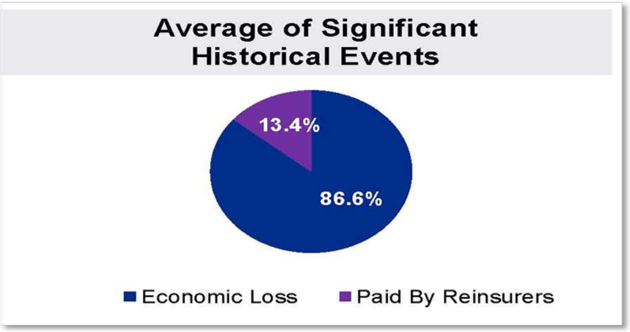
Economic Losses are 5 to 20 Times Greater than Reinsured Losses

Reinsurance is not nearly as significant a source of risk compared to uninsured loss.





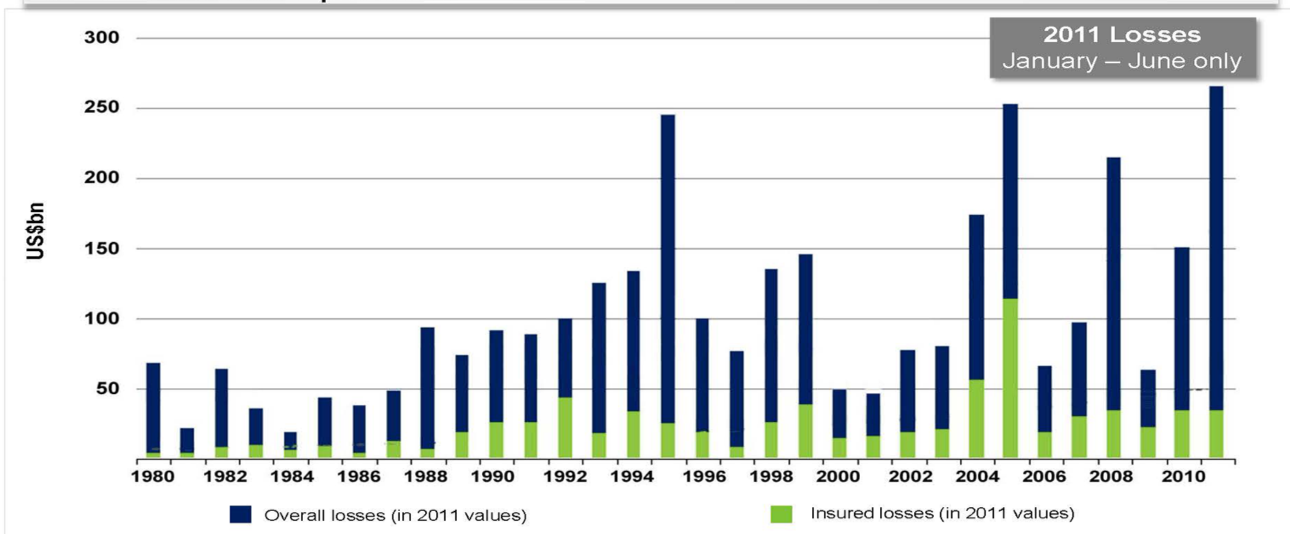




Worldwide Natural Disasters 1980 – 2011

Overall Economic versus Insured Losses

Insured losses are a small portion of economic losses: Reinsurance loss is an even smaller portion.



 Source: MR NatCat*SERVICE*

Stress Test Scenario:
100% Solvency Ratio

RAA

Creating an extreme scenario: What would it take to bring down a major reinsurer?

- To start with: let's focus on a leading global reinsurer to see **what amount of losses would be needed to reduce its capital base to 100% of the solvency ratio.** Let's use published data for Munich Re and Swiss Re (the global TOP2) and think of this **hypothetical reinsurer as a simple average of the two market leaders** (thus all numbers used in this example will be based on a simple average of the respective Munich Re and Swiss Re number).

- Taking into account an average 2009 solvency ratio of 253% for this hypothetical reinsurer and available capital of $33.7 bn., a fall to the 100% solvency ratio level (capital at $13.3 bn.) would imply a cumulated loss event in the magnitude of $~20.4 bn.

- This would imply a loss more than ten times the loss from Hurricane Katrina (~$1.9bn. for Munich Re and Swiss Re on average), the by far largest (re)insured loss event in history.

- Thus, it would take such an extremely large loss event (or equivalently, a series of very large loss events taking place within a short period of time) just to bring the level of capital to 100% of the solvency margin. One should therefore extend this stress scenario to the entire industry to see what level of economic loss would cause the whole reinsurance industry's capital to fall to a 100% solvency ratio level.

Solvency Ratio 253%	≡	Available Capital $33.7 bn
Solvency Ratio 100%	≡	Available Capital $13.3bn
$33.7bn - $13.3bn		**Hypothetical reinsurance loss must be ≥ $~20.4bn**

Hypothetical reinsurance loss equals more than **10-times Hurricane Katrina loss**

Such an extreme loss event would still only reduce capital to a 100% solvency ratio**, meaning that this hypothetical reinsurer remains a going concern and all claims are paid.**

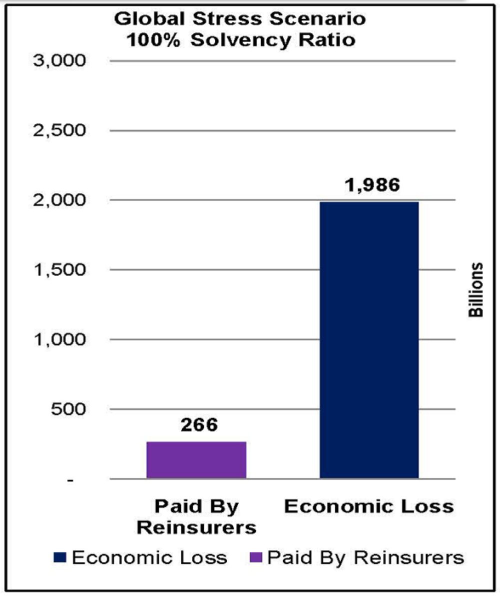
Source: Munich Re, Swiss Re

RAA

Extreme scenario at 100% solvency ratio shows: Respective economic loss would by far exceed the reinsurance industry loss.

- Assuming similar solvency ratios[1] for the rest of the industry and using numbers on total industry capital[2], it would take a loss to the reinsurance industry of $~266.1 bn. to create such a scenario that reduces industry capital to a 100% solvency ratio level.
- In contrast to these already very large numbers, the estimated **total economic loss** from such a series of extreme events is likely to be close to $**1,986 bn.** (for comparison again: the economic loss from Hurricane Katrina was $~125 bn.).
- **All of the Great Natural Catastrophes that have occurred World-wide from 1950 – 2010 amount to $2,100 bn.** (adjusted to 2010 values), which is about the size of loss from a series of events occuring in a single year that would be needed to bring industry capital down to a100% solvency ratio

- **The respective total economic loss of this extreme scenario would by far exceed the reinsurance industry loss. Moreover at a 100% solvency ratio, the reinsurance industry would not see widespread default as the existing capital base and reserves would be sufficient to pay the claims.**



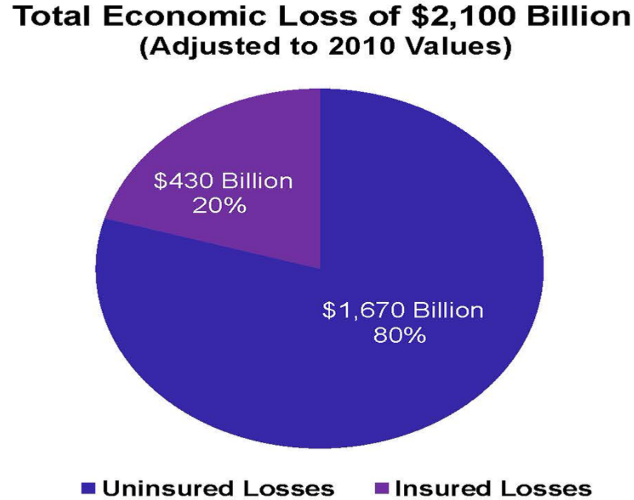
1) clearly a simplifying assumption, as solvency ratios differ between reinsurers; 2) taken from Aon Benfield's estimate that global reinsurance capital is $440 bn.

Source: RAA Analysis Based on Underlying Assumptions Provided by a Munich Re and Swiss Re Analysis

RAA

Great natural catastrophes worldwide 1950-2010

The total economic losses used in the global stress test are greater than all of the great natural catastrophes worldwide between 1950-2010.



Source: Munich Re Nat Cat SERVICE, As of January 2011

RAA

Stress Test Scenario:
40% Solvency Ratio

102

RAA

Extreme Stress Test Scenario Analysis	Swiss Re / Munich Re Combined	Global Industry
	$ in Billions	
Solvency Ratio 253%	33.7	440.0
Solvency Ratio 100%	13.3	173.9
Solvency Ratio 40%	5.3	69.6
Implied Cuml. Loss @ 100%	20.4	266.1
Implied Cuml. Loss @ 40%	28.4	370.4

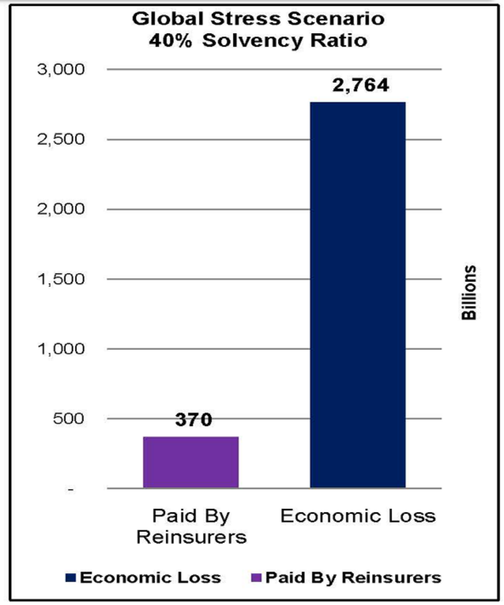
Economic Loss Scenarios Needed to Reduce Industry Capital to 100% of Solvency Ratio			Example Type of Events
	Global Re Loss	Global Economic Loss	
Reins Loss = 20% of Economic Loss	102.0	1,330.4	Hurricanes (U.S. /Developed Economies)
Reins Loss = 13.4% of Economic Loss	152.2	1,985.7	Mix of Global Events
Reins Loss = 5.5% of Economic Loss	370.8	4,837.9	Earthquake/Flood w/low take-up rate

Economic Loss Scenarios Needed to Reduce Industry Capital to 40% of Solvency Ratio			Example Type of Events
Reins Loss = 20% of Economic Loss	142.0	1,852.2	Hurricanes (U.S. /Developed Economies)
Reins Loss = 13.4% of Economic Loss	211.9	2,764.4	Mix of Global Events
Reins Loss = 5.5% of Economic Loss	516.2	6,735.2	Earthquake/Flood w/low take-up rate

Extreme scenario at 40% solvency ratio shows: Respective economic loss would by far exceed the reinsurance industry loss.

- Assuming similar solvency ratios[1] for the rest of the industry and using numbers on total industry capital[2], it would take a loss to the reinsurance industry of $~370.4 bn.) to create such a scenario.
- In contrast to these already very large numbers, the estimated **total economic loss** from such a series of extreme events is likely to be close to $**2,764 bn.**
- For comparison, a loss of $2,800 bn. equates to nearly twice the amount of economic losses from all hurricanes and earthquakes that occurred in the U.S. between 1900 and 2005 based on normalized loss statistics as published in studies by Dr. Roger Pielke—University of Colorado.

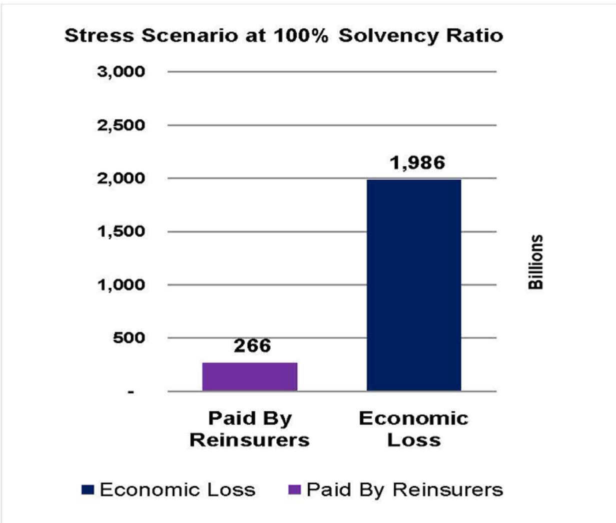
- **The respective total economic loss of this extreme scenario would by far exceed the reinsurance industry loss. Moreover the reinsurance industry's loss would largely be paid given their present $440 bn. in capital.**

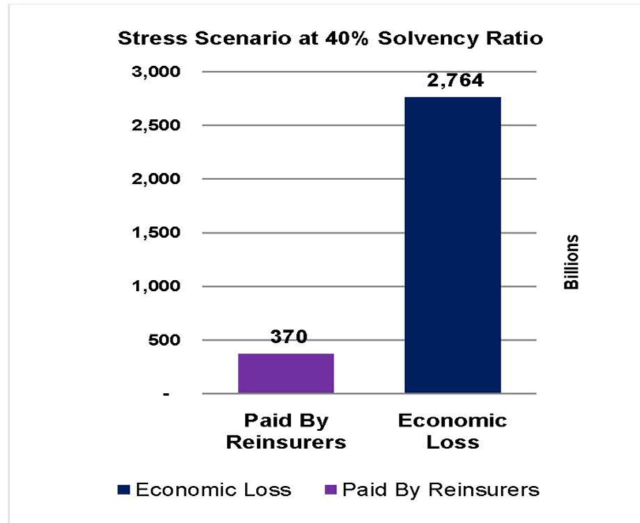


1) clearly a simplifying assumption, as solvency ratios differ between reinsurers; 2) taken from Aon Benfield's estimate that global reinsurance capital is $440 bn.

Source: RAA Analysis Based on Underlying Assumptions Provided by a Munich Re and Swiss Re Analysis

Economic losses (not reinsurance losses) are the true source of systemic risk following extreme loss events.





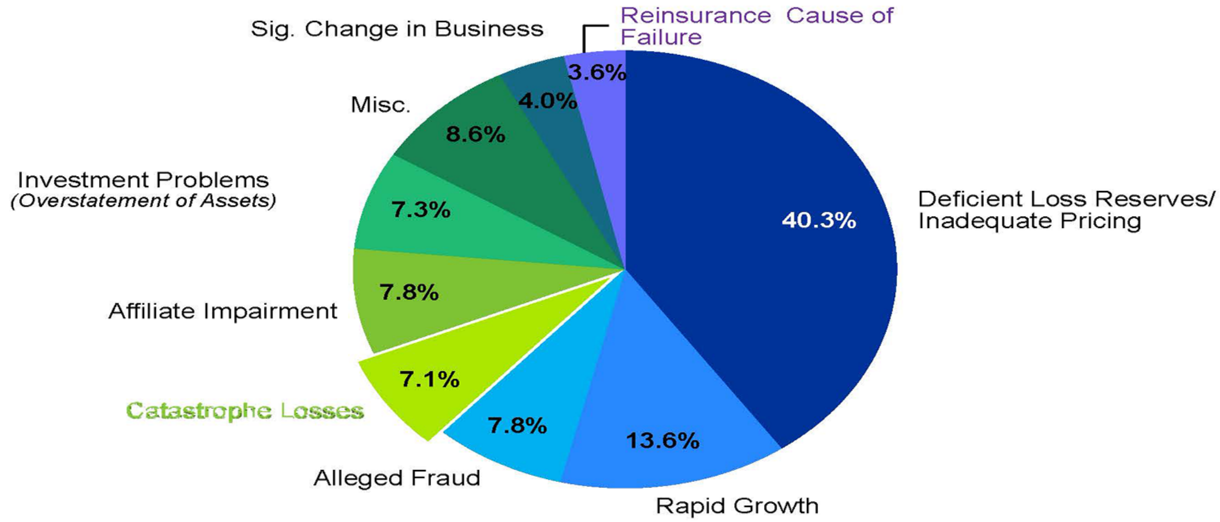
U.S. Financial Institutions Impairment History and Implications for P&C Reinsurance Systemic Risk

106

RAA

Insurance impairments attributed to reinsurance as the cause of failure are historically insignificant.

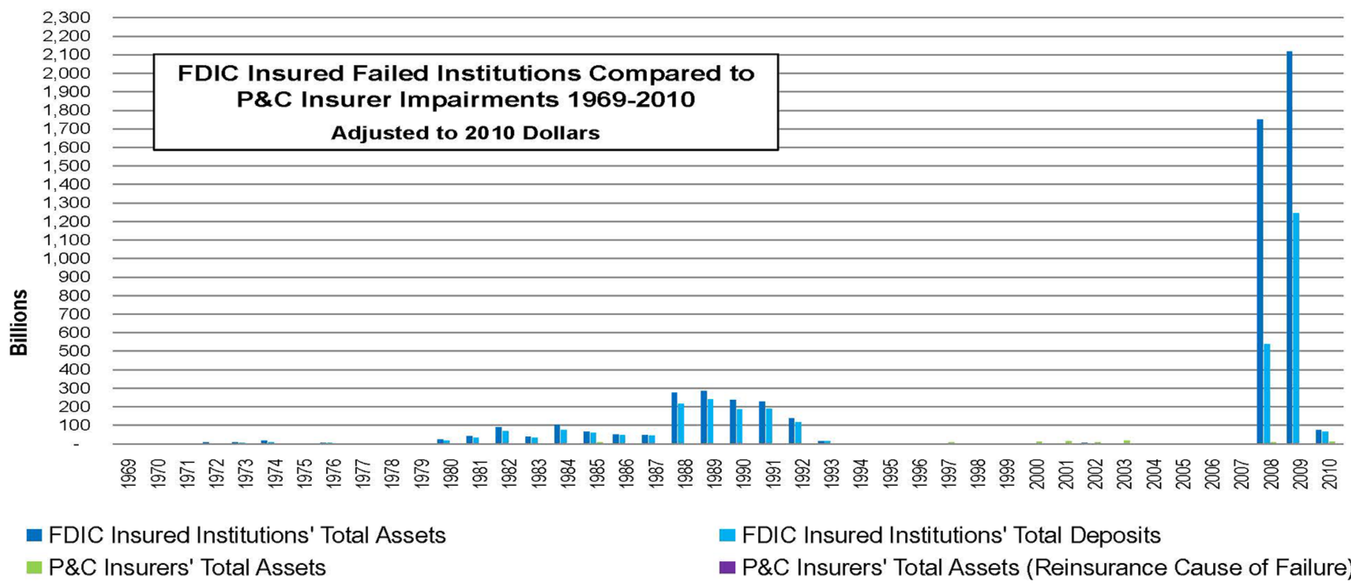
Reasons for US P/C Insurer Impairments, 1969–2010



Source: A.M. Best: *1969-2010 Impairment Review*, Special Report, April 2011.

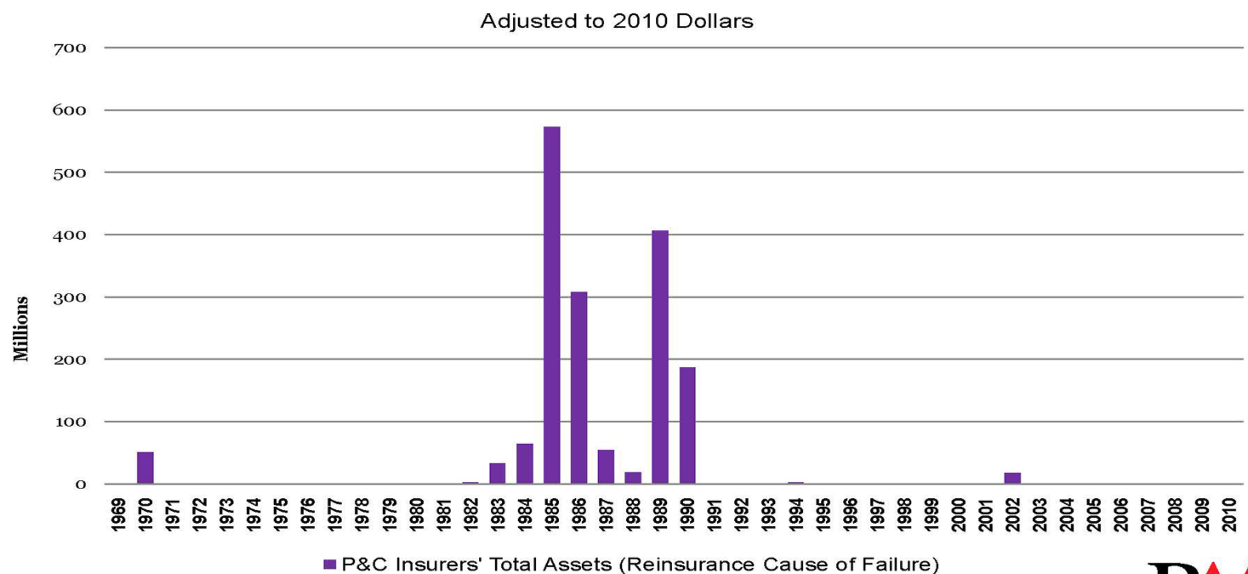
RAA

Insurance impairments are insignificant compared to bank impairments in past crises and over several economic cycles.



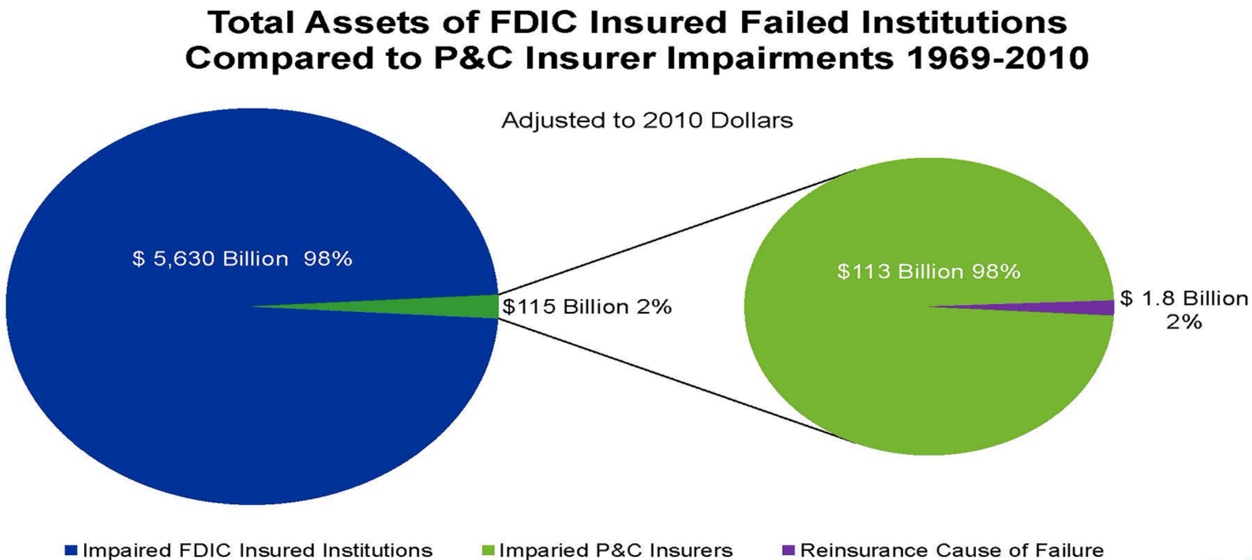
Source: A.M. Best: *1969-2010 Impairment Review*, Special Report, April 2011; FDIC.

Insurance impairments attributed to reinsurance failure are insignificant over the same period.



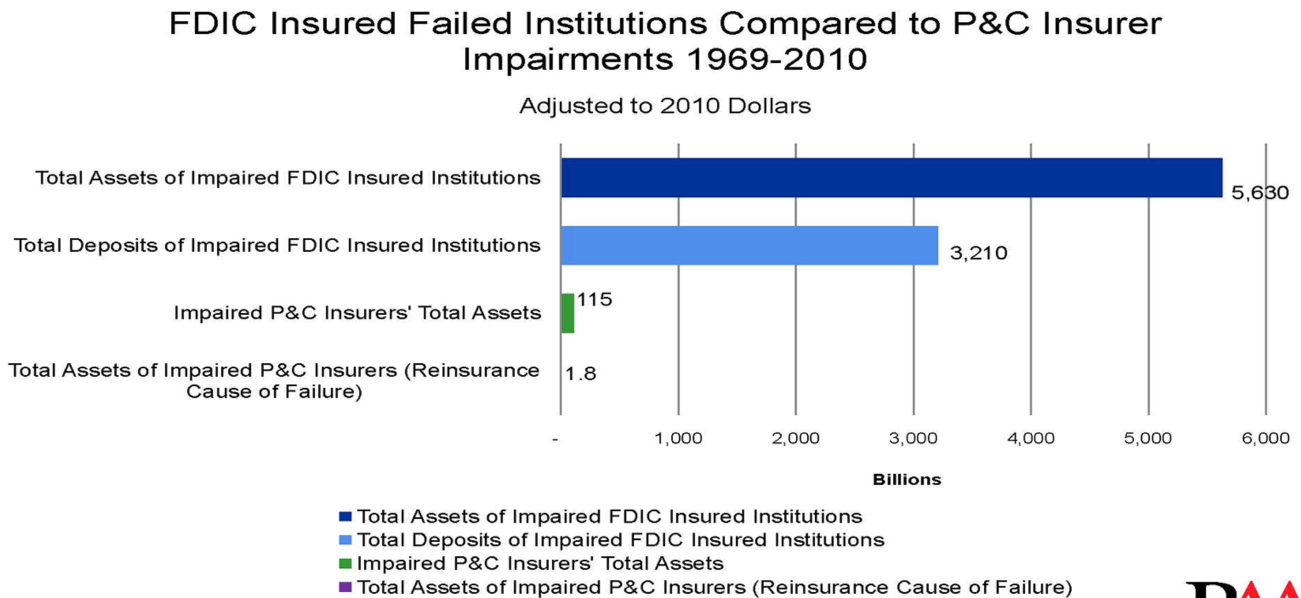
Source: A.M. Best: *1969-2010 Impairment Review*, Special Report, April 2011.

Reinsurance failure is not a significant cause of insurance impairment and pales in comparison to the systemic risk in the banking industry. - View 1



110

Reinsurance failure is not a significant cause of insurance impairment and pales in comparison to the systemic risk in the banking industry. - View 2

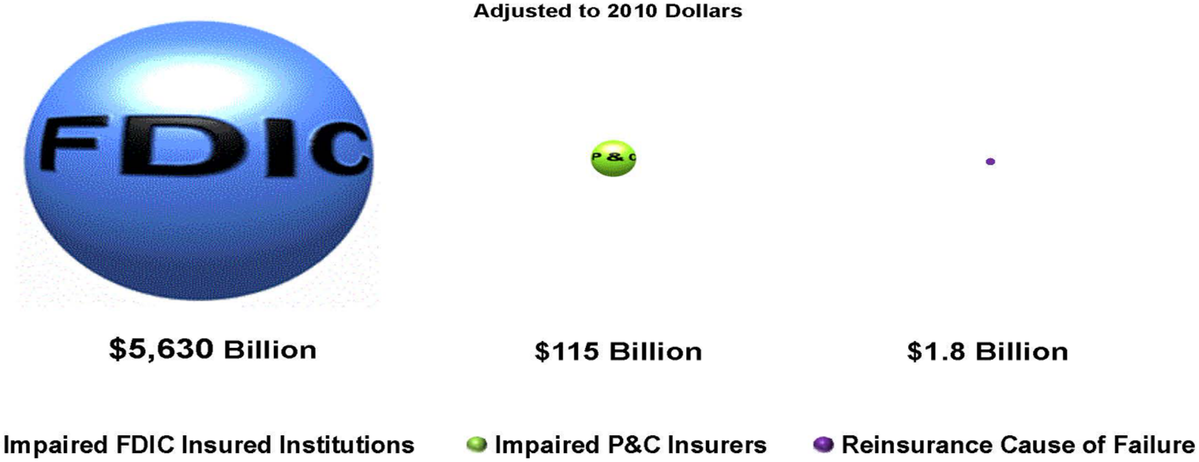


RAA

Reinsurance failure is not a significant cause of insurance impairment and pales in comparison to the systemic risk in the banking industry. - View 3

Total Assets of FDIC Insured Failed Institutions Compared to P&C Insurer Impairments 1969-2010

Adjusted to 2010 Dollars



RAA

Reinsurance Association of America

www.reinsurance.org

Joseph B. Sieverling

sieverling@reinsurance.org

RAA

STATEMENT SUBMITTED BY THE CENTER FOR CAPITAL MARKETS COMPETITIVENESS, U.S. CHAMBER OF COMMERCE

The U.S. Chamber of Commerce ("the Chamber") created the Center for Capital Markets Competitiveness (CCMC) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st Century economy. A key aspect of efficiency of the financial system is ensuring transparency and due-process as it relates to the Financial Stability Oversight Council and the identification and regulation of systemic risk. As the Senate Committee on Banking, Housing, and Urban Affairs holds a hearing entitled "Financial Stability Oversight Council Nonbank Designations," the Chamber would like to share its views regarding:

1. **Concerns with Designation of Nonbank Financial Firms as Systemically Important**
2. **Recent Actions Taken by the Financial Stability Oversight Council**
3. **The Financial Stability Oversight Council Improvement Act of 2019**

Concerns with Designation of Nonbank Financial Firms as Systemically Important

The Chamber has consistently raised concerns regarding entity-based approaches to identifying and regulating systemic risk in the United States and international forums. The Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") established the authority for the Financial Stability Oversight Council ("FSOC") to designate nonbank financial firms as systemically important and subject them to enhanced prudential standards by the Federal Reserve Board of Governors ("Federal Reserve"). The Chamber has argued that this designation authority under Section 113 of the Dodd-Frank Act is a blunt tool that that has harmed the efficiency of our capital markets and not improved the ability of the U.S. to mitigate systemic risk.

The Chamber strongly supports the repeal of Section 113 of the Dodd-Frank Act.[1] Furthermore, the Chamber has advocated against designations of nonbank financial firms as systemically important.[2] As long as Section 113 remains in place, the

[1] Hirschman, D. T. (n.d.). Review of Financial Stability Oversight Council determination and designation processes pursuant to the Presidential Memorandum for the Secretary of the Treasury of April 21, 2017 [Letter written August 15, 2017 to U.S. Secretary of the Treasury, Steven T. Mnuchin]. Available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2019/01/CCMC-Comment-on-FSOC-SIFI-Designation-Process-Aug-2017.pdf

[2] *See generally* Letter from Tom Quaadman, Center for Capital Markets Competitiveness, to the Bd. of Governors of the Fed. Reserve Sys. (Feb 2, 2015) (offering comments on the Application of Enhanced Prudential Standards and Reporting Requirements to General Electric Capital Corporation), available at https://www.federalreserve.gov/SECRS/2015/February/20150224/R-1503/R-1503_020215_129875_536678533422_1.pdf

authority it grants FSOC should not be used until all other options have been explored and found impracticable or insufficient, and unless FSOC can show that designating a nonbank would mitigate a threat to U.S. financial stability effectively and efficiently, thereby producing verifiable benefits that outweigh the substantial costs. The current nonbank designation guidance is therefore ripe for reform and we support fundamental changes.

In general, short of repeal of Section 113 of the Dodd-Frank Act, the Chamber has advocated for reforms to FSOC, including:

- The process for designating firms for systemic risk regulation should provide potential designees and their primary regulator with an opportunity to address concerns and, if appropriate, decide to take steps to de-risk before designation.
- Designee targets should be provided with an opportunity to review the record for the determination recommendation and an opportunity to rebut the record. Designee targets should have an opportunity for a hearing prior to a determination, with the opportunity to compel the production of records and call witnesses.
- Any determination of systemic risk should include a diverse set of views.
- There should be sufficient opportunity for review and appeal of a systemic risk determination.
- There should be a strong "off-ramp" process in place for designation firms to be considered for de-designation.
- The Federal Reserve should follow Congressional direction and propose and finalize a rule under Section 170 excluding classes and types of nonbanks from potential SIFI designation.

The Chamber supports the development of an activities-based approach for systemic risk to replace entity-based approaches. The Chamber believes that primary regulators should play a central role in this process. The FSOC was created to leverage the expertise and authority of the primary regulators, not to supplant them.

Metlife, Inc. vs. Financial Stability Oversight Council (U.S. District Court for the District of Columbia June 26, 2015), Chamber of Commerce Amicus Curiae in Support of the Plaintiff, available at https://www.chamberlitigation.com/sites/default/files/cases/files/2015/U.S.%20Chamber%20Amicus%20Brief%20--%20Metlife%20v.%20FSOC%20%28DDC%29.pdf

Recent Actions Taken by the Financial Stability Oversight Council

The Chamber supports actions taken by FSOC, under the leadership of Secretary Mnuchin, to de-designate nonbank financial firms that had been subject to supervision by the Federal Reserve. Currently, there are not any nonbank financial firms that are designated as "systemically important." This is preferable for limiting regulatory burden and encouraging capital formation and market discipline, but is also consistent with the fundamental truth that activities or practices across markets and geographies, and not a single entity in and of itself, generate systemic risk.

The Financial Stability Oversight Council voted unanimously on March 6, 2019, to propose interpretive guidance ("proposed guidance") regarding nonbank financial company designations. According to the U.S. Department of the Treasury, "The proposed guidance would implement an activities-based approach to identifying and addressing potential risks to financial stability. It would also enhance the analytical rigor and transparency of the Council's process for designating nonbank financial companies."[3] The proposed guidance will be open for a 60-day public comment period after it is published in the Federal Register.

The proposed guidance is consistent with FSOC's mission. FSOC should remain focused on its statutory purposes of identifying risks to U.S. financial stability, promoting market discipline and responding to emerging threats. The Chamber believes that it is important for FSOC to regularly convene so its members may share their views on disparate activities in the financial markets and coordinate on regulatory matters where they may have overlapping jurisdiction.

In general, the Chamber supports the proposed guidance. By looking at activities, products and markets rather than focusing on single companies, the FSOC will be better able to identify, monitor, and, when needed, work with the appropriate financial regulators to address truly systemic risks. The work formalizes work started under the Administration of President Obama where FSOC directed staff to "undertake a more focused analysis of industry-wide products and activities to assess potential risks" as it related to the asset management industry.[4] The proposed

[3] U.S. Department of the Treasury, Financial Stability Oversight Council. (2019, March 6). Financial Stability Oversight Council Proposes Changes To Nonbank Designations Guidance [Press release]. Retrieved from https://home.treasury.gov/news/press-releases/sm621

[4] U.S. Department of the Treasury, Financial Stability Oversight Council. (2014, July 31). Financial Stability Oversight Council Meeting July 31, 2014 [Press release]. Retrieved from https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July 31 2014.pdf

guidance embraces a number of recommendations provided by the Chamber in a letter to the Treasury Department.[5]

The Chamber supports improved transparency and due process protections in the designation process. The Chamber supports the proposed guidance's change to make a designation "only if the expected benefits to financial stability from the determination justify the expected costs that the determination would impose." This analysis or assessment should be informed by data provided by the company as well as its responses or rebuttals to FSOC conclusions or arguments.

The Chamber supports the establishment of a post-designation off ramp. The proposed guidance notes, "If a company adequately addresses the potential risks identified in writing by the Council at the time of the final determination and in subsequent reevaluations, the Council should generally be expected to rescind its determination regarding the company." Nonbank financial firms should not remain subject to costly supervision by the Federal Reserve if they have voluntary de-risked their activities or if enhancements of regulation which reduce the risk to US financial stability have been implemented.

We look forward to reviewing the guidance in its entirety and plan to provide detailed public comments to FSOC. We would be happy to share this feedback with the Committee when it is complete.

The actions taken by the U.S. Treasury Department are noteworthy with respect to international standard setting bodies such as the Financial Stability Board "FSB"), the International Association of Insurance Supervisors ("IAIS"), and the International Organization of Securities Commissioners ("IOSCO"). The Chamber believes the proposed guidance supports the core principles to "advance American interests in international financial regulatory negotiations and meetings" as delineated by the Presidential Memorandum directing the Secretary of the Treasury to conduct a thorough review of the determination and designation processes of FSOC.[6]

---

[5] Hirschman, D. T. (n.d.). Review of Financial Stability Oversight Council determination and designation processes pursuant to the Presidential Memorandum for the Secretary of the Treasury of April 21, 2017 [Letter written August 15, 2017 to U.S. Secretary of the Treasury, Steven T. Mnuchin]. Available at https://centerforcap.wpengine.com/wp-content/uploads/2017/08/CCMC-Comment-on-FSOC-SIFI-Designation-Process.pdf

[6] Report to the President of the United States, pursuant to the Presidential Memorandum Issued April 21, 2017. Financial Stability Oversight Council Designations (November 17, 2017). Available at, https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf

The FSB and other international entities should not designate a firm for enhanced systemic risk regulations if the home domestic regulator has not designated said firm as systemically important. Fortunately, in recent years, these organizations have shifted away from entity-based approaches to systemic risk and are in the process of developing activities-based approaches like that embodied in the proposed guidance. In 2016, the FSB shifted away from working on methodologies for designating nonbank firms to examining structural vulnerabilities from asset management activities.[7] On November 14, 2018, IAIS proposed a "Holistic Framework for Systemic Risk in the Insurance Sector" that demonstrates a shift to an activities-based approach.

Additionally, in November 2018, IOSCO issued its consultation paper on leverage.[8] IOSCO proposed various ways to measure leverage, noting that "there is no single measure that can capture the leverage exposure of all types of funds," showing an understanding of the need to consider various factors when measuring risk. While international standard-setters appear to be headed in the right direction, it is important that the U.S. continues to engage in discussions on systemic risk to ensure U.S. competitiveness abroad as well as effective and efficient regulation in the U.S.

The Financial Stability Oversight Council Improvement Act of 2019

The Chamber supports The Financial Stability Oversight Council Improvement Act of 2019 (S. 603). We appreciate the leadership of Senators Mike Rounds, Doug Jones, Thom Tillis, and Kyrsten Sinema, in sponsoring bipartisan legislation that would institute important due-process reforms to improve FSOC's process of designating nonbank companies as systemically important. The bill would prohibit FSOC from voting to subject firms to Federal Reserve supervision unless FSOC first consults with both the firm and its primary regulatory agency. Then, FSOC would have to determine that alternatives to a designation are impracticable or insufficient before proceeding with a designation. The bill's reforms are intended to increase transparency and avoid the significant compliance costs that firms incur when they are designated as systemically important, while maintaining FSOC's ability to address potential systemic risk in the financial system.

The legislation closely aligns with FSOC's proposed guidance. It is important that changes to the statute are made, such as those proposed by The Financial Stability Oversight Council Improvement Act of 2019, in order to enshrine these

---

[7] http://www.fsb.org/2016/06/proposed-policy-recommendations-to-address-structural-vulnerabilities-from-asset-management-activities/

[8] https://www.iosco.org/library/pubdocs/pdf/IOSCOPD615.pdf

important reforms into law. This will improve the abilities of primary regulators and firms to address concerns about systemic risk, and would mitigate burdensome compliance costs that impede economic growth.

The Chamber appreciates the opportunity to submit this statement for the record. We stand ready to work with you to ensure systemic risk concerns are addressed by FSOC in a transparent and accountable manner. Additionally, the Chamber strongly supports The Financial Stability Oversight Council Improvement Act and urges its swift passage by this Committee.