Statement before the United States Senate Committee on Banking, Housing, and Urban Affairs on "The Role of the Financial Stability Board in the U.S. Regulatory Framework"

The Financial Stability Board, the Financial Stability Oversight Council and the Federal Reserve: The Effort to Impose Prudential Regulation on Shadow Banks

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

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

Thank you for the opportunity to testify in this important hearing.

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

This testimony will discuss the relationship among the Federal Reserve, the Financial Stability Oversight Council (FSOC) established by the Dodd-Frank Act, and the Financial Stability Board (FSB). As this committee is aware, the FSB is a largely European group of financial regulators and central banks which was deputized by the G-20 leaders in 2009—after the financial crisis—to reform the international financial system.[1] The Treasury, the Federal Reserve and the SEC are members of the FSB.

Summary of this testimony

This testimony makes the following points:

- Both the FSB and the Fed have determined to impose prudential regulation—i.e., regulation of risk-taking—on what they call the "shadow banking system." They define the shadow banking system as all financial intermediation outside the regulated banking system.
- Shadow banks, then, are essentially all the nonbank firms that operate in in today's US capital markets—broker dealers, asset managers, hedge funds, mutual funds, insurance companies and many others.
- The FSB and the Fed believe that "complex chains of transactions" among these firms can create risks to financial stability that are similar to the failure of a large financial firm.
- On this basis, the FSB could decide that all member countries should impose prudential regulation on firms active in the capital markets—that is, shadow banks.
- The question is whether an agreement at the FSB to impose prudential regulation on complex chains of transactions can be enforced in the US under the Dodd-Frank Act.
- Section 113 of the Dodd-Frank Act provides the FSOC (and thus the Fed) with authority to designate firms as SIFIs because of their "mix of activities." These activities could be deemed to include participating in "complex chains of transactions."
- Although this would be a major extension of the language in the Dodd-Frank Act, it is possible that the courts would defer to the FSOC's interpretation.

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

- If the Committee does not want prudential regulation imposed on the capital markets, it must act to prevent this outcome, through amending Dodd-Frank or through aggressive oversight of the Fed, FSOC and Treasury.

Introduction

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

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

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

> The turmoil that attended the collapse of several large nonbank financial institutions, and the extraordinary government measures necessary to contain the turmoil, had quickly changed into a consensus—previously a minority view—that prudential regulation should be broadened to better safeguard the financial system as a whole.[4]

The Fed is devoting a great deal of attention to this FSB project—and for good reason. Governor Tarullo, is leading the FSB's work in this area. The close collaboration between the Federal

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

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

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

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

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

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

This raises the question whether the Dodd-Frank Act or any other US law has given US regulators the authority to impose on US firms the decisions that originate in an agreement at the FSB. It is not true, as some may believe, that Dodd-Frank does not provide authority that can be used for this purpose. Unfortunately, as I will discuss below, the excessively broad language of the Dodd-Frank Act may permit the FSOC and the Fed to impose substantially the same

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

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

regulations in the US as the FSB will prescribe for its other members. Moreover, US officials seem to believe that if the FSB adopts prudential regulation for the capital markets—that is, the shadow banking system—US regulators will be able to impose it in the US. If this effort succeeds, it will be a disaster for robust economic growth in the US. Accordingly, this testimony will also explore the authorities that the FSOC and Fed might use, at the behest of the FSB, to control shadow banking in the US.

In March, 2015, the FSB issued what it called its Second Consultative Document on Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (the Second Consultative Document).[7] This is similar to a US regulatory agency taking a second set of comments on a proposed regulation under the Administrative Procedure Act. The Second Consultative Document is basically a roadmap for FSB members to follow if they wish to subject nonbank firms within their jurisdictions to prudential regulation. There is little question that under the Dodd-Frank Act the FSOC could designate any financial firm as a systemically important financial institution (SIFI), and in fact after the FSB designated three US insurers as global SIFIs, the FSOC did the same.

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

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

The need to cover these activities was outlined by Governor Tarullo a year ago: "Prudential regulation," he said, "must deal with threats to financial stability whether or not those threats emanate from traditional banking organizations. Hence the need to broaden the perimeter of prudential regulation, both to certain nonbank financial institutions and to certain *activities* by *all*

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

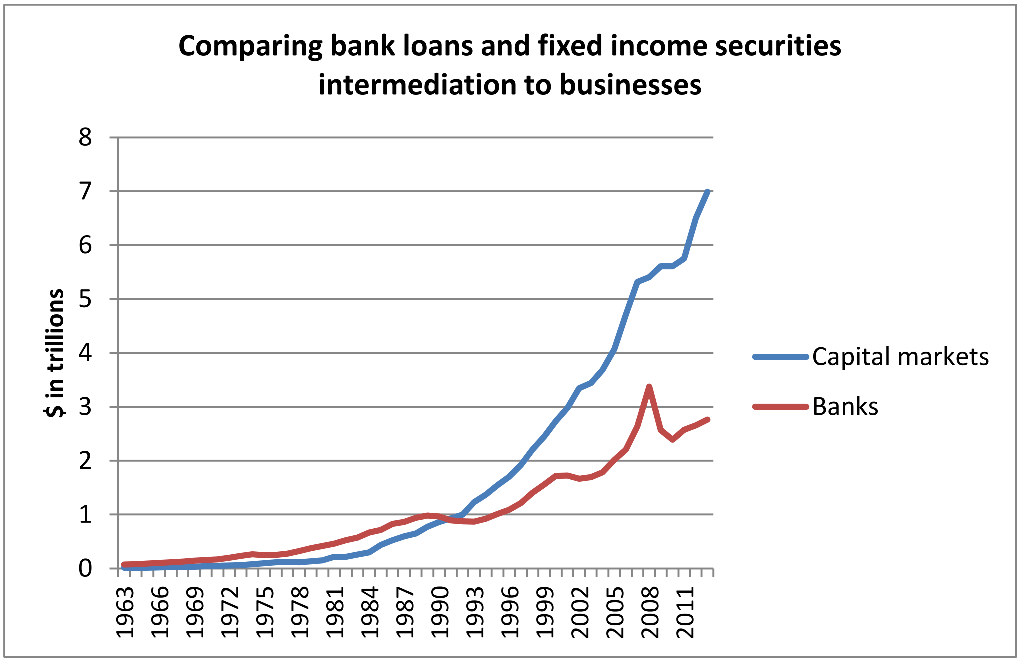
[8] John Heltman, "Fed's Tarullo Favors Activities-Based Regulation for Asset Managers," *American Banker*, June 4, 2015.

financial actors."[9] [emphasis supplied] This is a statement of determination; if the Dodd-Frank Act provides the necessary authority, we may see an effort by the FSOC and the Fed to impose prudential regulation on activities—that is, what they see as excessive risk-taking—in the capital markets.

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

Efforts by the FSB and the Fed to regulate shadow banking

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



Source: Federal Reserve Flow of Funds

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

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

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

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

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

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

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

> As an illustration of shadow banking at work, consider how an automobile loan can be made and funded outside of the banking system. The loan could be originated by a finance company that pools it with other loans in a securitization vehicle. An investment bank might sell tranches of the securitization to investors. The lower-risk tranches could

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

> be purchased by an asset-backed commercial paper (ABCP) conduit that, in turn, funds itself by issuing commercial paper that is purchased by money market funds.[12]

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

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

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

The Fed's pursuit of shadow banking

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

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

At the meeting, Fischer was interviewed by Larry Fink, chairman of BlackRock, one of the largest asset-management firms in the world. According to a transcript of the interview, Fischer was asked by a member of the audience: "Stan, can you talk a little bit more about the shadow

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

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

banking system and what, if anything, you think should be done at a policy level to ensure that there is the financial stability over this 80 percent that you don't—you have less control over?"

Fischer responded:

"FISCHER: Well, the—you know, there are real institutions in the—in the shadow banking system. There are hedge funds. There are insurance funds.

FINK: Even asset managers.

(LAUGHTER)

FISCHER: Even asset managers, I've been reliably informed.

(LAUGHTER)

"And other financial institutions, some of those have regulators. The insurance companies, for instance, have regulation. Others do not have—have regulation. And what is being done right now is mapping out this system. One of the most complicated maps you've ever seen was produced in the New York Fed showing the shadow banking system and the interactions between it and, you know, everybody is talking to everybody else, doing business with everybody else, it's to understand that [sic] that system is as a system, how it interacts with the banking system, and who has any authority that will enable them to take action—undertake actions to deal with a firm, which is if it's large enough or interconnected enough, would create a big problem if it failed.

"That's what we're doing now. And then, if it's—if we the Fed have the authority to regulate it. Then on the basis of that analysis, we would then go ahead, if we have the authority -- for instance, we have control over margin requirements—and if we don't, then it goes to the FSOC and is discussed there."[14]

The identity between the work of the FSB and the work of the Fed on shadow banking is nowhere better exemplified than in a statement by Mr. Fischer to a banking audience at a conference sponsored by the Federal Reserve Bank of Atlanta in March 2015:

[N]onbank intermediation often involves *complex chains of activity* encompassing many entities and markets. Such chains tend to increase the web of interconnections in the financial system that, in some circumstances, can increase the likelihood or severity of systemic stress…It is often said that stronger regulation of the banking sector will cause activity to move outside the perimeter of regulation. The evolution also could lead to greater complexity, such as longer chains of interconnection, which make it more difficult for market participants to understand the risks arising from their exposures. *Examples of migration that have already occurred include the movement of many loans made to large corporations from banks to collateralized loan*

[14] Bloomberg transcript.

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

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

The FSB's influence on SIFI designations

The way the FSOC has exercised its designation authority suggests that it is also cooperating with, if not leading, the FSB's efforts. In any event, the FSOC has been implementing the FSB's decisions in the US. When Congress authorized the FSOC to designate large nonbank financial firms as SIFIs, it assumed that the FSOC would follow a fair, objective, and fact-based process in exercising that authority. Although officials have asserted that the FSOC's designation decisions have been the result of such a process, that is not supported by the facts.

The Treasury and the Federal Reserve Board are unquestionably the most important and influential members of the FSOC—the Treasury because the secretary of the Treasury is the chair of the FSOC and the Fed because it is by far the most powerful and well-resourced US financial regulator, especially after the extraordinary authorities it received in Dodd-Frank. Both the Treasury and the Fed are also members of the FSB, and it is reasonable to assume, given the importance of the US financial system, that the Treasury and the Fed are the most important and influential members of the FSB.

After receiving this mandate from the G-20 in 2009, the FSB determined to proceed by designating certain firms as "global SIFIs," and on July 18, 2013, it designated nine large international insurers—including three large US insurers, AIG, Prudential and MetLife—as global systemically important insurers, or G-SIIs.[16] The FSOC had designated AIG as a SIFI before the FSB had made its designations, but Prudential was not designated as a SIFI until September 2013 and MetLife not until December 2014.[17]

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

[16] FSB, "Global systemically important insurers (G-SIIs) and the policy measures that will apply to them" July 18, 2013, http://www.financialstabilityboard.org/wp-content/uploads/r_130718.pdf?page_moved=1.

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

The designation of SIFIs by the FSOC is what is called a quasi-judicial proceeding, where evidence is weighed against a statutory standard of some kind, and an administrative agency applies the standard to a single party, as a court—based on evidence—would apply the law to a single defendant. Quasi-judicial proceedings are usually expected to meet certain standards of fairness and objectivity. This fairness and objectivity was missing in the FSOC's treatment of at least two of the US insurers designated as G-SIIs by the FSB.

In March testimony before the House Financial Services Committee, Treasury Secretary Lew stated that the FSB "acts by consensus."[18] A consensus literally means an agreement; synonyms of consensus in most dictionaries are concurrence, harmony, accord, unity and unanimity. So when these three firms were designated by the FSB as G-SIIs the Treasury and the Fed necessarily concurred in the decision.

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

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

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

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

In the regulations it adopted to implement the designation process, the FSOC outlined two principal ways that the distress or failure of a firm could cause instability in the financial system

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

as a whole: by causing losses to others financially exposed to the failing firm (called the Exposure Channel) or through a "fire sale" liquidation of assets that drives down asset prices and thus weakens other firms holding the same assets (the Liquidation Channel).

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

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

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

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

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

The memorandum noted peremptorily that the FSB expects "full, consistent and prompt implementation of [its] agreed reforms."[21] This sounds like the FSB's decisions are binding, but when questioned about this by Chairman Jeb Hensarling at the HFSC's March hearing, Treasury Secretary Lew denied that the US was bound by these "agreed reforms." Hensarling pointed out that the FSB had recently "exempted" three Chinese banks from the reforms and asked "if these are preliminary suggestions and not rules [by the FSB] why is it that the FSB found it necessary

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

[20] MetLife Brief, p52

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

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

If in fact the FSOC, the Treasury and the Fed are committed to the idea that FSB members are bound by FSB decisions, there is a further reason for seeing the FSOC's designation of Prudential and MetLife as illegitimate. The designation decision was in effect made by the FSB and not the FSOC.

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

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

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

Thus, while the FSB's decisions have no direct legal effect in the US, it seems that the US members of the FSB believe that they have sufficient authority to agree to the FSB's decisions

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

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

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

and impose them in the US. Whether they actually have that authority is covered in the next section.

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

If, as Secretary Lew avers, the Obama administration is using the FSB as a mechanism for raising "global standards" to a level that "we think are appropriate in the United States," this must mean that the Treasury and the Fed believe they have the authority to do in the United States what they are attempting to get the FSB to prescribe for all other FSB members.

Where is this authority?

Although the Dodd-Frank Act clearly provides authority for regulating *entities* that are deemed to be systemically important, the authority for regulating "complex chains of transactions" is not as clear. Yet, by concurring with—if not actually sponsoring—the FSB's idea that "complex chains of transactions" should be regulated in order to control the dangers of shadow banking, it is apparent that the Treasury and the Fed believe that they would have the power to regulate those transactions when the directive from the FSB instructs them to do so.

Indeed, a concept similar to "complex chains of transactions" has already been articulated by the FSOC, while using a slightly different form of words. In its December 18, 2014 Notice on Asset Management Products and Activities, the FSOC stated: "risks to financial stability might not flow from the actions of any one entity, but could arise *collectively* across market participants."[25][emphasis supplied]

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

However, the FSOC's authority is not limited to designating SIFIs because their financial distress could cause instability in the US financial system. It also has authority to designate as

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

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

SIFIs—and consign to regulation by the Fed—many firms that are not large and whose failure alone would not cause financial instability. For example, Sec 113(a) of Dodd-Frank states:

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

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

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

Finally, Sec. 120 provides that

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

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

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

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

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

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

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

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

What to Do

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

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

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

should repeal this list. Alternatively, Congress could make clear that the term "activities" was not intended to include specific chains of transactions, but the best solution would be to remove the term "activities" from the act.

Conclusion

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