

The Systemic Risk Council

June 9, 2014

The Honorable Jeb Hensarling
Chairman, House Committee on Financial Services
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Maxine Waters
Ranking Member, House Committee on Financial Services
B301C, Rayburn House Office Building
Washington, DC 20515

Dear Chairman Hensarling and Ranking Member Waters,

We¹ are writing to convey our deep concerns about H.R. 4387, the FSOC Transparency and Accountability Act. We fear that this proposed legislation would undermine the Financial Stability Oversight Council's (FSOC) ability to identify emerging risks in the financial system and perform the functions necessary to prevent crippling financial crises from happening in the future.

Imposing a moratorium on FSOC determinations is similarly counterproductive and would worsen the problem of too big to fail by (1) chilling regulatory efforts to ensure sufficient capital and loss absorbency at potentially destabilizing large, complex -financial institutions; (2) perpetuating regulatory "blindness" over the consolidated risks of these firms; and (3) delaying, further, the creation and review of living wills and resolution plans to make sure that these firms can fail in an orderly way without taxpayer bailouts. By helping to address these risks, FSOC designations play an essential part in protecting the American public from unbridled risk-taking by large, inter-connected financial institutions – and the sudden, widespread market disruptions that can result when they fail. We urge the Committee to reject these bills.

A Functioning FSOC Plays an Important Role in Improving Our Financial Regulatory Framework and Ending Too Big To Fail. FSOC was created to address many of the regulatory breakdowns that contributed to the financial crisis, among them supervisory tunnel vision or siloed thinking, industry capture and occasional "turf" battles where agencies too often sacrificed

¹ The independent non-partisan Systemic Risk Council was formed by CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. capital markets focused on systemic risk. The statements, documents and recommendations of the private sector, volunteer Council do not necessarily represent the views of the supporting organizations. The Council works collaboratively to seek agreement on all recommendations. This letter fairly reflects the consensus view of the Council, but does not bind individual members.

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their public mission in the name of their private “independence.” As a result, weak and risk-*enabling* regulation, (e.g., money market mutual fund rules and OCC preemption) went largely unquestioned because they existed within a single regulator’s jurisdiction or silo. In addition, risks that ran across entities and markets (e.g., mortgage securitization) were largely ignored because no single regulatory agency had clear accountability for the risks building in that sector. Finally, when agencies did work together, for example, through the President’s Working Group on Financial Markets, too often they worked to *weaken* or stop important reforms (e.g., derivatives reform), instead of strengthening them.

The FSOC is an important structural improvement that makes the heads of all the major financial regulatory agencies accountable, collectively, for identifying and seeking to address systemic risks. By regularly bringing together the heads of these agencies, with a clear mission, the FSOC improves communication and information sharing, and is intended to reduce unhealthy turf battles and finger pointing.

The FSOC also helps ensure that there is a venue for open and honest communication about *potential* threats to system stability so that regulators won’t be as far behind as they were in 2008. Finally, it holds all the agency heads accountable for failing to address risks that might cause the type of financial instability that led to massive taxpayer support in 2008 and 2009. Already, the FSOC’s efforts have helped shed light on ongoing taxpayer risks and moral hazard from money market mutual funds. Moreover, through the SIFI designation process FSOC has helped ensure some consolidated oversight – and living wills – over large, potentially systemic nonbank financial firms, like AIG. Both AIG and money market funds played major roles in worsening the financial crisis, and both were bailed out by taxpayers.

The Proposed Legislation Would Undercut a Functioning FSOC. First, by making FSOC an agency of agencies (instead of a group of principals), the legislation would significantly increase the FSOC’s size and *reduce* real accountability. Instead of independent agency heads working together in a generally constructive and collegial way, the bill would force member agencies back into their silos, first negotiating against themselves and then against the other agencies. We fear this is a recipe for infighting and stalemate, not functioning government.

Second, by requiring that the FSOC open itself up to more staff and representatives of Congress, the bill would dramatically undermine the FSOC’s ability to talk about sensitive information and protect proprietary information. As taxpayers we want our regulators to know and talk honestly about the risks posed to the markets and broader economy from potentially systemic events or institutions. Adding political staff and members of Congress would not only chill open and frank dialogue, it would compromise the ability of regulators to discuss and decide issues without the appearance and risk of political influence.

If Congress is concerned about potential “politicization” of the FSOC by the Executive Branch, a better solution would be for the FSOC to have an independent Chair, appointed by the President and confirmed by the Senate for a fixed term. This approach would be more consistent with the independent status of member agencies and help address the partisan and political concerns without undercutting the FSOC’s ability to perform its mission.

Finally, a number of us have served as Commissioners and can relate to the desire to participate in every discussion involving the agency's head. However, we also understand that this is not a realistic or efficient way to facilitate inter-agency cooperation and decision-making. As the regularity of Congressional testimony illustrates, we also should not ignore the fact that agency heads' are widely –viewed as being particularly responsible and accountable for their agency's actions. This accountability and responsibility is essential for a functioning inter-agency body like the FSOC. The Chair's obligation is to seek informal advice and input from his or her board or commission members, but in inter-agency deliberations and dialogue, the Chair should be able to speak with one voice and of necessity, that voice must be his/her own.

A Six Month Designation Moratorium Would Help Perpetuate Too Big To Fail. We understand the Committee may also consider legislation to put a moratorium on FSOC nonbank determinations. This would be a mistake.

FSOC determinations are essential to ensuring that potentially systemic nonbank financial firms have consolidated oversight and capital standards as well as basic resolution planning and “living will” obligations. Before and during the crisis, a number of large nonbank financial firms, thought to be “safe” and well-regulated were not. Not only did regulators lack meaningful information about the activities and risk-taking of these firms, the firms' demise were so sudden that regulators had little time to learn about them before making “bailout” decisions. The CSE investment banks (e.g., Bear Stearns and Lehman Brothers) and AIG are prime examples. Regulators' lack of knowledge and understanding of risks inside of these institutions, as well as the potential impact of their failure on the broader economy, created a bias in favor of bailouts (or, in the case of Lehman Brothers and the Reserve Primary Fund, a market expectation of one).

The FSOC designation process was designed to help address these problems. First, by reviewing firms on a case-by-case basis, the FSOC can get a sense – in advance – for whether a firm's failure could be destabilizing. Second, if so, the designation imposes consolidated Federal Reserve Board oversight and dramatically improves regulatory knowledge about the institution. Consolidated capital requirements reduce the likelihood of a sudden, destabilizing failure. Finally, the FSOC designation also triggers a requirement that such firms file “living wills” outlining their structure and resolvability. Under the statute, these living wills should credibly show the firm can fail in bankruptcy without systemic disruptions. If they cannot, the regulators have authority to require structural changes to the firm and its activities, including spin-offs.

A moratorium would further delay these necessary protections, and put regulators – and potentially taxpayers – back where they were pre-crisis. Without the FSOC designations, the Fed and FDIC have little or no ability to gather the information they need to engage in contingency planning, to determine whether traditional bankruptcy is possible, or plan for an effective resolution.

In conclusion, we respect, support, and encourage Congress to exercise appropriate oversight of independent regulatory agencies and to revisit and revise their authorities and structures as reasoned, fact-based inquiry might dictate. In exercising these functions, we hope

Congress will be balanced and even-handed. While progress has been made, significant structural weaknesses and moral hazard still remain in our financial system. Directionally, instead of new legislation, we might all encourage, support and where necessary, push our regulators and the FSOC to get the job done.

Respectfully,

A handwritten signature in blue ink that reads "Sheila Bair". The signature is written in a cursive style and is contained within a thin black rectangular border.

The Systemic Risk Council
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