The Systemic Risk Council

May 21, 2019

Submitted electronically

Financial Stability Oversight Council
Attn: Mark Schlegel
1500 Pennsylvania Avenue, N.W.
Room 2208B
Washington, D.C. 20220

Re: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (RIN 4030-AA00)

COMMENT BY SYSTEMIC RISK COUNCIL ON THE PROPOSAL OF THE US FINANCIAL STABILITY OVERSIGHT COUNCIL TO MARGINALIZE ITS POWERS TO ENSURE SYSTEMIC NON-BANKING FIRMS ARE RESILIENT

The Systemic Risk Council urges the US Treasury, and the other members of the Financial Stability Oversight Council, to abandon their proposal to marginalize the designation of non-bank financial intermediaries as systemically significant. It is an important and useful power that can be used to protect the American people from financial instability, and should be utilized when warranted by the threat to stability that would be caused by an intermediary's failure or distress.

<u>Background</u>

On March 6, 2019, the US Treasury issued, on behalf of the Financial Stability Oversight Council (FSOC), a proposal to downgrade the use of the FSOC's power to designate specific non-bank financial groups as systemically significant, instead giving priority to an approach that relies on identifying particular activities as systemically significant.[1]

The proposal has two components that, although blurred in the US Treasury's document, must be distinguished. First, a proposal to concentrate on identifying and addressing activities that pose a meaningful threat to the stability of the financial system. The Systemic Risk Council (SRC) applauds this, and urges FSOC energetically to identify and address activities that pose a material threat to stability; putting activities-policy center stage should not be a device for inaction. In particular, FSOC should urgently articulate a general policy for containing threats to stability from shadow banking of all kinds. As we have said before, that is a dangerous gap in the post-crisis regime.[2]

The second part of the US Treasury's proposal is to raise a series of hurdles in the way of FSOC deploying its statutory power to designate specific non-bank firms as systemically significant. This is to be achieved by applying the following proposed conditions before FSOC will designate a non-bank firm as systemically significant:

1) The potential systemic risks posed by the firm cannot be addressed through an activities-based approach;

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[1] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 9028 (proposed Mar. 13, 2019).

[2] *See* The Systemic Risk Council, Statement to the Finance Ministers, Governors, Chief Financial Regulators, and Legislative Committee Leaders of the G20 Countries (Feb. 27, 2017), *available at* http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2017/02/Systemic-Risk-Council-Policy-Statement-to-G20-Leaders.pdf; Letter from Sir Paul Tucker, Chair, Systemic Risk Council to the Financial Stability Board (Oct. 15, 2016), *available at* http://www.systemicriskcouncil.org/wpcontent/ uploads/2016/10/Systemic-Risk-Council-Letter-to-FSB-re-Asset-Management-Proposals.pdf; Letter from Sir Paul Tucker, Chair, Systemic Risk Council to the Financial Stability Board (Jan. 13, 2016), *available at* http://www.systemicriskcouncil.org/wp-content/uploads/2016/01/SRC-Letter-to-SEC-re-Open-End-Fund-Liquidity-Risk-Mgmt-01-13-16.pdf; Letter from Sheila Bair, Chair, Systemic Risk Council to the Financial Stability Board (Jan. 18, 2013), *available at* http://www.systemicriskcouncil.org/wp-content/uploads/2013/01/Systemic-Risk-Council-Letter-on-Money-Market-Funds-1-18-13.pdf.

2) A cost-benefit analysis demonstrates that the expected (social) benefits in increased financial stability justify the expected (private) costs to the firm that designation would entail;
3) In conducting such cost-benefit analysis, the FSOC has assessed the probability of a firm failing, not only the impact if and when it does fail; and
4) The firm has failed to mitigate potential risks to stability identified by FSOC.

Each of these conditions might sound innocuous enough on its own but the cumulative effect would almost certainly be to deprive the FSOC of the capacity to designate a systemically significant firm in a timely way: meaning in time to head off the risks posed to stability.[3]

<u>The SRC's previous statements to the US Treasury on this issue</u>

The SRC's reasons for holding this view were set out in an earlier letter to the US Treasury (with key text emboldened):[4]

> "Part of the problem is that there are no neat lines between *de jure* banks and other forms of intermediation. Anyone with a high-quality bond portfolio can, in effect, construct ("roll their own") banking business by using the repo or securities-lending markets to loan out their bonds against cash at call and investing the proceeds in a portfolio of illiquid, opaque credit instruments such as loans or low quality bonds. The fragility of the consequent structure was on display during AIG's problems in

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[3] That is the core point made in the comment letter on the proposed FSOC guidance submitted by former Secretaries of the Treasury Geithner and Lew and former Chairs of the Board of Governors of the Federal Reserve System Bernanke and Yellen. They argue that while "[a]ppropriate enhancement of procedures and engagement with firms under consideration for designation is appealing, [] following this revised approach would make designations an unworkably lengthy process in the best case." Comment from former Chairs of the Financial Stability Oversight Council and two previous Chairs of the Federal Reserve Board (May 13, 2019), *available at* https://www.regulations.gov/document?D=FSOC-2019-0001-0010.

[4] Letter from the Systemic Risk Council to Secretary of the Treasury Steven T. Mnuchin (Feb. 23, 2018), *available at* https://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2018/02/SRC-Comment-Letter-to-Treasury-Dept-2.23.18.pdf.

late-2008.[5]…

…But the problem is not limited to specific non-banks becoming bank-like in their functions and significance. The SRC wants to suggest that the US authorities should be bothered about the resilience of markets themselves….

Designating systemic institutions: the importance of resolution policy

Consistent with that…**the UST favors a focus on 'activities' rather than on 'institutions'. The SRC agrees that that is where policy analysis should begin, but not that it must always end there. Policy should depend on the facts rather than on a doctrinal commitment that no non-bank intermediary can ever be 'systemic'. Most obviously, if an activity were regarded as 'systemically significant' but the activity in question was dominated by one intermediary with high barriers to entry, it would be hard not to conclude that that intermediary was 'systemically significant'. If reducing the barriers to entry would take time or could be achieved only at the cost of frequent failures among vulnerable firms, regulators would surely need to ensure the resilience of the dominating intermediary. The same goes for a market dominated by a handful of intermediaries where the withdrawal of any one of them would directly or indirectly entail large costs for users or for the wider economy…**

So far as intermediaries are concerned, the relevant test here is the social costs of distress or failure. Practically, this amounts to asking (a) whether there are ready substitutes and if not, (b) whether the institution could be resolved in an orderly way without fiscal support to its solvency. That test should be applied by the relevant authorities to insurance companies, reinsurance companies, asset management vehicles, and so on. We did not see that recognized in the UST Reports. Given that, with the best will in the world, systemically significant intermediaries will not always be identified in advance, meaning US policymakers should ensure that there are effective resolution regimes for all types of intermediation. Already late in ensuring that CCPs are resolvable, US policymakers need to go further in ensuring resolvability policy extends to wherever it is needed across the system."

Conclusions

[5] Federal Reserve Bank of New York, Shadow Banking, Staff Report No. 458 (July 2010, Revised February 2012).

If the US Treasury and its fellow FSOC members go ahead with their proposal, they will be exposing the American people to risks that are quite unnecessary given the powers granted to them by Congress in the Dodd Frank Act. Setting aside questions of the legality of the FSOC's proposal, we do not know how its members will be able to give an adequate account of the exercise of their statutory responsibilities if ever a non-bank financial intermediary ends up being bailed out by Congress or provided with liquidity support by the Federal Reserve when it was (or should have been) fairly obvious beforehand that the firm was in fact systemically significant.

The Systemic Risk Council urges the FSOC to abandon this proposal, and get back to ensuring the financial system is resilient, where there is plenty of work still to be done. That should include energetically identifying and addressing activities that pose a material threat to stability, and not flinching from designating intermediaries whose disorderly failure would create a problem for the system and the economy.

Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council
www.systemicriskcouncil.org

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