Insight

AAF Submits Recommendations for Reform to FSOC

MEGHAN MILLOY, DOUGLAS HOLTZ-EAKIN | JULY 27, 2017

Earlier this year the Treasury Department invited AAF to participate in a roundtable discussion with other think tanks and academics as it researched and wrote its report on banks and credit unions, pursuant to Executive Order 13772. At least three other Treasury reports are due for publication this fall. For the next report, in lieu of further roundtables, however, interested groups and individuals are invited to submit written comments on FSOC-specific matters. Below are written comments from AAF President Douglas-Holtz-Eakin and AAF Director of Financial Services Policy Meghan Milloy to Treasury staff regarding FSOC and recommendations for reform.

July 27, 2017

Financial Stability Oversight Council

Attn: Bimal Patel

U.S. Department of the Treasury

1500 Pennsylvanie Avenue, NW

Washington, DC 20220

Re: Upcoming Report on FSOC

Dear Mr. Patel:

Douglas Holtz-Eakin and Meghan Milloy, scholars at the American Action Forum ("AAF"), appreciate the opportunity to submit comments to the Financial Stability Oversight Council ("FSOC") as it prepares to write its report on the status of the institution and its regulatory oversight in response to Executive Order 13772. We hope that these comments will be helpful to explain our views on how FSOC should function to best serve the interests of American taxpayers and abide by the core principles of the United States financial system as outlined in the executive order.

AAF is an independent, nonprofit 501(c)(3) organization unaffiliated with any political group. Its focus is to educate the public about the complex policy choices now facing the country and explain as cogently and forcefully as possible why solutions grounded in the center-right values that have guided the country thus far still represent the best way forward for America's future.

As you are undoubtedly aware we have a large body of research that supports the conclusion that the structure of the FSOC, as created by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and its conduct since its inception have produced a duplicative, unnecessary institution that burdens American financial companies and oversteps its statutory authority. Its stated purpose is to prevent "systemic risk." Yet there is no FSOC measure of systemic risk, a reflection of the fact that by many experts' accounts, there is no fundamental, proven way to measure systemic risk. With that being true, how is FSOC to reduce or prevent systemic risk? Considering that it is duplicative, unnecessary, overstepping, and has no real way to accomplish its mission, we are of the opinion that FSOC should be eliminated entirely.

That being said, we understand the challenges in wholly eliminating a regulatory body, especially in our current legislative climate. Since elimination is not a realistic option, at least for the foreseeable future, below we address the substantive and procedural reforms FSOC should make.

AAF scholars have long championed FSOC reform. In 2014, we wrote our basic principles for reforming the FSOC designation process, and, although some of those were adopted in 2015, many of them remain untouched. Before discussing more timely recommendations, it is important to reiterate some of the most fundamental reform recommendations.

1. Be more transparent

FSOC itself explicitly states its “commitment to conducting its business in an open and transparent manner,” and yet it maintains a list of reasons why meetings may be kept confidential. It points out that concerns about “market sensitive data” and related privacy concerns require closed meetings. In fact, FSOC will be hosting a closed meeting at the end of this week to discuss the broad topics of the Volcker Rule and the designation of MetLife as a nonbank systemically important financial institution (“SIFI”). FOSC is right to worry about the effect of leaks and disclosures of proprietary information, but for discussions of policy and broader considerations, it’s unclear what the harm would be in open meetings, or, at the very least, a detailed release of meeting minutes soon after, much like the Federal Reserve’s Open Market Committee meetings.

When FSOC members are discussing potential designations, they should not be discussing transaction-level data and proprietary technologies. Rather, they should be discussing wider concerns of how a given firm’s funding structure and exposure to various market risks could lead to broader financial system distress. None of that information would be sensitive to public exposure. And as the Office of Financial Research (“OFR”) made clear in its white paper on asset managers, it is considering these issues in the broadest, theoretical, and macro terms. The risk of moving market prices in response to council decisions is mitigated by quasi-real-time disclosure of discussions and considerations rather than sudden, major policy announcements.

2. Perform proper cost benefit analyses

FSOC must make an attempt to move in the direction of fully assessing the economic effect of designating certain nonbanks both in form of costs and of benefits. The omission of a full cost benefit analysis has been pointed out by the Government Accountability Office (“GAO”), the House Financial Services Committee, and others. This begins with having a convincing model of how a given firm’s (or firm type, e.g., asset managers) failure or distress could destabilize the financial system. This will help clarify what exactly is at stake, how designation will help, and will further justify any future costs.

If the potential direct and indirect costs of material financial distress at a given entity are high, the expected benefits or regulation could be sizable even if the probability of distress is low. However, if it is argued that the system-wide consequences of material financial distress at an entity are so high that there is no need to consider the probability of material distress, it is incumbent on those making the argument to establish a compelling case that the consequences could indeed be extremely serious. The FSOC has not done so for its nonbank designations. And this is not to imply that precise quantification of probabilities, potential consequences, and expected benefits are feasible or even required. But economic justification for additional regulation requires at least some consideration of probabilities and analysis and evidence that goes beyond speculative worse cast scenarios.

3. Quit setting arbitrary standards across sectors

Banks and insurers are fundamentally different in several key respects. Banks rely heavily on short term, liquid sources of financing and invest heavily in illiquid loans with longer-term maturities than their liabilities. Because life insurers rely heavily on longer-term, less liquid sources of funds and invest heavily in relatively liquid, longer-term financial assets, the potential for systemic risk is an order of magnitude lower than for the banking sector. Shocks to life insurers do not threaten the economy's payment system, as is true for commercial banks. Insurers also have far fewer interdependencies with other insurers and financial institutions than banks.

Historical differences in regulation across the banking and insurance sectors would appear to be broadly consistent with differences in systemic risk. Greater systemic risk favors stronger government guarantees of financial institutions' obligations to protect consumers and deter runs and relatively stringent capital requirements to help internalize systemic risk and mitigate the moral hazards that accompany strong government guarantees. Because insurance poses much less systemic risk than banking, there is less need for stringent regulatory requirements and relatively broad guarantees of insurers' obligations. Market discipline is relatively strong, with insurers commonly holding much more capital than required by regulation in order to achieve high financial strength ratings.

The designation of a few insurers for enhanced supervision also raises issues of regulatory scale and scope – in additional to the question of whether the needed funding could be more efficiently spent under an alternative approach. While some scale and scope economies from Federal Reserve regulation of designees is feasible given Federal Reserve oversight of a dozen insurance organizations that own a bank or savings and loan, the fact remains that implementing Section 113 will require substantial resources to regulate very few organizations, including the development of specific and new risk based capital requirements. The Federal Reserve's recognition that insurance has fundamentally distinct features that require tailored regulation has been a very positive development. But the question arises as to whether coming up with elaborate supervisory rules and capital requirements for a handful of organizations makes economic sense.

4. Return to being a coordinating entity

Dodd-Frank tasked FSOC with "facilitating regulatory coordination" and "facilitating information sharing and collection" and gave these duties just as much importance as its designation and recommendation obligations. In light of recent events, it seems that FSOC has gotten away from its coordination and sharing responsibilities and put an enhanced emphasis on designations and regulatory recommendations. FSOC should reverse course, and become an entity with a focus on coordination and collection.

Specifically, FSOC has a statutory duty to "facilitate information sharing and coordination among the member agencies regarding domestic financial services policy development, rulemaking, examinations, reporting requirements, and enforcement actions." It also has a duty to "facilitate the sharing of data and information among the member agencies. In instances where the data available proves insufficient, the FSOC has the authority to direct the OFR to collect information from certain individual financial companies to assess risks to the financial system, including the extent to which a financial activity or financial market in which the financial company participates, or the financial company itself, poses a threat to the financial stability of the United States." FSOC should not lose sight of and instead should put a greater emphasis on fulfilling these statutory duties.

The President's Working Group on Financial Markets ("PWGFM") has been around for nearly thirty years, and, by most accounts has been successful in its mission to "enhance the integrity, efficiency, orderliness, and competitiveness of our Nation's financial markets." Much of what the PWGFM aims to do overlaps with what FSOC has been trying to do lately. FSOC should leave those tasks to them, and forge ahead with their own mission.

5. Refrain from power grabs

The most recent report from Treasury (on making a financial system that creates economic opportunities) the authors included one strange, seemingly out of place, recommendation: "The statutory mandate of the FSOC should be broadened so that it can assign a lead regulatory as primary regulatory on issues where multiple agencies may have conflicting and overlapping regulatory jurisdiction" The report goes on to say that "[t]his new authority would allow the FSOC to play a larger role in the coordination and direction of regulatory and supervisory policies." While we believe that FSOC should be more focused on its existing statutory duties to coordinate and facilitate, FSOC's statutory powers should by no means be "broadened." This apparent attempt by Treasury to grab power should be resisted. More generally, Treasury should consider the consequences of bequeathing to much additional power to successors who are very likely to have less appealing visions for the future of financial regulation.

6. Remember the ultimate goal

FSOC should keep in mind the goal of Title I of Dodd-Frank: ultimate financial stability. If, for example, FSOC determines that a firm's exposure to certain markets or extensive use of particular types of financial instruments, poses significant counterparty risk, the firm should be able to remediate that problem itself.

A basic principle of regulation is that a rule's burden should be avoidable if a lower cost alternative achieves the same end. Consider a manufacturer subject to pollution regulations. If the firm is found to be beyond the allowable acceptable limit of smokestack emissions, it can do one of three things: pay the penalty; invest in cleaner technology; or lower production volume so emissions are below the allowable level. A single regulation with a single end goal results in multiple ways to achieve it. The firm will choose the lowest cost option every time. The current FSOC approach, instead, is akin to telling the firm, “The problem is you. Report to detention.”

Of course not all systemic threats will be easily defined the way point source pollution might be. But that shouldn’t deter FSOC from doing so when they can. This will mean, among other things, tasking OFR with the mission of clearly defining the potential systemic threat through data and modeling. It will then behoove FOSC to fully consider their research in order to address the risk or move ahead with the designation process.

In its broadest application, an ends-focused approach would establish a tentative model of how particular nonbank firms types are systemically important: insurance companies are structurally very different from asset managers, etc. Remember that FSOC’s mission consists of “identifying and responding to emerging threats to financial stability.” Designating firms is but one tool among many to achieve that goal.

In sum: we’d prefer FSOC didn’t exist at all. At the very least we’d like to see FSOC ability to designate at arbitrary thresholds removed and FSOC’s ability to designate non-banks as SIFIs repealed. Since those reforms are easier said than done, at the very least we would like for FSOC to consider the aforementioned discussion and take into account some easy reforms that will make a big different – and that will make it a more appealing body to a Congress that would just as well do without it.

We thank you for taking the time to read our comments. Please feel free to reach out if you would like to discuss further.

Sincerely,

Douglas Holtz-Eakin	Meghan Milloy
President	Director, Financial Services Policy
American Action Forum	American Action Forum