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U.S. Nonbank Systemic Risk Regulation On Life Support

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Introduction

- My topic: What happened to financial stability regulation of shadow banks since the Dodd-Frank Act?
- The Dodd-Frank Act:
  - Created the Financial Stability Oversight Council (FSOC)
  - Authorized FSOC to oversee systemic risk in 2 major ways: entity-based and activities-based regulation

Entity-Based Regulation

- *Entity-based approach*: Designates individual firms as systemically risky.
- Congress authorized FSOC to designate nonbank financial firms as systemically important financial institutions (SIFIs) if FSOC determines that:
  - (1) "material financial distress" at the company, or
  - (2) "the nature, scope, size, scale, concentration, interconnectedness, or mix" of the company's activities

  could pose a threat to U.S. financial stability.
- Any company that FSOC designates as a nonbank SIFI undergoes systemic risk supervision by the Federal Reserve Board.
  - With enhanced prudential regulation and potential enforcement.

Activities-Based Regulation

- *Activities-Based Approach:* Congress also gave FSOC the power to make recommendations to other federal agencies to adopt new activities-based rules.
  - This approach singles out individual activities for systemic risk regulation industry-wide.
    - Examples: Derivatives regulation, money market mutual fund rules.
  - However, FSOC can only *recommend* activities-based rules. It cannot *require* adoption. Nor can it issue such rules on its own.

Track Record of Entity-Based Regulation

- Initial wave of designations under the Obama Administration:
  - FSOC designated AIG, MetLife, Prudential, and GE Capital as nonbank SIFIs in 2013-2014.
  - All four companies underwent supervision and enhanced prudential regulation by the Federal Reserve System.
- Early on, nonbank SIFI designations came under criticism:
  - For creating an unlevel competitive playing field.
  - For subjecting insurance SIFIs to “bank-centric” regulation.

Track Record of Entity-Based Regulation, Cont'd

- Subsequently, entity-based regulation suffered death by three cuts under the Trump Administration.
  - First, FSOC de-designated AIG, GE Capital and Prudential and MetLife shed its SIFI designation through successful litigation. There are no nonbank SIFIs left standing in the U.S.
  - Second, FSOC under chair Steven Mnuchin adopted a guidance—based on the flawed MetLife decision—with such a high standard of proof that SIFI designations are almost impossible now.
  - Finally, FSOC under Mnuchin announced that it was substituting activities-based regulation for entity-based regulation of nonbanks.

Track Record of Activities-Based Regulation

- Activities-based regulation has had only one accomplishment to date, and even that was hard-won:
  - In 2014, FSOC convinced the Securities & Exchange Commission to adopt a rule curbing the risk of runs on institutional prime money market mutual funds.
- It has had no other accomplishments to date.
- And no wonder, since FSOC lacks the power to *mandate* activities-based regulation.
  - Further, after embracing activities-based regulation, FSOC under Mnuchin did not even recommend any activities-based rules.

In sum . . .

- Entity-based regulation, which is the only type of systemic risk regulation that FSOC can mandate, has effectively been dismantled because the new FSOC guidance requires impossibly strong proof for nonbank SIFI designation.
- Activities-based regulation is all that's left, but FSOC lacks the power to require it.
- In short, nonbank systemic risk regulation is on life support.
  - At least when it comes to FSOC and the Federal Reserve Board.

Philosophy of FSOC Chair Janet Yellen

- Yellen previously defended the importance of entity-based regulation in a comment letter opposing the Mnuchin-era guidance:
  - "Designation authority is an essential complement to prudential supervision of banks in a financial system where other financial firms are permitted to compete alongside banks without being subject to similar regulatory constraints on leverage and funding."
- However, at a Senate Banking Committee hearing in March, Yellen sent mixed messages, saying she was not inclined to designate asset managers such as BlackRock and instead favored restrictions on asset management activities.
  - But she also said that it is "appropriate to designate institutions whose failure would pose material risk to U.S. financial stability."

What Will It Take To Reinvigorate FSOC?

- Action by FSOC:
  - The Council needs to reverse the Mnuchin-era guidance undermining nonbank SIFI designations.
    - This will allow future designations and also give FSOC more leverage to demand activities-based rules.
  - The Treasury Department needs to restore FSOC to its Obama-era budget and staffing levels.
- Action by Congress:
  - Congress needs to amend Dodd-Frank to authorize FSOC to *mandate* activities-based regulation.