

Americans for Financial Reform

President Joseph R. Biden
The White House
1600 Pennsylvania Avenue
Washington, DC 20500

July 28, 2021

President Biden,

We write to urge you to appoint a new Director for the Office of Financial Research (OFR). The OFR has a vital role to play as an “early warning system” for threats of future financial crises and instability in the financial system, and it needs new leadership in order to do so effectively. You have the legal authority to appoint a new Director, and we urge you to do so.

The OFR had great promise when it was created as part of the Dodd-Frank Act. It offers a vehicle to gather data and provide analysis on threats to financial stability that may cut across the boundaries and siloes of our numerous financial regulators. The OFR can then provide crucial information both to the Financial Stability Oversight Council, another important body charged with keeping watch over the stability of the financial system and to the public. Without the OFR’s data collection and analysis, FSOC and the various financial regulators will have more trouble spotting emerging threats and developing a coordinated response. Moreover, publicly available research and analysis helps improve market discipline and regulatory accountability. Information is a crucial ingredient of effective financial regulation.

Unfortunately, the current Director has presided over a hollowing out of this critical agency. During the Trump Administration and under the leadership of the current Director, the OFR had its funding slashed by 25% and its staffing by 50%.¹ The OFR’s work was crippled with the agency providing few reports and not shedding light on emerging threats to financial stability, including those outlined in this letter. Few reports have been made publicly available.

A new director needs to prioritize transforming the OFR into a central data repository and, in the process, empower its analysts to provide timely and cutting-edge analysis to policymakers, financial markets, and the broader public. It is vital to have a director who provides the leadership and direction necessary to raise the alarms on pending threats to the financial system. Economic recovery should provide *more* not *less* reason to be vigilant about threats to financial

¹ See Gregg Gelzinis, Center for American Progress, *5 Priorities for the Financial Stability Oversight Council* (Mar. 31, 2021) available at <https://www.americanprogress.org/issues/economy/reports/2021/03/31/497439/5-priorities-financial-stability-oversight-council/>.

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stability. Indeed, risks to financial stability may be growing as witnessed by the waves of speculation in

- ¶ real estate;
- ¶ securities markets, such as the boom in Special Purpose Acquisition Companies (SPACs); and
- ¶ new investment classes such as cryptocurrencies and non-fungible tokens (NFTs).

Although low interest rates remain important for economic recovery, they also add fuel to these speculative waves. Corporate and financial institution leverage, after briefly declining during the pandemic, have resumed their climb to new record highs, surpassing even the peak in 2007. Leverage in financial institutions and markets makes the financial system fragile. Leverage among large corporations can make the entire economy vulnerable to the kind of shocks we saw in 2020.

At the same time, in 2020, for the second time in 12 years, the Federal Reserve provided extraordinary support to a range of financial markets, including money market mutual funds, repo, and securitization markets. The markets recovered, and now leverage and risk-taking are booming again. But these Federal Reserve interventions create the specter of moral hazard, as many large financial institutions may come to expect a Federal Reserve backstop.

These financial markets form the arteries of what is often called the “shadow banking system” – complex and opaque financial markets that serve much of the same economic functions of traditional banks, are subject to the same risks of failure in a financial crises as banks, now – thanks the Federal Reserve – benefit from the same emergency government interventions as banks, but are not regulated like banks. Regulating these shadow banking markets represents major unfinished business of financial reform made more urgent by the Federal Reserve’s 2020 interventions.

However, without an effective OFR, your Administration, Congress, and federal financial regulators are more likely to lack critical data to measure the scope of threats to financial stability from shadow banking – let alone be able to fashion comprehensive responses. This problem is exacerbated by a host of deregulatory actions taken by the Federal Reserve, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and the Securities and Exchange Commission during the last Administration.² Even while the pandemic raged and American families suffered the economic fallout, these agencies took drastic steps to roll back crucial financial regulations.³ Most troubling, these agencies decided to diminish their ability to even gather

² For example, during the Trump Administration, the Federal Reserve Board:

- ¶ Passed so-called “tailoring” rules that allowed both large banks to increase leverage, lower liquidity and take on more risk;
- ¶ Diluted capital and capital planning rules;
- ¶ Greenlit mergers for giant regional banks; and
- ¶ Weakened stress tests.

³ The Federal Reserve Board’s actions in 2020 provide an example of the rush to deregulate the financial sector even during the economic fallout from the pandemic. In that year, the Federal Reserve Board:

- ¶ Weakened capital rules;

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information about emerging risks. For example, they individually and collectively chose to apply significant restrictions to their historically established powers to supervise and issue guidance to financial institutions.⁴

Reinvigorating the OFR must be a cornerstone of rebuilding the capacities of federal financial regulators and their ability to detect and respond to emerging threats. These threats will not abate. Instead, the incoming waves farther out at sea loom larger. Recovering from the pandemic and ensuring greater resiliency is but one wave. Preventing another 2008 financial crisis is another. The systemic risks from climate change represent a wave that could dwarf these others. We need an effective OFR with a capable leader to understand the systemic risks posed by climate change.

A reinvigorated OFR should also study how income, wealth, and racial inequality contribute to financial instability. This is not just in keeping with your Administration's commitments to reducing inequality, this threat to financial stability has also been the subject of prominent research by many eminent economists for years. As but one example, Raghuram Rajan, an economist who famously warned the Federal Reserve of growing financial instability in 2005, provided a detailed study in 2010 of the continuing risk that inequality would set the stage for future financial crises.⁵

We worry about the lessons from 2008 *and* 2020 being lost. In the 2008 global financial crises, the United States suffered unnecessarily because there was no government body tasked with spotting emerging threats to financial stability across banking, securities, derivatives, commodities, and insurance markets. Financial crises tend to fester in the gaps between regulatory siloes, and the OFR was designed to shed light into these spaces. 2020 also provides another bitter lesson in what happens when government capacity to detect and analyze risks – in that case, a public health system that could detect pandemic risks – deteriorates or is dismantled.

We need a new OFR director who understands these lessons and will rebuild a crucial agency.

Sincerely,

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- ¶ Allowed banks to make capital distributions to shareholders even as banks benefitted from Federal Reserve interventions;
 - ¶ Weakened requirements that banks prepare “living wills”;
 - ¶ Dismantled crucial liquidity rules (including “the net stable funding ratio” and “required stable funding” rules);
 - ¶ Diluted the Volcker rule, including allowing large banks to invest in risky and opaque private funds;
 - ¶ Allowed banks to increase their exposure to derivatives via lowering margin requirements; and
 - ¶ Greenlit more mergers for giant regional banks.

⁴ *E.g.*, Federal Reserve Board, Final Rule: Role of Supervisory Guidance, 86 Federal Register 18,173 (Apr. 8, 2021). The Federal Reserve and other regulatory agencies proposed this rule on November 5, 2020, two days after the election.

⁵ *E.g.*, RAGHURAM G. RAJAN, *FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY* (2010).

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Better Markets

Government Accountability Project

Government Information Watch

Greenpeace US

Institute for Agriculture and Trade Policy

Public Citizen

Revolving Door Project

Individual signatories:

Hilary Allen

Professor

American University Washington College of Law*

Dean Baker

Center for Economic and Policy Research*

Erik F. Gerding

Professor & Wolf-Nichol Fellow

University of Colorado Law School*

Patricia A. McCoy

Professor of Law

Boston College Law School*

Arthur E. Wilmarth, Jr.,

Professor Emeritus of Law

George Washington University Law School*

cc: Treasury Secretary Yellen

Deputy Treasury Secretary Adeyemo

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* Affiliations of individual signatories are for identification purposes only.