May 13, 2019

Financial Stability Oversight Council
ATTN: Mark Schlegel
1500 Pennsylvania Avenue NW
Room 2208B
Washington, D.C. 20220

Re: RIN 4030-AA00, "Authority to Require Supervision and Regulation of Certain Non-Bank Financial Companies"

Dear Mr. Fields,

Americans for Financial Reform Education Fund ("AFR Education Fund") appreciates the opportunity to comment on the above referenced proposed Interpretive Guidance (the "Guidance" or "Proposed Guidance") by the Financial Stability Oversight Council (the "Council" or "FSOC"). AFR Education Fund is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR Education Fund include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

As you know, Section 113 of the Dodd-Frank Act grants the FSOC the authority to determine that a non-bank financial company will be subject to prudential standards and supervision by the Federal Reserve Board of Governors. Section 113(a)(1) states that such designation shall be made "if the Council determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States". Section 113(a)(2) then lays out a list of eleven specific considerations for the FSOC to consider in making such a determination. Further elements of Section 113 lay our procedural safeguards for the process of designation.

The Proposed Guidance purports to implement Section 113. In fact, it is at odds with the Congressional mandate. It imposes conditions on designation that conflict sharply with the specific instructions in Section 113 and make it unlikely that the Council will ever act to designate a nonbank financial firm even if such a firm could impose a threat to financial stability.

[1] A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/.

The claimed justifications for the changes made in the Guidance, such as a shift to an "activities-based" framework for systemic risk regulation, are flawed and unpersuasive.

The actions of the Council over the past several years indicate that, regardless of stated policies, the current FSOC has no intention of designating non-banks for prudential oversight. Not only has the Council not designated any new firms, it has systematically reversed the designation of all non-banks which were selected for enhanced prudential supervision since the financial crisis. This is true even for companies such as AIG and Prudential whose systemic risk footprint had not declined or had even increased since they were designated for enhanced prudential supervision.[2] The FSOC has also slashed funding and staff for systemic risk monitoring through the Office of Financial Research – monitoring that would be needed if the Council were to seriously implement the kind of activities-based approach outlined in this Guidance.[3]

The Council now proposes to add to these actions by adopting an explicit policy that would create major roadblocks to the intent of Congress in empowering FSOC designation of non-bank SIFIs. Below, we discuss several key elements of this policy and its justification – the turn to an "activities-based approach" to regulation, the claim that competitive distortions are created by entity designation, and the requirement to perform a cost-benefit analysis that includes an assessment of the likelihood of material distress at a non-bank financial firm as part of the designation process.

The end result of these changes would be to fundamentally undermine the Dodd-Frank approach to addressing the oversight of systemically important non-bank financial institutions, without putting an effective alternative in its place. If these changes are implemented, the FSOC would effectively become an advisory body similar to the President's Working Group on Financial Markets, the loose and informal pre-FSOC coordination group for financial regulatory discussion that failed to predict or stop the disastrous 2008 financial crisis.

We urge the FSOC not to implement these policies as proposed.

The Proposed "Activities Based Approach" in the Guidance

The Guidance states that the FSOC will de-emphasize entity designation in favor of an activities based approach to financial regulation. We are not in principle opposed to an emphasis on financial activities. Clearly, effective oversight of the financial system requires understanding and regulation of both financial activities and the entities that engage in those activities.

[2] Kress, Jeremy C., "The Last SIFI: The Unwise and Illegal Deregulation of Prudential Financial" (November 5, 2018). 71 Stanford Law Review Online 171 (2018). Available at SSRN: https://ssrn.com/abstract=3278730 ; Gelzinis, Greg, "Deregulating AIG Was A Mistake", (October 11, 2017), Center for American Progress, available at https://ampr.gs/2Yuq9d8

[3] Office of Financial Research, "Congressional Justification for Appropriations: FY 2018", United States Department of the Treasury, FY 2018 Budget Documents, available at http://bit.ly/2Q7VlMg

But the issue with the activities based approach in this Guidance is twofold. First, it does not accord with the statutory scheme laid out in the Dodd-Frank Act. The standard interpretation of the Dodd-Frank Act, which the current FSOC appears to hold to, is that the Council has no direct authority over financial activities. The Council's power with respect to activities is limited to an essentially advisory role under Section 120 of the Dodd-Frank Act, which permits non-binding recommendations to the independent financial regulatory agencies. The President's Working Group on Financial Markets was also free to issue similar non-binding advisory recommendations prior to the passage of the Dodd-Frank Act, although the process was slightly less formal (e.g. the regulatory agencies were not required to respond in writing).

The key new regulatory power granted to the FSOC under the Dodd-Frank Act was not a grant of authority over financial activities, but instead the power to designate entities for prudential regulation by the Federal Reserve Board. This decision was directly affected by the experience of the financial crisis, where non-banks such as Lehman Brothers, Bear Stearns, and AIG played a key role in the financial crisis but the Federal Reserve lacked both key data about these entities and important prudential authorities.[4] Committing to a low priority for entity designation thus rejects the key new power granted by the Dodd-Frank Act to address gaps in oversight, and instead to revert to the same fragmented regulatory coverage that failed prior to the 2008 crisis.

Even more important, the Guidance appears to view activity and entity regulation as substitutes, so that activity regulation can be effective without supervisory coverage of systemically significant entities. We believe this is a grave error. Activity and entity regulation must instead be viewed as complementary. The systemic risks of a financial activity cannot be fully understood without understanding the safety and soundness and leverage position of the major entities involved in the activity. It is also crucial to have supervisory insight into the policies and procedures used by major entities that are market leaders in the activity. While market regulators such as the Securities and Exchange Commission do issue rules related to permissible leverage levels and procedures for executing transactions, they do not have the in-depth supervisory understanding created by prudential supervision. Market regulators failed to provide effective oversight at large non-banks prior to the financial crisis. In addition, one of the most important categories of large and systemically significant entities – large insurance companies – are not regulated at all at the Federal level unless they are designated by the FSOC.

Without the increased market insight created by prudential supervision, regulation of activities can present a confusing array of issues that are difficult to put together into a coherent picture of systemic risk. The list of activities that contributed to the financial crisis is long. It includes

[4] For a discussion of how the lack of information regarding the internal operations of large non-banks such as AIG, Bear Stearns, and Lehman hampered crisis management in 2007 and 2008, see e.g. Ben Bernanke, Tim Geithner, and Hank Paulson, Firefighting: The Financial Crisis and Its Lessons, (April 16, 2019), Penguin Books, https://amzn.to/2LGk0ss

commercial paper, repurchase agreements, securities lending, mortgage-backed securitizations, re-securitizations, synthetic securitizations, derivatives activities, and more. Many of these activities would not present systemic risk if conducted using effective risk controls by properly capitalized entities. However, they created grave systemic risks when conducted by highly leveraged entities that did not properly manage their risks. An understanding of the status of the largest and most significantly significant entities engaged in key activities is a crucial element of understanding systemic risk.

With all that said, we are not tied to the system of non-bank designation laid out in the Dodd-Frank Act, which was in many ways a compromise in lieu of deeper reform of the financial regulatory system. A truly aggressive system of activities-based regulation that accessed adequate entity-level data could have strengths that the system laid out in the Dodd-Frank Act does not. But there is absolutely no evidence that the Council truly wishes to put in place a strong system of activities-based regulation that differs from the excessively fragmented pre-crisis system that failed to spot and address critical issues at non-banks during the 2008 financial crisis. The Treasury has not asked Congress for additional legislative authorities to expand coordination or FSOC powers over activity-based regulation. The Council has not used the Office of Financial Research (OFR) to expand the data available on financial activities, for example by using its subpoena powers. Instead, both staff and funding at the OFR have been cut. We are also not aware of any significant regulatory initiatives at the individual financial regulators to strengthen activity-based regulation in any important area. We have instead seen regulations proposed that materially weaken oversight of key financial activities, such as for example liquidity in regulated funds, derivatives trading rules, and proprietary trading.[5] Nor have we seen any effort, either legislatively or administratively, to address the lack of Federal oversight of the insurance industry, which is clearly a systemically significant activity.

Addressing Competitive Market Distortions

A repeated theme in the Guidance is that the use of an activities-based as opposed to an entity-based approach will minimize competitive distortions in markets that arise due to firm-specific supervisory decisions. This claim ignores the fact that, by their nature, large systemically critical firms create competitive distortions. This is because of the possibility that they will receive a bailout in a situation where their failure could create systemic risk. This source of competitive distortion can be created by size alone, given assumptions about the treatment of "too big to fail" firms by government.

[5] For a few recent examples see e.g. Federal Reserve Board, "Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds" (July 17, 2018), 83 FR 33432, http://bit.ly/30qWR0K ; Commodity Futures Trading Commission, "Swaps Execution Facilities and Trade Execution Requirement: Proposed Rule" (November 30, 2018), 83 FR 61946, http://bit.ly/2vVuAkP ; Securities and Exchange Commission, "Investment Fund Liquidity Disclosure: Final Rule" (July 10, 2018), 83 FR 31859, http://bit.ly/2WHPXSg .

Such competitive distortions can be addressed through prudential supervision of designated firms. For example, mandated resolution planning can facilitate private sector resolution of a failing firm and lessen pressures for public subsidies or support in case of an unexpected systemic event. Mandatory capital requirements can address competitive distortions that occur if markets permit firms suspected to be "too big to fail" to be undercapitalized as compared to smaller competitors, based on the assumption that government may bail out counterparties to large firms in a systemic event. Additional mandated disclosures can help market counterparties better interpret the operations of particularly large and complex firms, which may be more difficult to understand than those of smaller competitors.

These are only some of the ways that designation and supervision of particularly large and systemically significant non-banks can act to counterbalance competitive distortions created by "too big to fail" firms. Yet the potential competitive distortions created by size and systemic significance are not discussed in the Guidance. Instead, the guiding assumption seems to be that

Cost Benefit Analysis and Assessing Likelihood of Material Distress as Part of the Designation Process

A major change from current practice in the Proposed Guidance is the requirement that new designation decisions pass a cost-benefit analysis. A key component of that analysis would be a requirement to assess the likelihood that a firm will experience material financial distress. This is done as part of the assessment of the impact of a designation, which is then compared to the cost of designation in a cost-benefit analysis. The stated principle guiding this assessment is that a full cost-benefit analysis must assess not only the impact of a risk, but the likelihood that this risk will be realized (CFR 9035).

The Proposed Guidance states that the relevant analysis:

> "will be conducted taking into account a period of overall stress in the financial services industry and a weak macroeconomic environment. When possible, the Council will attempt to quantify the likelihood of material financial distress; as an alternative, when doing so is not possible with respect to a specific firm, the Council will generally consider quantitative and qualitative factors." (CFR 9035)

The decision to incorporate the likelihood of financial distress as part of the designation determination is deeply flawed, both from a statutory and an analytic perspective. From a statutory perspective, Section 113(a)(1) clearly states that a designation should take place "if the Council determines that material financial distress at the U.S. nonbank financial company, or the

nature, scope, size, scale, concentration, interconnectedness, or mix of activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States".

There are two important things to notice about this mandate.

First, in the case of material financial distress, the mandate requires that the Council ask simply if such distress, if it hypothetically took place, ***could*** post a threat to financial stability. Not only is there no requirement to analyze the probability of financial distress, the mandate is to ask the hypothetical question of whether financial distress, should it ever occur, could pose a threat to financial stability. Requiring the analysis to incorporate the likelihood of financial distress directly conflicts with this statutory mandate, since a firm at which material financial distress clearly could pose a threat to U.S. financial stability would avoid designation if the assessed likelihood of financial distress was low.

There is good analytic reason for Congress' decision to specifically mandate the designation of firms at which material financial distress, even if apparently unlikely, could undermine financial stability. These are precisely the firms that are systemically significant or "too big to fail" in the proper sense of the word. That is, they are the firms for which government would face a substantial incentive to intervene and prevent their failure if the firm experienced distress, in order to prevent economic fallout. Such firms could receive an implicit subsidy from counterparties due to the assumption that they would be rescued during a financial crisis. Indeed, the fact that counterparties would advance better terms to such a firm might in itself reduce the firm's likelihood of material financial distress. This implies that the proposal to incorporate the likelihood of material financial distress could make a firm less likely to be designated as systemically significant precisely because it was too big to fail – a clearly problematic result.

Another reason not to require an assessment of the likelihood of failure is that requiring such an assessment changes the signal given by an FSOC designation. Under the proposed requirement, designation would indicate to the market that the government believed based on its analysis of the firm's proprietary information that the firm was likely to fail in stressed market conditions. Turning the designation process into this kind of vote of "no confidence" in the firm would distort markets. It would make it more likely for counterparties to run from a systemically significant firm, especially if the designation took place in a period of financial stress. Increasing a firm's likelihood of failure due to designation is, again, a very problematic result.

A second important element of the statutory mandate is that designation does not even require the assumption that the firm experiences material financial distress at all. The statute states that the Council should designate a firm if material financial distress at that firm could threaten financial stability, "***or*** the nature, scope, size, scale, concentration, interconnectedness, or mix of activities" at the firm could threaten financial stability. The reason for this is clear. A firm can

threaten financial stability through its activities even if the firm itself does not experience material financial distress. A firm that successfully imposes the costs of its activities on outside investors or counterparties could create enormous risk to financial stability even if it did not experience financial distress itself. For example, an asset manager could impose costs on investors without technically taking losses to its own assets, a firm which used an originate to distribute model could successfully offload risk to counterparties, or a firm which acted as a financial utility without taking principal risk could create damage to the financial system through flawed policies without itself taking immediate losses.

We believe that the requirement to assess the likelihood of a firm's material financial distress as a pre-requisite to designation will itself serve as an almost insurmountable barrier to the designation of non-bank financial firms, even in cases where such firms could threaten financial stability. This is both because of the inherent difficulty of predicting whether a firm will experience financial distress, and what will likely be the reluctance of government officials to send a negative signal about the viability of the firm through the designation process. The requirement also conflicts directly with the statutory mandate. We would thus urge the Council to drop this requirement.

More broadly, we are deeply skeptical of the incorporation of a requirement to perform a cost-benefit analysis in order to designate a company as systemically significant. As pointed out by the previous FSOC in its brief in the Metlife case, such an analysis is not included in the extensive list of factors the FSOC is required to consider by Section 113 of the Dodd-Frank Act. That list explicitly does not include an assessment of regulatory costs of a designation to the designated company, or a requirement to forecast the full costs and benefits of a designation.

To perform such a cost benefit analysis would effectively require the FSOC to make a prediction about whether a future systemic event will occur and the nature of that systemic event. Rather than place such an inherently speculative and near-impossible burden on the Council, Congress simply required that the Council analyze whether a non-bank financial firm was large enough and interconnected enough to create risk to the financial system during a hypothetical future systemic event. Requiring the Council to speculate as to the likelihood of a future systemic event and defend its forecast in court, would drastically narrow the ability of the Council to ensure that the systemically significant non-bank financial firms receive prudential supervision.

Thank you for your attention to this letter. If you have questions, contact Marcus Stanley, Policy Director for the AFR Education Fund, at 202-466-3672 or marcus@ourfinancialsecurity.org.

Sincerely,
AFR Education Fund